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China must reduce its excessive savings rate

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Much of the recent debate on global economic imbalances has centred on Chinese exchange-rate policy. China has a balance of payments surplus. The People's Bank of China has been buying some \$20bn a month in its attempt to keep the renminbi's parity with the US dollar stable.

American legislators are concerned about the advantage that a weak currency gives Chinese exporters. The US Treasury has given the Chinese six months to act on the currency and has appointed Olin Wethington as a special envoy to carry the message to Beijing. The Chinese authorities fear that a currency appreciation might worsen social and regional imbalances. An appreciation might slow job creation in manufacturing, worsening urban unemployment. It would lower the relative price of agricultural products, thus reducing rural income. Is there an alternative solution?

Excessive savings are at the root of the imbalance in China. In spite of China's impressive investment rate, its domestic savings rate is even higher and it attracts massive foreign direct investment. This abundance of savings is what is expressed in the external imbalance. A misallocation of resources occurs. Consumption is foregone, sacrificing the welfare of today's low-income generation now for the benefit of future, wealthier generations but in order to accumulate unneeded low-yielding foreign assets.

A reduction in China's savings rate could correct the imbalance. It would lead to faster growth and job creation and improve the welfare of the present generation. It would reduce the balance of payments surplus and stimulate faster global growth through increased exports to China. The increased internal demand would raise the rate of return of investment projects in China that cater to the domestic market. With proper macroeconomic management, even higher rates of investment and growth could be achieved.

But can China grow even faster than its current high rate? High growth becomes unsustainable when the economy becomes constrained by an insufficient supply of critical inputs. Usually, investment demand exceeds savings, bringing about a destabilising current account deficit. In other cases, high growth is checked by labour shortages and inadequate infrastructure. These shortages create inflationary pressures associated with currency depreciation, rising labour costs and bottlenecks.

In spite of China's rapid growth, these symptoms appear to be absent. The country exhibits an excess of savings over investment. Policymakers are concerned about unemployment rather than labour shortages. Infrastructure is expanding at an impressive pace. Inflation has remained low, with core inflation (excluding energy and food) almost nil. This suggests that the economy's speed limit may well be higher than the current growth rate.

An acceleration of growth would create pressures towards real appreciation, because the supply of importable goods is usually more elastic than that of non-tradables. In the context of faster job growth and incipient inflationary pressures, the Chinese authorities would be much more willing to allow an appreciation of the renminbi.

The reduction in savings could be engineered through either fiscal or monetary expansion. There are reasons not to choose the latter. First, an eventual credit expansion would be channelled through an already fragile banking system. Credit booms often end in tears. Second, a credit-induced expansion is likely to allocate the additional spending to those who can provide collateral. This would have the wrong distributive consequences both socially and regionally.

A fiscal solution has several advantages. First, it can be targeted to favour the regions and the social groups that have fallen behind. Second, it avoids the problem-ridden banking system. Third, it can address other developmental and social goals, such as housing, urban development and infrastructure. Moreover, the country can afford a fiscal expansion. Its debt level is barely 26 per cent of gross domestic product.

A fiscal solution is not without dangers. These include corruption, the risk of poorly designed programmes, allocations that are not compatible with sustainable development and the creation of entitlements that may be difficult to reverse.

As a response to the 2001 recession, the US Treasury allowed the fiscal deficit to widen by more than 5 percentage points of GDP. Public debt was put on a rising trend. When Mr Wethington meets the Chinese authorities, he might mention the US experience with expansionary fiscal policy. After all, what is good for the goose . . .

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