Japan, China, and the U.S. Current Account Deficit

Richard H. Clarida

Exchange rate protectionism is a subject much in the news these days especially in regard to the actions of Japan and China in foreign exchange markets and in the financing of the U.S. current account deficit. I will discuss each of these issues in turn.

Japan's Rebound

I remain encouraged by the balance of evidence that Japan appears to be emerging from a decade in which a deflation spiral was a serious concern. This reflects well on policies pursued by the Bank of Japan under Governor Fukui's leadership, but there is no doubt Japan has also benefited substantially from the expansion in greater Asia, and not just China. As for currency policy, I believe that the major goal of BOJ policy must be to reflate the Japanese economy. Given the low level of interest rates, all tools at the BOJ's disposal, including non-sterilized intervention should be deployed. I would in fact favor, as an interim measure, an explicit price level target for Japan consistent with inflation in the range of 1.5 to 2 percent. If this target were implemented, the yen might weaken, but this would not be evidence of a beggar-thy-neighbor policy but rather—as emphasized by Lars Svensson (2003) at Princeton—as part of an effort to anchor expectations in a way consistent with reflation. And of course, if the reflation does continue, a weakening of the nominal exchange rate need not translate into a depreciation of the real exchange rate. As the yen has weakened in tandem with slower growth in recent months, the BOJ appears to have scaled back significantly in its intervention

Cato Journal, Vol. 25, No. 1 (Winter 2005). Copyright © Cato Institute. All rights reserved.

Richard H. Clarida is the C. Lowell Harriss Professor of Economics at Columbia University and Chief Economic Strategist at the The Clinton Group. He was Assistant Secretary for Economic Policy at the U.S. Treasury in 2002–03.

activities. I would support aggressive additional quantitative easing measures going forward if the goal of reflating the Japanese economy appears to be in jeopardy.

Financing the U.S. Current Account Deficit

The United States runs a current account deficit of more than $600 billion per year. In recent years, foreign central banks, especially those in Asia, have made substantial purchases of U.S. government bonds to add to their foreign exchange reserves. It is argued that because of this intervention, the current deficit continues to widen and the necessary adjustment is being delayed. It is important to appreciate that the U.S. current account deficit is a general equilibrium phenomenon and is, in part, a reflection of a global excess of saving relative to profitable investment opportunities in the post-bubble world. When I was at Treasury, I published an op-ed in the *Financial Times* in October 2002 that made this same point in the following way: The U.S. current account deficit reflects a deficit of growth and growth prospects in much of the rest of the world, especially in the rest of the G-7. Although growth prospects in the rest of the world are brighter than they were in the fall of 2002, so are U.S. growth prospects. In international finance, it is relative valuations that matter for international capital flows and international adjustments, and the growth differential between the United States and its major trading partners has not appreciably narrowed in recent years. I note that in a world, like the present, in which there is a global excess supply of saving relative to investment, some country or group of countries must absorb the surplus of internationally mobile capital. As evidence in favor of this view, I point out that the level of global interests, including real interest rates, is quite low by historical standards. I conclude that the United States, because of the role of the dollar as a vehicle currency, because of the depth and breadth of the U.S. financial markets, and because of the credibility of U.S. monetary policy, is destined for some time, as it has been for the last 20 years, to run a structural international capital inflow, and thus a structural current account deficit.

Recall that in 2000, a year of U.S. budget surpluses and strong growth in the global economy, the United States ran a current account deficit of 4 percent of GDP. I expect that over time the U.S. current account deficit will narrow, and certainly hope that this occurs in the context of a growing and prosperous global economy. Indeed, I see no reason to expect that this adjustment will be disorderly.

The Case of China

China has made breathtaking, historically unprecedented progress in economic development in the past 25 years. There is little doubt in my mind that in the next 25 years China will succeed in completing the transition from an impoverished centrally planned country with minimal presence in the global financial system to a major force in international capital markets. By all accounts, China is serious and conscientious about living up to its WTO commitments, which are substantial in this area. However, at present, its internal capital market is sheltered and contributes to a significant misallocation of saving to state-owned enterprises (SOEs), while its linkages with global capital markets are encumbered by capital controls and restrictions. And, of course, in this setting the exchange rate is fixed.

I believe that there is a sound case for a revaluation of the currency within the context of the present fixed exchange rate system, and I applaud the ongoing efforts of Secretary John Snow and IMF Managing Director Rodrigo de Rato to encourage the Chinese to bring this about. My argument is as follows. Under the present arrangement, China has a serious nonperforming loan (NPL) problem. With a financial system that has allocated vast pools of domestic saving to SOEs with little regard to profitability or economic efficiency, the cost of capital to the state sector tends to fall short of the opportunity cost of resources deployed in SOEs. At least to some extent, the flip side of the NPL problem is the surge in the production of exportables that find their way into the international goods market. For these goods to be absorbed, the *real* exchange must be prevented from appreciating. The capital controls that are in place make this possible, but that does not mean it is efficient or even in China's own interest. A once-off revaluation of the currency, perhaps in conjunction with moving to a wider band and a peg to a basket of currencies, would be an appropriate policy response by the Chinese who have themselves expressed a desire to avoid the overheating of the Chinese economy.

According to published accounts that I have seen, Chinese officials appear to be committed to a plan that would gradually introduce more exchange rate flexibility, but they would not move all at once to a regime of floating with an open international capital market. I think that in this case, some degree of gradualism is appropriate in the broader context of China's effort to shore up the banking system and to deepen and broaden the foreign exchange market. However, a step that could, and I think should, be taken immediately would be to revalue the currency within the context of the present system of capital controls.

Conclusion

The topic of exchange rate protectionism is timely, but is also complex. Current account imbalances, capital flows, exchange rates, and interest rates must be analyzed in a global context. In this brief article, I have attempted to summarize my thinking on this wide-ranging topic.

References

Clarida, R. H. (2002) "America's Deficit, The World's Problem." *Financial Times* (22 October).

Svensson, L. (2003) "Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others." *Journal of Economic Perspectives* 17 (4): 145–66.