Chinese *Fire Drill*

By Charles Wolf, Jr.

Forget tinkering with the renminbi's dollar peg. The key is to increase consumption.

A strident chorus has lately attacked China's stubborn adherence to its policy of maintaining a narrowly-controlled renminbi peg to the U.S. dollar. The chorus includes senior U.S. government officials, politicians turned economists, economists turned political scientists, and political scientists turned financial experts. The choral theme proclaims that appreciation of the renminbi by perhaps 20 percent to 40 percent is essential for good things to happen and bad consequences to be avoided. The narrow band within which China has announced it will allow the peg to fluctuate is said to be drastically insufficient. "It's time to get tough with China," goes the choral refrain.

Most of this flies in the face of basic economics. It also ignores an inevitable question that, although rarely asked, is one whose answer, unlike currency revaluation, could indeed contribute to making things better all around.

The basic economics that the chorus ignores resides in an inexorable accounting identity: namely, the difference between an economy's (in this instance, China's) aggregate domestic savings and its aggregate investment must equal the difference between its international earnings and its international payments (that is, China's current account surplus). Put simply, a country's excess savings are inextricably linked to an equivalent excess of its international earnings from exports and

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other sources over its international payments for imports and other obligations. China's aggregate savings at about 45 percent of GDP exceed aggregate investment by perhaps 10 percent of GDP.

The inevitable question that needs to be asked is why doesn't China's leadership—the political bureau of the standing committee (PBSC) of the Communist party, and the State Council of the Chinese government—move aggressively to boost domestic consumption, thereby changing the parameters of the accounting equation, enhancing the government's popular appeal, complying with China's formal commitment to "rebalance" its international accounts, and modestly shrinking China's current account surplus?

Movement in this direction will benefit China and its trading partners (including the United States), while appreciation of the renminbi will not.

Although the call for revaluing the renminbi is misguided, it seems at first glance to make sense. If the renminbi were revalued from ¥6.8 per U.S. dollar to, say, ¥5 per dollar, the renminbi prices of Chinese imports from the United States would initially decline so China's imports would tend to increase. Similarly, revaluation would initially raise the dollar prices of imports from China, so U.S. imports from China would tend to decrease.

However, as long as the elements in the inexorable accounting identity hold—and therefore China's savings continue to hugely exceed its investments—the tendencies implied by revaluation will be negligible and transitory. Offsets to the revaluation's effects will ensue through quick adjustments of renminbi import prices, as well as of the dollar prices charged to U.S. importers. Renminbi import prices will tend to rise, while the dollar prices charged to U.S. importers will tend to fall because aggregate savings continue to exceed aggregate investment, and earnings from China's international transactions will continue to exceed its international payments.

For appreciable "rebalancing" to occur, the avoided but inevitable question needs to be asked and resolved: why don't China's policymakers move aggressively to boost domestic consumption? For example, if the economy's enormous savings ratio of 45 percent of GDP were to be reduced by, say, 7–8 percent (that is, consumption were to rise), the parameters of the accounting identity would be changed; by contrast, currency revaluation would not change them. Moreover, these changes can be accomplished through fiscal and credit policies that, unlike currency revaluation, will have direct and lasting effects, benefiting both China and its trading partners, as well as silencing the voluble critics.

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The appropriate policy measures include easing of bank provision of consumer credit, facilitating wider issuance of credit and debit cards, and expediting the expansion of social security support both by government and corporate providers. The first two measures will directly boost consumption, and the third will indirectly help to raise consumption by allaying the widespread precautionary motives that lead to excessively high household and business savings.

If the benefits from such policies are evident, why don't China's policymakers move aggressively to implement them? The question is inevitable, but the answer is elusive. Perhaps the answer lies in the leadership's deeply ingrained political and cultural conservatism. Economic growth and improvements in living standards in China over the past three decades have already been noteworthy. Might still further improvement be too much? Might a still more rapid pace be too fast? If improvements were to accelerate further, might the public become too self-confident, too demanding? Might this in turn lead to demands for political democracy, and to restiveness at one-party authoritarianism? And might all of this accelerated change further threaten or abridge the remnant traditions of Chinese culture and Confucian society?

The inevitable question and its corollaries need to be asked. Even if answers are elusive, focusing on them is a better bet than tinkering with the renminbi's dollar peg. ◆