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Why the renminbi has to rise to address imbalances

By MARTIN FELDSTEIN

Global leaders have agreed reducing global imbalances is a priority. In practice, that means reducing the US \$500bn current account deficit and shrinking the \$350bn surplus of China. All other current account imbalances pale by comparison.

Since a current account surplus is the difference between a nation's savings and investment, that agreement means the US must raise its national saving to be less dependent on foreign funds. China must lift domestic spending to maintain high employment without producing so many exports.

Some progress is happening on both fronts. The US household savings rate has risen, driven by the need for US households to rebuild wealth. Corporate retained earnings have also begun to rise. But increasing private saving is not enough to raise US national saving if federal deficits remain high. The Obama administration must agree a budget that will reduce deficits in the years ahead.

China has succeeded in raising its domestic spending through fiscal incentives and an explosive growth of credit. Its real consumer spending has jumped 15 per cent in the past year, outpacing the almost double digit rise in gross domestic product. Chinese government spending has also increased domestic demand via major rises in infrastructure investment and building low income housing.

But while these two shifts are necessary to reduce global imbalances, they are not enough. For that, exchange rates must also adjust.

The dollar must decline relative to other currencies to make US products more attractive to foreign buyers and to cause Americans to substitute US goods and services for imports. Without that incentive to increase exports and reduce imports, the rise in domestic saving will just lead to US economic weakness and rising unemployment. That is why the recent decline in the dollar relative to the euro, the yen and other currencies is a natural and desirable part of the process of reducing the US trade deficit and shrinking global imbalances.

Unfortunately, the Chinese government has not allowed the renminbi to appreciate. It has kept it pegged at a rate of 6.82 renminbi per dollar. With the dollar falling relative to other major currencies, the fixed exchange rate of the renminbi relative to the dollar has caused the Chinese currency to fall relative to the euro, yen and other currencies. The trade-weighted value of the renminbi has therefore been declining, making Chinese exports more attractive and foreign goods more expensive in China.

The result has been an increase in China's exports from \$276bn in the second quarter of the current year to \$325bn in the third quarter. This helps lift GDP and jobs in China but prevents reducing global imbalances.

China's policy of keeping the renminbi weak means that the US dollar must decline more rapidly against the euro, yen and other currencies to achieve the same overall trade-weighted fall of the dollar. China's weak renminbi policy therefore not only prevents remedying China's large current account surplus but also reduces Europe's exports.

China's policy of expanding domestic spending while depressing the renminbi will lead to its economy overheating, particularly its manufacturing sector. Allowing the renminbi to rise would shift demand in China from manufacturing to services and prevent inflation. A stronger renminbi would thus reduce China's domestic imbalance and global imbalances.

Although China has agreed to take steps to reduce global imbalances and its trade surplus, it is reluctant to let its currency rise. Chinese officials argue that the best way to reduce the US trade deficit is for the US to relax its restrictions on the sale to China of high technology military products.

The US will not allow these sales because of national security concerns. Even if the US were to do so, it would not change the size of the US trade deficit, only its composition. The basic fact is that the current account deficit is equal to the difference between national investment and national saving. The dollar exchange rate would therefore adjust to cause fewer exports to other countries or more imports from the rest of the world.

Fortunately, the Chinese economy is expanding rapidly and its growth is becoming less dependent on exports. When it has the confidence to allow the renminbi to rise, we will be on the path to reduced global imbalances.

The writer is professor of economics at Harvard and president emeritus of the National Bureau of Economic Research. He chaired the Council of Economic Advisers under President Reagan and is a member of President Obama's Economic Recovery Advisory Board.