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China’s Dollar Problem

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CAMBRIDGE – When will China finally realize that it cannot accumulate dollars forever? It already has more than $2 trillion. Do the Chinese really want to be sitting on $4 trillion in another five to 10 years? With the United States government staring at the long-term costs of the financial bailout, as well as inexorably rising entitlement costs, shouldn’t the Chinese worry about a repeat of Europe’s experience from the 1970’s?

During the 1950’s and 1960’s, Europeans amassed a huge stash of US Treasury bills in an effort to maintain fixed exchange-rate pegs, much as China has done today. Unfortunately, the purchasing power of Europe’s dollars shriveled during the 1970’s, when the costs of waging the Vietnam War and a surge in oil prices ultimately contributed to a calamitous rise in inflation.

Perhaps the Chinese should not worry. After all, the world leaders who just gathered at the G20 summit in Pittsburgh said that they would take every measure to prevent such a thing from happening again. A key pillar of their prevention strategy is to scale back “global imbalances,” a euphemism for the huge US trade deficit and the corresponding trade surpluses elsewhere, not least China.

The fact that world leaders recognize that global imbalances are a huge problem is welcome news. Many economists, including myself, believe that America’s thirst for foreign capital to finance its consumption binge played a critical role in the build-up of the crisis. Cheap money from abroad juiced an already fragile financial regulatory and supervisory structure that needed discipline more than cash.

Unfortunately, we have heard leaders – especially from the US – claim before that they recognized the problem. In the run-up to the financial crisis, the US external deficit was soaking up almost 70% of the excess funds saved by China, Japan, Germany, Russia, Saudi Arabia, and all the countries with current-account surpluses combined. But, rather than taking significant action, the US continued to grease the wheels of its financial sector. Europeans, who were called on to improve productivity and raise domestic demand, reformed their economies at a glacial pace, while China maintained its export-led growth strategy.

It took the financial crisis to put the brakes on US borrowing train – America’s current-account deficit has now shrunk to just 3% of its annual income, compared to nearly 7% a few years ago. But will Americans’ newfound moderation last?

With the US government currently tapping financial markets for a whopping 12% of national income (roughly $1.5 trillion), foreign borrowing would be off the scale but for a sudden surge in US consumer and corporate savings. For the time being, America’s private sector is running a surplus that is sufficient to fund roughly 75% of the government’s voracious appetite. But how long will US private sector thrift last?

As the economy normalizes, consumption and investment will resume. When they do – and assuming that the government does not suddenly tighten its belt (it has no credible plan to do so) – there is every likelihood that America’s appetite for foreign cash will surge again.

Of course, the US government claims to want to rein in borrowing. But, assuming the economy must claw its way out of recession for at least another year or two, it is difficult to see how the government can fulfill its Pittsburgh pledge.

Yes, the Federal Reserve could tighten monetary policy. But they will not worry too much about the next financial crisis when the aftermath of the current one still lingers. In our new book *This Time is Different: Eight Centuries of Financial Folly* , Carmen Reinhart and I find that if financial crises hold one lesson, it is that their aftereffects have a very long tail.

Any real change in the near term must come from China, which increasingly has the most to lose from a dollar debacle. So far, China has looked to external markets so that exporters can achieve the economies of scale needed to improve quality and move up the value chain. But there is no reason in principle that Chinese planners cannot follow the same model in reorienting the economy to a more domestic-demand-led growth strategy.

Yes, China needs to strengthen its social safety net and to deepen domestic capital markets before consumption can take off. But, with consumption accounting for 35% of national income (compared to 70% in the US!), there is vast room to grow.

Chinese leaders clearly realize that their hoard of T-Bills is a problem. Otherwise, they would not be calling so publicly for the International Monetary Fund to advance an alternative to the dollar as a global currency.

They are right to worry. A dollar crisis is not around the corner, but it is certainly a huge risk over the next five to 10 years. China does not want to be left holding a $4 trillion bag when it happens. It is up to China to take the lead on the post-Pittsburgh agenda.