China tipping the scales of global imbalance
Stephen Grenville
The Australian Financial Review
4 Jun 2007
P. 21

Seemingly unsustainable global imbalances have been with us so long that it's hard to maintain the anxiety: maybe it is different this time and there is no need for painful adjustment.

While we have been waiting for something to happen, however, China's imbalances have come to loom larger in the wider story. China's trade surplus was always at the forefront of America's attention, but a few years ago it was only a small element in the overall equation. As recently as 2003, the current account surplus was $US50 billion and reserves were $US100 billion - far smaller than Japan. Now China is running a current account surplus equal to 10 per cent of its gross domestic product (more than double the figure of two years ago) and its reserves are $US1.2 trillion, equal to half of its GDP and far larger than Japan's. This is neither sensible nor sustainable.

Why isn't it sensible? Funding this low-yield reserve holding can't be the best use of resources for a country that still has, on World Bank reckoning, 135 million people living in poverty, and huge problems of pollution and water shortages. Capital should not be flowing uphill from emerging-but-still-poor countries to the mature economies.

Why isn't it sustainable? It is technically feasible to sterilise the impact of the reserve increase, to offset any monetary effect, but this sets up a chain of distortions. Some of the burden of funding the reserves has been shifted to the banks, by requiring them to hold more than 10 per cent of their balance sheets as idle reserves at the central bank. This is an implicit tax on bank intermediation and a drag on the development of the financial sector. Interest rates are too low, in part to avoid attracting more foreign capital. While consumer price inflation is quiescent, asset prices are so inflated that former US Federal Reserve chairman Alan Greenspan has identified a bubble in China's sharemarket, which doubled last year and is up 60 per cent so far this year.

If this were a temporary matter or if the current account surplus reflected weak domestic demand, policy could wait for this to sort itself out, but it seems likely to get worse rather than better, with the surplus expected to reach 12 per cent of GDP this year. When a strong current account coincides with fast domestic demand, it usually signals exchange rate undervaluation. Moreover, the equilibrium exchange rate will be rising over time. As China accumulates capital and moves towards the technological frontier, it will do the same transformation that occurred in Japan in the 1960s. The yen, pegged at 360 yen per US dollar until 1971, appreciated 40 per cent over the next five years.

The pressures on the yuan to appreciate will increase as international capital once again flows downhill, from the mature economies, so China will have not just the large current account adding to reserves, but significant capital inflow as well. Capital inflow has not kept pace with the expansion of the current surplus, but this is unlikely to remain the case for long. China is progressively opening its financial sector to foreign investors (as part of its World Trade Organisation obligations). Foreign portfolio diversification, the promise of high emerging-market returns (the search for "exotic beta"), and the prospect of a significant appreciation at some stage will all add to the inward press of foreign funds. Capital controls become more porous over time.

Certainly, there are numerous good reasons why a significant appreciation is a fraught decision. With reserves equal to 50 per cent of GDP, a 20 per cent appreciation would administer a capital valuation loss to the holder of the reserves, the central bank, equal to 10 per cent of GDP.

Manufacturing exports will feel the effect of the loss of competitiveness. With China now acting less as a "final assembly line" and more as an integrated producer, the impact on production will be stronger and more widely felt. But these issues will not diminish or get easier to handle over time: continuing imbalances build up vested interests in resisting change and more investment is made at the wrong price relativities.

It would not be necessary for all the adjustment to be on the exchange rate: capital inflow can be offset with greater capital outflow. China has already made moves to permit its citizens to invest overseas, but the opportunities for them to buy foreign equities are limited. To open these up would not only encourage more capital outflow, but would diversify Chinese private portfolios away from the bubble of domestic equities, softening the blow when this bursts. At the same time, diversification of official foreign assets through a wider range of assets and currencies might soften the balance sheet damage when the appreciation comes (and help disguise it).

China is, of course, only one element in the overall equation of global imbalances. It is, however, an important one. For a start, if China appreciated, the rest of emerging East Asia would feel able to follow suit without losing export competitiveness or the attention of foreign investors. As well, it might make it easier for America to avoid exacerbating the distortions through import protection.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy and former deputy governor at the Reserve bank of Australia.