

The right way to respond to China's exploding surpluses

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What is the most important high-level dialogue in international economics? The answer is not the discussion among the finance ministers of the Group of Seven high-income countries. It is the "strategic dialogue" between China and the US. This is not because the latter will produce answers, but because it asks the right question. The biggest challenge in international economic policymaking is the incorporation of China. This, to his credit, Hank Paulson, the US Treasury secretary, has recognised. But his bilateral approach will fail. The G7 should, instead, be replaced by a multilateral body that can address such issues more effectively.

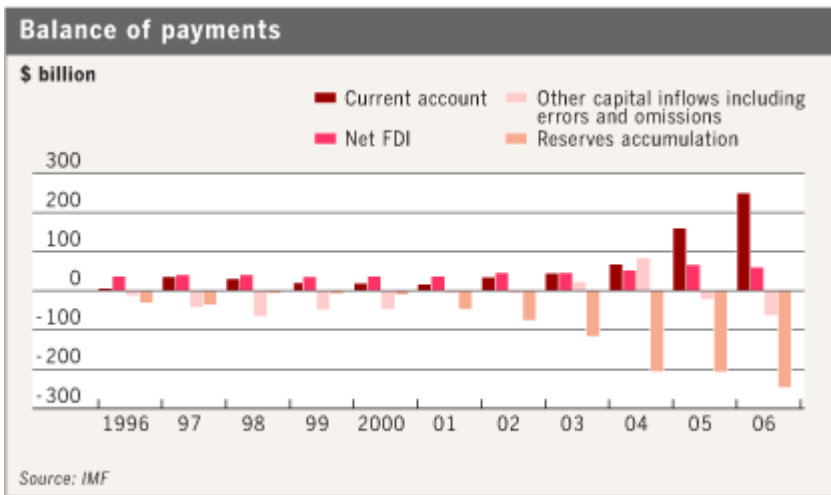
To understand the challenge, we must appreciate what makes China's impact special. Experts often describe today's globalisation as the "second globalisation", to distinguish it from the "first globalisation" between 1870 and 1914. In the earlier era the rising economic power was the US and the UK was by far the world's most important exporter of capital. But China is now emerging as both the world's most dynamic economy and its largest source of capital. This helps explain a signal feature of our era: the combination of rapid growth with low real interest rates.

China's current account surplus has exploded in recent years from a modest \$46bn in 2003 to \$250bn last year. This puts Japan's \$170bn surplus of 2006 in the shade. China's current account surplus last year was 9.5 per cent of gross domestic product, more than double the highest ratio Japan has ever achieved, 4.3 per cent of GDP in 1986. If one adds the balance on flows of long-term capital (net foreign direct investment), the surplus in China's "basic balance of payments" reached 12 per cent of GDP last year.

To put this in historical context, UK net foreign investment was 8 per cent of gross national product between 1905 and 1914. What makes China's position even more extraordinary is that gross domestic investment itself appears to be more than 40 per cent of GDP. Thus China both is the world's largest exporter of capital and has the world's highest ratio of domestic investment to GDP. This is capital accumulation on a grand scale.

Yet the tale does not end there. In China's case the government has been the direct source of the capital outflow. This has been a by-product of its interventions in the currency market aimed at keeping the renminbi down against the US dollar. Thus, between 2003 and 2006 the country had a cumulative current account surplus of \$525bn, together with a \$228bn net inflow of FDI. These were almost perfectly offset by its \$777bn accumulation of official foreign exchange reserves. By March of this year, the reserves had reached \$1,202bn, the biggest in the world and more than two-fifths of China's GDP.

The reserve accumulations are not, it should be stressed, in response to inflows of speculative "hot money". They reflect a policy of shipping out the foreign exchange received from huge trade surpluses and inflows of long-term investment, to keep the exchange rate down (see charts).



