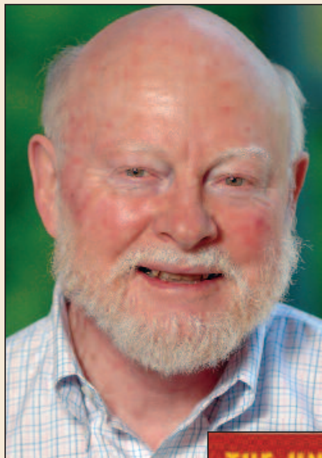
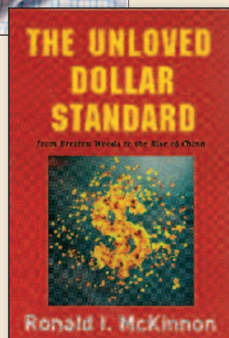
THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E.
Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

A SYMPOSIUM OF VIEWS

Can Changes in Exchange Rate Valuations Affect Trade Imbalances?





In his new book, *The Unloved Dollar Standard: From Bretton Woods to the Rise of China,* Stanford economist Ronald McKinnon argues that the "China bashers" have been captured by a false theory of the U.S. trade balance. That theory argues that exchange rate changes can compensate for large discrepancies in saving behavior. McKinnon counters that the United States has had a large trade deficit for an extended period directly as a result of a major saving deficiency which America finances with a long dollar line of credit with the rest of the world.

No exchange rate change, McKinnon argues, can compensate for, or alleviate, this trade imbalance when investment is globalized and is itself dependent on the exchange rate.

A collection of noted experts tackles McKinnon's thesis.

McKinnon gets the direction of causation between savings and investment in the Sino-U.S. dollar zone wrong.

DIANA CHOYLEVA
Director, Lombard Street Research, and co-author,* The American Phoenix *(2011) and* The Bill from the China Shop *(2006)

Ronald McKinnon's fascinating new book, *The Unloved Dollar Standard: From Bretton Woods to the Rise of China,* is right in drawing attention to the interaction between global saving and investment in creating the global financial imbalances. But McKinnon gets the direction of causation between savings and investment in the Sino-U.S. dollar zone wrong. As a result, he advocates the continuation of China's dollar peg and closed capital account—the very mechanism which greatly contributed to the global financial crisis.

Economics is not a precise science. The direction of causation between economic variables can switch, leading to diametrically opposite outcomes. McKinnon argues that America's saving deficiency caused its large current account deficit. But for American profligacy, or in other words its desire to invest in excess of its national savings, to have caused China's excessive saving, interest rates would have needed to rise to induce the extra saving.

The opposite has happened. Interest rates have progressively fallen to test the zero bound. This proves that the key driving force in the dollar zone, created by Beijing's exchange rate policy, has been China's desire to save excessively. If the desire to save and lend is higher than the desire to borrow and spend, the rate of interest falls to create better prospects for investor returns.

High savings become excessive when the desire to save out of income exceeds the economy's need for productive investment. Excess savings are malign, because by definition they depress demand, causing income to fall in order to equate the absolute level of savings and investment.

China's excess savings phase started with its entry into the World Trade Organization in 2001 and coincided with the same dynamic in Japan, Germany, and north-central Europe to produce a global savings glut. If not for the borrower economies, in particular America, being willing to rack up debt to finance their excessive spending, the global economy would have been depressed much earlier.

Instead, China poured its excess savings into risk-free U.S. dollar assets, stoking America's consumer boom which itself fueled China's export-led growth machine. But the symbiotic relationship was broken once the U.S. private sector exhausted its ability to take on debt and the excesses in its housing and financial sectors became visible, triggering the seize-up of global liquidity and the near-collapse of the global financial system.

Contrary to McKinnon's assertion, China's mode of development has made the global economy more unstable, and the yuan-dollar peg has been the chief mechanism through which China's desire to save excessively has spawned America's credit-fueled asset price bubbles. Four years on from the start of the global imbalances workout, the global status quo is little changed. The borrower economies are still borrowing excessively, but this time it is their public sector. Overall growth has been depressed due to the huge private sector deleveraging. The saver economies, China in particular, continue to save excessively and to rely on exports or investment to pull their economies through.

