



Don't Bet On The Yuan

by Calla Wiemer



RUMOR HAS IT that hot money is betting on a sharp appreciation of the yuan. This anyway has been offered as an explanation for the ever greater leaps in China's official reserve assets that can no longer be accounted for by the current-account surplus and net foreign direct investment inflows. The appearance is one of short-term capital coming in, but why would speculators be betting on a big-time revaluation? It doesn't fit with macroeconomic fundamentals.

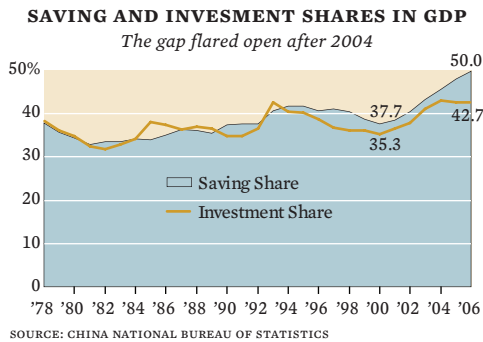
The fundamentals lie with the domestic relationship between saving and investment. The difference between the two is the trade imbalance, since saving not channeled into domestic investment becomes a capital outflow and a capital outflow is financed by export revenues not spent on imports. In a span of just 6 years, China's national saving rate rose by a dramatic 12 percentage points of gross domestic product, to 50% in 2006 from 38% in 2000. From an already high level then by international norms, it went stratospheric. The investment rate was also high and until 2004 rose in tandem with the saving

rate. During this stretch, the saving/investment gap ran at a roughly stable 2.5% of GDP. Then the investment rate flattened out at around 43% while the saving rate pushed inexorably upward and correspondingly the trade surplus soared.

My own research shows that most of the increase in the saving rate in the post-2000 period can be explained by China's extremely high rate of GDP growth. When countries experience breakneck growth in income, consumption as a general rule does not keep up. Also contributing to the rising saving rate in the Chinese case is a falling dependency ratio which means that those in their income earning and saving years dominate the more consumption-oriented young and elderly.

The pattern of rising saving rates during economic take-off is common among the successful economies of East Asia. Singapore, South Korea and Vietnam all saw their saving rates climb dramatically from low starting points early on. At its indepen-

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dence in 1965, Singapore had a saving rate of just 10% of GDP. The rate rose to 46% by 1984, then dropped during a recession, subsequently heading back up to over 50% before the Asian financial crisis and the bursting of the tech bubble dragged it down, only to be followed by yet another rebound when growth resumed once again. Korea in the early 1970s had a saving rate in the teens that rose over the years to touch 40% in 1988. The latest East Asian nation to enter the fast lane is Vietnam, which since 1990 has seen growth at a pace second only to China's worldwide. In connection with this, its saving rate rose to 30% from less than 5% over a span of 15 years.

At the outset of their growth take-offs, Singapore, Korea, and Vietnam all relied on capital inflows to sustain domestic investment rates over and above low saving rates, and Vietnam does so still. Over time, as saving rose faster than investment, the gaps closed for Singapore and Korea and indeed in the case of Singapore eventually reversed sharply. Singapore now projects capital outflows far larger as a share of GDP than does China in consequence of a steep fall-off in domestic investment against continued high saving relative to GDP.

The life-cycle theory of saving behavior serves to explain the rise in the saving rate in connection with rapid income growth. The premise of the theory is that consumption is smoothed over an individual's lifetime based on expected cumulative income.

When income growth accelerates beyond expectations, a disproportionate share of the increase is saved so that consumption is spread over the earner's remaining lifespan. Moreover, those in their retirement years do not participate in the income growth spurt and hence maintain a consumption profile based on the lower income standards of their working years.

Factors specific to the Chinese case have amplified the saving response to an economic boom. The downsizing of the state sector and the shifting of productive assets including housing to private hands that took place in the late 1990s opened broad new vistas for household investment. Yet since China's immature financial sector was not up to the task of channeling funds to meet these needs, households have had to sock away savings in order to self-finance their purchases. Meanwhile, profits soared in a state sector that was pared down selectively for monopolistic advantage and given a new lease on life through restructuring and reincentivizing. State sector profits, until recently, were entirely retained by enterprises—there being no obligation to remit them to government owners and every reason for managers to hoard and reinvest in a quest to expand their own domains. Finally, the precautionary motive for saving was boosted significantly as life beyond the iron rice bowl presented myriad threats to personal security.

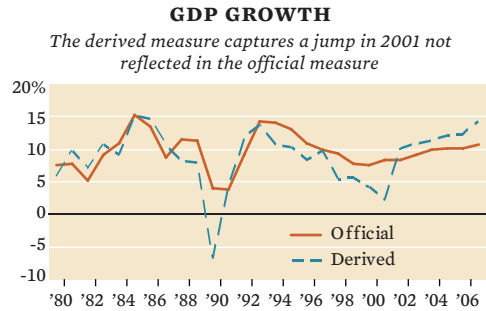
The growth surge that fueled the rise in saving post-2000 was stupendous beyond even what official figures indicate. The official approach to measuring real GDP growth is a throwback to the planned economy. It is based on reporting by businesses of output value for the current year expressed in both current year prices and the prices of a prescribed base year. The numbers supplied are likely to be off-the-cuff and rife with error. Fortunately, there is a ready remedy for this problem. Nominal GDP figures need simply be deflated by

a suitable price index where such an index can be compiled from reported sectoral rates of inflation for primary, secondary, and tertiary industry.