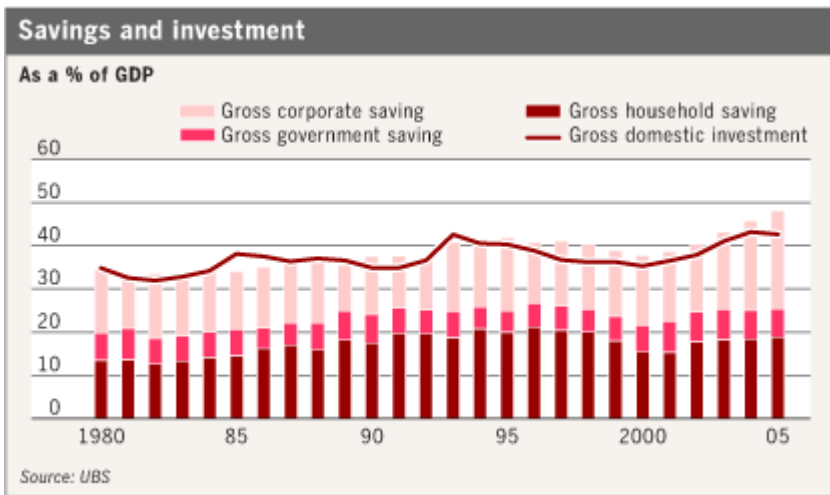
Is this behaviour desirable and, if not, what should be done about it?

A good argument can be made for the proposition that this pattern of behaviour is indeed desirable. It is desirable for the rest of the world because it lowers real interest rates, thereby allowing more spending. It is desirable for China, some economists also argue, because rapid export growth is the best way to generate sustainable economic expansion and higher employment.

The arguments against the pattern, however, are also strong, in my view stronger. So long as the counterpart trade deficits are concentrated in the US, there is a risk of protectionist action, particularly as the latter's economy slows down. More important, it is hard to believe that vast accumulations of low-yielding foreign assets, so vulnerable to the almost inevitable appreciation of the renminbi against the dollar, make sense for the Chinese themselves. Indeed, the Chinese leadership itself has repeatedly declared its intention to rebalance growth, which has depended unduly in recent years on the growth of investment and the external surplus. Over the past two years, the expansion in net exports generated close to a quarter of the growth of GDP. This cannot continue much longer. At some point rather soon, demand has to grow at least as fast as GDP, if not rather faster.



In a thought-provoking recent paper*, Nicholas Lardy of the Peterson Institute for International Economics in Washington argues that the present development path has many evident disadvantages for China itself: household consumption is too low, at a mere 38 per cent of GDP in 2005; growth is too dominated by the coastal regions; employment growth ran at only 1 per cent a year between 1993 and 2004; energy consumption is too high; and the low domestic interest rates that result, in part, from foreign currency interventions distort the financial system and encourage wasteful investment.



So what is to be done? The answer seems simple: save less and let the nominal exchange rate appreciate faster, to eliminate possible inflationary consequences of such a policy shift. The Chinese government can easily afford to spend more on health and education. It can also usefully set up a modest pension system for those now alive. Moreover, the bulk of Chinese savings are not by households but by the government and corporations, many of which are owned by the government itself (see chart). Savings then are a policy choice, not a given. At 50 per cent of GDP, they also look far too high.

How then, if at all, can the outside world cajole China in a direction that seems to make such sense for the Chinese themselves? Mr Paulson is quite right to approach this question as a discussion of mutual interests. But it is almost inconceivable that the Chinese will grant what will appear to be one-sided concessions to demands from the "sole superpower". That would be far too humiliating.

The Chinese will need, instead, to participate as equals in a wider global dialogue among the leading economic players. The obvious move is to replace the G7 with a group of four – the US, eurozone, Japan and China. In time, no doubt, India will join, but its time has not yet come. Such a grouping, moreover, should not focus on China alone. It must consider the range of policies adopted in these four dominant economies. Mr Paulson is indeed addressing many of the right questions, but in too narrow a forum. It is time to broaden the dialogue.

*China: Rebalancing Economic Growth,
<http://www.petersoninstitute.org/publications/papers/lardy0507.pdf>

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