The problems of our globalized world need a global solution. McKinnon is right to point out that if China were to save less and spend more and America were to save more and spend less, the Sino-American financial imbalances would disappear. But he doesn't provide a credible policy solution of how to enforce such simultaneous changes. Worse still, he tries to discredit the ability of a fundamental market mechanism—the change in real exchange rates—to achieve the necessary adjustment.

Underlying his model is the unsubstantiated assumption that domestic savings are relatively insensitive to the exchange rate even though investment in a globalized world is. But China's dollar peg and its closed capital account, together with its warped domestic financial system, are key reasons behind China's excess savings. Chinese people save excessively, among other things, because the real return on their assets, which have to be invested largely at home, is paltry. An open capital account and a market-driven exchange rate would ensure Chinese people get the best real rate of return on their assets, driving down their desire to save.

Luckily for America, whether by design or not, the Federal Reserve's easing policy has already forced the necessary real exchange rate adjustment in the dollar zone by exacerbating the natural tendency towards inflation of China's undervalued economy. The chief obstacle preventing a sustainable improvement in U.S. growth prospects has now been removed. America has made substantial progress rebalancing its economy, while China has deepened the excesses on which its growth model is built.

McKinnon is simply wrong.

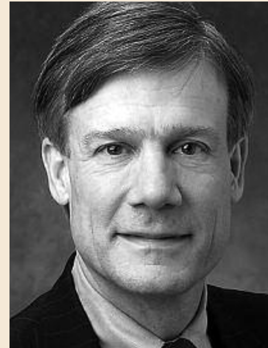
JEFF FRANKEL
James W. Harpel Professor for Capital Formation and Growth, Harvard University

Ron McKinnon has made many important contributions to international macroeconomics over the years. But on this issue, he is simply wrong.

It goes without saying that the current account is equal to the difference between national saving and investment. But it does not follow that we should try to improve the current account by increasing national saving. Under current conditions, that would send the United States back into recession.

The national saving identity is a tautology: it does not in itself imply causation. True, many of the big movements in the U.S. current account deficit can be explained by changes in national saving: the fiscal expansion of the early 1980s, the investment boom of the late 1990s, and the new fiscal expansion of the 2000s. But the important point is that we care about a lot more besides external balance (the trade balance and current account). We care at least as much about internal balance (growth, employment, and inflation). To say that an increase in the budget balance and national saving would improve the trade balance does not imply that this would be good policy or that it is the only way to improve the trade balance. Under current circumstances—a still-weak economy, high unemployment, low inflation, rock-bottom interest rates—a reduction in public or private spending would send the economy straight back into recession. That is why the fiscal cliff of January 1, 2013, was such a danger. To observe that the trade balance would improve would be small consolation.

The U.S. trade deficit is not the problem it was five years ago. But if improving the trade balance is considered an important goal, then a devaluation or depreciation of the currency is a better tool for the job. (This proposition does not violate the national saving propositions. Nor, on the other hand, does it justify China-bashing.) Because a real devaluation would also raise demand for U.S. products—admittedly with a lag—and thus move us closer to internal balance, it would be a far more appropriate tool for improving the current account under present-day conditions than cutting national spending.



McKinnon's thesis is persuasive and consistent with some notable experiences.

JIM GLASSMAN
Managing Director and Senior Economist, JPMorgan Chase & Co.

Ron McKinnon's thesis, that a yuan appreciation would do little to balance the U.S.-China trade flows, is persuasive and consistent with some notable experiences. Japan comes to mind. McKinnon argues that, because the trade imbalances are a reflection of fundamental "saving discrepancies," efforts to rebalance trade flows by forcing a currency adjustment are ineffective and likely would do more harm than good by intensifying deflationary forces. McKinnon's case is even stronger when the causes of the U.S.-China "saving discrepancies" are exposed. Are these a U.S. problem? Are they China's problem? Are they a problem at all?

Popular views about international imbalances, and in particular about the U.S.-China trade imbalance and calls for China to appreciate the yuan to restore balance, are shaped by the simple textbook story that offers few insights about the U.S.-China relationship. The textbook story asserts that persistent trade imbalances are red flags, because they eventually lead to currency crises and punishing spikes in interest rates. International investors grow reticent about accumulating ever-larger holdings of the deficit country's currency without adequate compensation. So, restoring balance by whatever means trumps most other considerations. Many believe that a currency depreciation offers one way to rebalance international trade accounts. Perhaps in a regime of fixed exchange rates, such as the Bretton Woods fixed exchange rate system adopted after World War II, when exchange rates are set at artificial levels, a currency realignment might make sense. But the story is not very convincing today when exchange rates are free to float or impoverished economies are managing their currencies to promote development. In fact, the textbook story has few insights to offer on the U.S.-China trade relationship.