Real GDP growth numbers derived in this manner are revealed to be far more erratic than the official record would have it. The derived figures indicate the economy contracted by nearly 7% in 1989 as nominal growth plummeted while inflation remained high. The slowdown of the late 1990s was similarly much more severe than official figures let on. During this period the economy was beset domestically with massive lay-offs by state-owned enterprises and downsizing in government employment, and internationally with the Asian financial crisis. Against this deterioration in growth, the rebound that accompanied China's entry into the World Trade Organization appears very strong indeed. Not only did the economy lift from a lower trough, it soared to a higher plateau with growth edging up to 14.2% in 2006.

Growth of this order triggered the dramatic increase in the saving rate. Then, when investment was administratively restrained beginning in 2004 the trade imbalance gaped open. Rather than growth being slowed by the investment pull-back, sustained output increases were diverted abroad through exports.

The exchange rate played a passive role in this story. The peg in place at the outset of the postmillennial growth surge dates essentially to 1994. Exchange-rate unification at that point established a rate that was in line with market forces, yielding a small, arguably prudent, surplus in the trade account (i.e., a small gap of saving over domestic investment). Indeed, in the wake of the Asian financial crisis a few years later the Chinese government made much of holding the line against pressure to devalue the currency. For a decade, the pegged exchange rate was a boon to trade and investment because it provided stabil-



ity, not because it distorted the market. To have prematurely revalued the currency would have choked off exports and stimulated imports at a cost of slower income growth and job creation.

Until the 2004 juncture a peg at 8.3 yuan to the dollar had been credible. With the sudden expansion of the trade surplus though, the exchange rate came under pressure. The Chinese government's response to that pressure has been to move gradually away from a peg while developing the institutional infrastructure for market-based exchange-rate determination. This involves dismantling controls on currency trading and developing markets for hedging instruments. In the context of a maintained peg and a saving rate shooting up beyond the domestic investment rate, the Chinese central bank has been caught holding the bag. It must absorb excess foreign-exchange inflows created by a widening trade surplus and strong private investment inflows. There was no deliberate policy stance to run up the trade surplus by leaps and bounds and accumulate massive foreign reserves. It just turned out that way given the existing peg and phenomenal growth in GDP.

Growth momentum was sustained in part through a feedback loop to the U.S. economy. The accumulation of foreign exchange reserves in China found its counterpart in a capital outflow to the U.S. The inflow on the U.S. side tends to push up the

value of the dollar which in turn undermines U.S. exports and boosts U.S. imports. This slows down the U.S. economy. The ready antidote to a threat of slowdown is monetary stimulus which the U.S. undertook in abundance and which found an outlet in rising U.S. asset prices. This made Americans happy to go on consuming. The bottom line was the U.S. kept growing and buying Chinese goods and China kept growing and lending money to the U.S. For a while both sides enjoyed strong output growth and rising wealth. The problem, we found out belatedly, was that the U.S. financial system was not capable of allocating burgeoning investment funds effectively, and the fallout from that has spelled the end of the cycle.

There are Chinese observers who blame U.S. monetary policy for the imbalances and the whole upward spiral which ultimately bore the seeds of its own collapse. And Americans of course blame China's "artificially low" exchange rate. Actually, the forces were symbiotic and both sides enjoyed the boom times while they lasted.

The inevitable slowing of China's growth rate will by itself only gradually contribute to a decline in its saving rate. But there are policy measures that can be brought to bear with very substantial prospects for pushing consumption up and saving down, and these measures are worthwhile for intrinsic reasons as well. Such measures include: building up the social welfare system; developing the financial system; and absorbing profits from state enterprises in the fiscal budget.

Increased fiscal spending on social welfare programs has an expansionary impact and this at a time when the econo-

my is already showing signs of rising inflation. This is where the exchange rate justifiably comes in. There is a role for currency appreciation within the broader scope of macroeconomic policy now where there had not been one previously, in my view, strictly for purposes of reducing the trade surplus. In combination with expansionary fiscal policy

used to stimulate domestic consumption, currency appreciation acts to divert resources out of tradable goods production (less exports and import substitutes) and into social-welfare service provision. In this way

inflation is kept in check despite the increased fiscal spending. However, the appreciation called for in this context is modest and gradual, and as such should not be cause for any onslaught of speculative capital.

In 5 years' time, a rebalancing of China's trade account could well be achieved without recourse to much further appreciation of the yuan. All it would take to bring this about would be a reduction in the national saving rate to a level last observed as recently as 2003 when it stood at 43.2% of GDP given a maintained level of domestic investment at the 2004-06 status quo. This is a plausible scenario. It rests on a combination of: a slowing of growth to below double digit levels; an acceleration in the implementation of social welfare programs so as to stimulate consumption directly as well as to mitigate the precautionary motive for saving; and continued advances in financial sector development so as to free households of the need to save in order to finance lumpy consumption and investment expenditures. Appropriate policy programs are already in the formative stages and ready for broader ramping up. ■

Macro policies in the U.S. and China were symbiotic and both countries enjoyed the boom while it lasted.