Testimony on "U.S. China Economic Relations" to the Senate Committee on Finance, Thursday, June 23, 2005

Kenneth Rogoff, Professor of Economics and Thomas D Cabot Professor of Public Policy, Harvard University

The massive and growing United States current account deficit, presently running at over 6% of GDP, is a key point of vulnerability –perhaps the key point of vulnerability -- in the global economy today. Incredibly, if one adds up the surpluses of Japan, Germany, OPEC, China and *all* the other countries in the world running current account surpluses (a broad measure of the trade balance), the United States is absorbing three quarters of the global total. It is unprecedented to have the world's largest country soaking up so much of the world's excess savings. When Britain was an empire in the 1800s, it ran giant *surpluses* sometimes running as high as 10 percent of GDP. Whereas it is perfectly possible that the present situation will resolve itself in a relatively benign fashion – especially if the US current account very slowly shrinks as a share of GDP over fifteen to twenty years – there is also a significant chance of much more rapid and painful adjustment. This would imply, at the very least, a sharp further collapse in the dollar against a broad index of currencies, a collapse of 20% or more. Such an appreciation might be relatively benign as in the 1980s, but more likely, a sharp closing up of the US current deficit will imply a significant slowdown in global growth, particularly in regions like Europe, Japan and Latin America, with their relatively inflexible economies. Some of this will surely boomerang on the United States in form of lower exports. In a worse case scenario, a global slowdown and sharp drop in the dollar will set off a series of financial crises, and a sharp rise in United States borrowing costs.

Unfortunately, there is no painless way to defuse the global imbalances. Financial globalization may help explain why the US has been able to borrow so much, but adjustment must ultimately come through the real side of the economy, with the US needing massive rises in exports and probably even larger falls in imports to bring the two into balance.

One can outline a mix of factors that might soften the landing for the economy, if not necessarily for the dollar. American citizens, whose savings rates are hovering below 1% (excluding capital gains on homes) could start saving more. The consolidated government sector of the United States could also contribute more savings, or at least less dissavings. Ideally, the European and Japanese economies would grow faster through increased domestic demand, not just higher imports. Finally, in almost any scenario, the real value of the dollar needs to weaken further, especially against the major surplus regions. The dollar has already declined somewhat against the flexible rate currencies like the euro, the Canadian dollar and British pound (though substantial further depreciation would still be needed if the US current account were to close up completely). But the largest adjustment has to come from the Asian currencies, many of which have moved very little against the dollar. According to my calibrations with

Professor Maurice Obstfeld of Berkeley[1] the Asian currency block would need to appreciate against the dollar by an average of 18% in a scenario where the US current account deficit is cut in half over two years. The appreciation would have to be 36% in a scenario where the United States current account is completely eliminated (and that is assuming no exchange rate "overshooting"). I hasten to add that a dollar depreciation will be as much a consequence of a closing of the US current account deficit (say because a flattening of house prices raises other forms of US savings), rather than a cause of it. Absent savings or productivity shifts, if the dollar were to magically depreciate by 20% against all other currencies (not just Asia), it would probably not knock off little more than a third of the US trade and current account deficits, even after the effects had fully played out.

Where does China fit in? Even if *all* Asian currencies were to rise by 20% of the dollar, it would not begin to solve the US trade and current account deficits. But Asian exchange rate flexibility would be helpful. Most importantly, it would help cushion the potential effects of a lower US trade deficit on the rest of the world outside Asia. In my calibrations (with Obstfeld), we find that if the Asia sticks to its de facto peg against the dollar while, say, a shift of global savings towards the US eliminates the global imbalances, the non-Asian currencies would have to appreciate by more than 50% against the dollar versus 10-15% if Asian currencies are flexible. And to add insult to injury, Europe alone would lose over a trillion dollars in this scenario, as its Asian and US currency holdings fell in value. Europeans should be even more concerned than Americans about having more flexible exchange rates in Asia.

It is important to recognize that while China may be the coming economic giant, it is not yet the colossus that it is sometimes portrated as. China, for example, is not yet nearly the world's largest (current account or trade balance) surplus country. That distinction belongs to Japan and Germany, with oil producers also collectively becoming important as oil prices rise. Indeed, China's giant bilateral trade surplus with the United States is partly an illusion. In the typical Chinese export good to the United States, about 80% of the value added comes from other countries, mostly in Asia. When a Korean manufacturing firm decides to fill a shirt order in the United States, it may well have the yarn spun and dyed in the Philippines, the yarn woven into fabric in Thailand, and only then will the shirt be cut and packaged in China. But when the shirt arrives in the United States, it will only say "made in China." So pointing to China's bilateral surplus with United States is extremely misleading; if assembly did not occur in China, it would be occurring in other low cost countries outside the United States. Unless Americans started saving more, the overall results would not be so different.

I have argued that a more flexible Yuan exchange rate would help cushion adjustment to global trade imbalances, even if it did not provide a cure. That is, by making its currency more flexible, China could play the role of good global economic citizen, helping deal with the a problem that it fundamentally did not create, the US trade

[1] See Maurice Obstfeld and Kenneth Rogoff, "Global Current Account Imbalances and Exchange Rate Adjustments," forthcoming (with revisions) in William Brainard and George Perry (eds.), *Brookings Papers on Economic Activity*, Spring 2005.

deficit. There is, however, the small matter of whether a more flexible exchange rate is in China's best interests. On balance, I would say the answer is definitely yes, but it not the black and white case that many seem to believe. The problem is that China today is really two countries. There is booming coastal China with about 450 million people that is an emerging market; like any emerging market it will eventually have a catastrophe if it sticks to a fixed rate. Right now, all the pressure on the currency is up, which is not such a problem. But exchange rates have a habit of boomeranging, and some day the pressures may all be in the opposite direction. A high level of reserves will offer scant protection if a severe political crisis or a financial meltdown suddenly has Yuan holders fleeing for the exits. So the emerging economy in China needs to learn to float.

But then there are the 850 million people in the rest of China, where more than a 150 million unemployed workers sit on the sidelines, waiting for a chance to be allowed to migrate to the high-growth coastal cities. This part of China is still a poor developing economy. Poor developing economies generally do better by having a fixed exchange rate rather than a floating one.[2] Balancing the needs of these two worlds is a genuine source of tension for China's leaders. On balance, the need for China to protect the fast growing coastal regions from overheating and crisis probably trumps over factors. But one should not pretend this transition, inevitable as it may be, is necessarily going to be riskless or painless. As such, it is important that the United States show that it, too, is willing to take painful measures to deal with a global imbalance problem that has much to do with low American saving levels.

The United States China economic relationship has been, on balance, a lynchpin in both countries' success over the past decade. For the United States, the pressures from globalization have not only provided US consumers with massively better and cheaper goods than they would otherwise enjoy, but it has also helped make the United States the most competitive and flexible economy in the world. For China, export led growth has helped lift hundreds of millions out of desperate poverty over the past two decades. The United States' open trade policy has been the most successful aid policy in history, helping countries to help themselves. Whereas the time has come for China let its currency appreciate and become more flexible, Americans must not pretend China, or more broadly Asia, is the main source of our country's trade deficit. Low US savings is at least as great a problem, if not more so. For better or for worse, the US trade deficit is one thing we thing we Americans consume that is still has a large American content.

---

[2] See Aasim Husain, Ashoka Mody and Kenneth Rogoff "Exchange Rate Durability and Performance in Developing versus Advanced Economies," *Journal of Monetary Economics* 52 (January 2005), 35-64.