McKinnon correctly argues that, because trade imbalances, like that between the United States and China, are the result of fundamental saving discrepancies between the two countries, they are not easily corrected with currency adjustments. In fact, pressures to drive up the yuan, for example, likely would only lead to a deflationary spiral for those whose currencies are forced up.

McKinnon's argument is even more persuasive when the causes of the U.S.-China saving discrepancies are considered. Some blame the saving discrepancies on inadequate U.S. saving. The claim is unconvincing. Low U.S. saving is a response to the relatively high net worth of many American households and to optimism about long-run economic prospects. The saving discrepancy is largely a reflection of China's decision to develop by opening her borders and inviting the international business community to invest there and take advantage of her attractive labor costs rather than to rely on organic growth.

Having chosen to develop on a fast track, China naturally would be expected to export more than she imports. That will change over time as China's consumers gain purchasing power. And although China is investing heavily in infrastructure, in the aggregate China spends less than she earns and saving is elevated. China's temporarily lopsided trade balance with the United States implies that she must be willing to hold the dollars she earns in trade with the United States—largely in the form of Treasury securities—in order to avoid a development-ending surge in the value of the currency. The saving discrepancies between the two countries are a temporary result of China's fast-paced development. For that reason, an aggressive appreciation of the yuan not only would fail to address the U.S.-China saving discrepancy, which is a result of China's decision to modernize, but would also jeopardize her development agenda, with negative implications for the United States and the rest of the world as well.

In many ways, China's managed currency is similar in spirit to the Bretton Woods fixed exchange rate system that enabled Germany and Japan to get back on their feet after World War II. In this case, however, China voluntarily chooses to manage her currency and to accumulate the dollars that are a result of lopsided trade flows.

The saving discrepancies between the United States and China are a result of China's economic development and rising living standards in Asia—keep in mind that real GDP per capita in China and India still are only at levels seen in the United States back in the late 1930s. They symbolize a stabilizing force and not one that should or could be corrected by forcing the yuan higher.

This opinion is the author's own and not necessarily that of JPMorgan Chase.

The "exchange rate **cum** *trade balance fallacy" exists only in McKinnon's imagination.*

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

Professor McKinnon misrepresents his critics' views on exchange rates and trade balances. We all agree that exchange rates do not have an effect on trade that is independent of saving and investment. Trade imbalances are always and everywhere saving and investment imbalances. McKinnon, however, does not acknowledge that policies that affect exchange rates also affect saving and investment.

Thus, the massive funneling of capital into U.S. Treasury bonds by the government of China has kept interest rates lower than otherwise in the United States. To fund these currency purchases, the government of China borrows inside China, putting upward pressure on Chinese interest rates. These interest rate movements raise saving and lower investment in China while doing the opposite in the United States. The exchange rate is the price that equates the saving surplus in China with the saving deficit in the rest of the world (chiefly the United States), thus ensuring that the trade imbalance equals the saving-investment imbalance.

An objection may be raised that central banks have the power to offset the above-mentioned movements in interest rates. But central banks have little room to maneuver on that front. If they fail to move interest rates to their market-clearing levels, inflation will move away from its target level in an accelerating fashion. The stability of inflation in both China and the United States over the past ten years argues strongly that any deviations of interest rates from their market-clearing levels have been modest and transitory.

China's extraordinarily high rates of both saving and investment reflect its rapid rate of development and distortions in its domestic economy. These unique circumstances do not alter the fact that China's massive currency manipulation has raised saving relative to investment inside China and reduced saving relative to investment outside of China. Currency manipulation is fundamentally a government-directed saving imbalance designed to achieve an exchange-rate objective.

McKinnon's critics may be guilty of over-emphasizing the exchange rate and under-emphasizing the policies that underlie the exchange rate. But the "exchange rate *cum* trade balance fallacy" exists only in Professor McKinnon's imagination.

McKinnon presumes that the U.S. savings-investment imbalance is immune to changes in the exchange value of the dollar. Several perspectives counter this.

CATHERINE L. MANN

Barbara '54 and Richard M. Rosenberg Professor of Global Finance and Director, Rosenberg Institute of Global Finance, International Business School, Brandeis University, and Visiting Scholar, Federal Reserve Bank of Boston

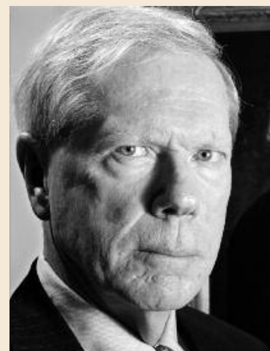
The statement of the fallacy, "that the United States has had a large trade deficit for an extended period directly as a result of a major saving deficiency…[and that] no exchange rate change… can compensate for, or alleviate, this trade imbalance…" appears to presume that the U.S. savings-investment imbalance is immune to changes in the exchange value of the dollar. Several perspectives counter this presumption.

First, the exchange value of the dollar is a summary statistic of the U.S. economy's relative performance on the global stage. The dollar reflects the interplay of several factors, including spending and saving by U.S. consumers, businesses, and government, relative to those abroad; expectations for U.S. economic returns, relative to those abroad; and the monetary policy primitives of the funds rate (or more recently quantitative easing) and outcomes of inflation, relative to those abroad. The dollar cannot be uniquely disentangled from our imbalances because the dollar also reflects the savings-investment outcomes of other countries. To suggest that the dollar cannot affect the U.S. trade imbalance implies that it similarly has no effect on the individual and collective trade imbalances of other countries. The vocabulary of "currency wars" implies that many policymakers believe otherwise.

Going back to the work of Joan Robinson, Alfred Marshall, and Abba P. Lerner, it is clear that the value of a country's currency is important for consumption and production decisions and resource allocation. Although these researchers worked in a world where international capital flows did not dominate, it remains the case today that international capital does respond to expectations for, and in turn does affect, real resource reallocations.

Today, the signal for relative price adjustment still comes from external imbalance—but more so from imbalances in international asset portfolios. When the external imbalance gets "too large" whether in flow or stock terms, the exchange value of the country's currency adjusts, and so do internal and external balance. While this has been most dramatic in the cases of Latin debt and the Asian crisis, the process has unfolded for the dollar as well. In 2002, the dollar moved from trend appreciation to trend depreciation because the supply of U.S. assets offered to international investors exceeded those investors' preferences, given the asset composition and growth of their portfolios. The adjustment of real investment, production, and consumption in the United States to the dollar depreciation took time to unfold, but both internal and external balances narrowed.

In 2013 and going forward, the dollar will reflect global asset preferences, including attitude toward risk and desire for return, but the implications of the asset allocation choices will unfold in the real economy with consequences for both trade and domestic imbalances.



I buy at least half of McKinnon's argument.

PAUL CRAIG ROBERTS

Former Assistant Secretary of the U.S. Treasury for Economic Policy, former Associate Editor,* Wall Street Journal, *and author of* Wirtschaft Am Abgrund *(Weltbuch, Dresden, 2012)

I buy at least half of Ronald McKinnon's argument. Despite exchange rate changes and a substantial weakening of the dollar with respect to the Chinese yuan, the U.S. trade deficit with China has risen. From 2006 through 2011, the value of the U.S. dollar in terms of the yuan has fallen from 8.1 to 6.3, a decline in the dollar's exchange value of 22 percent or 29 percent, depending on the base.

During this period, the U.S. trade deficit with China rose from $232.5 billion to $295.5 billion, an increase of 27 percent.

The question is: Is the U.S. trade deficit with China due to large discrepancies in the savings behavior of the two populations, with Americans splurging on imports and the Chinese not, or is it due to U.S. corporations offshoring their production for their U.S. markets?

Why do economists think exchange rate or savings discrepancies account for the U.S. trade deficit with China when the main driver of the deficit is labor arbitrage by U.S. corporations? Goods produced abroad for home markets enter as imports. About 50 percent of the U.S. trade deficit with China is the offshored production of U.S. corporations.

A few years ago when I looked into this matter, some of the Chinese coastal cities reported that 60 percent or more of their exports were the products of U.S. firms.

In addition to lower labor costs, offshoring provides lower environmental, regulatory, and compliance costs. These savings go directly into profits, managerial bonuses, and shareholder earnings. The rise in the U.S. trade deficit is an external cost that is not paid by the U.S. corporations.

Some years ago when I testified before the U.S.-China Commission, some economists estimated that a 30 percent rise in the Chinese currency would balance the trade between the two countries. Obviously, this estimate was incorrect.

Other economists were misled by reports in the early years of this century that Chinese manufacturing employment was falling. These reports reflected employment effects of the closure of state-run enterprises and various statistical confusions.

In the April 2009 *Monthly Labor Review,* the U.S. Bureau of Labor Statistics reported that despite a 40 percent rise in the compensation costs of Chinese labor, Chinese manufacturing employment increased by more than 10 percent to 112 million during the four years from 2002 to 2006.

U.S. manufacturing employment as of December 2012 was just under twelve million.

Despite a very weak U.S. economy, the U.S. trade deficit widened substantially in November 2012, the last available data at time of writing.

In my opinion, McKinnon is correct in this way: Americans cannot save, because they are heavily in debt and their real incomes have been falling for some years. They shop at Walmart where approximately 70 percent of the goods available are made in China, much of which is the offshored production of U.S. corporations.

No, exchange rates must be at the center of the global discussion.

JEFFREY SHAFER

Visiting Lecturer of Public Affairs, Princeton University, and former Undersecretary of the U.S. Treasury for International Affairs

Fixed or heavily managed real exchange rates can and have helped produce large, persistent current account imbalances. This is not because exchange rates alter current accounts without changes in saving-investment balances—that would be illogical—but because they can generate endogenous changes in these balances. Prominent examples from the past decade are first, the imbalance of China *vis-à-vis* the United States and increasingly others, and second, the intra-eurozone imbalance between Germany and the southern perimeter of the zone.

In the first case, as China gained competitiveness, the renminbi's value in dollar terms was held down by large-scale purchases of dollar securities by the Chinese authorities in the presence of extensive capital controls, which limited monetary spillover and adjustment. As the resulting price distortion reduced the competitiveness of tradable goods produced in the United States, slowing demand was countered by easy monetary conditions consistent with inflation stability. Demand was transferred to non-tradable housing investment and sustained by a widening fiscal deficit when housing demand eventually collapsed. On the Chinese side, strong tradables demand allowed growth to be sustained with rising government and state-owned enterprise saving. Fortunately this imbalance is being unwound, partly as a result of renminbi appreciation, but largely as a result of government-driven infrastructure investment and rapid wage increases in China's tradables sector. This is creating conditions under which the United States can bring its fiscal deficit down and where failure to do so will carry higher costs for it at home. China is succeeding in strengthening domestic demand.

In the case of the euro imbalances, a similar shift towards unsustainable nontradables activity (housing and government spending) took place in the southern countries as competitiveness diverged by one-quarter to one-third after establishment of a single currency and the asymmetrical shock of labor market reforms in Germany.

These imbalances were supported by capital flows in an environment of expectations that cross-border credit risks as well as exchange rate risks had been eliminated by the establishment of a common currency. The result has been a crisis with deep and long-lasting consequences. The fiscal tightening demanded by Germany is easy for that country, given its strong external demand, but has created a downward spiral in its uncompetitive partners. The adjustment of relative costs has begun but will be very slow and painful without the instrument of nominal exchange rate adjustment.

This is not to say that the exchange rate is always the driver of current account imbalances. The U.S. policy mix of tight money and easy fiscal policy in the early 1980s drove up the dollar and the U.S. current account deficit to satisfy the saving-investment-external balance identity.

These and other cases underscore the need to keep the exchange rate, along with monetary and fiscal policy, in the center of discussions among economic powers regarding collective responsibility for global economic stability. Unilateral maintenance of an exchange rate that creates unsustainable imbalances must not be allowed.

The argument that exchange rate changes cannot induce large changes in exports and imports is overstated.

MICHAEL J. BOSKIN
Tully M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and former Chair, President's Council of Economic Advisors

The intellectual history of economics traditionally focused far more on international trade flows than international capital flows. It was as if the national income identity relating net exports to the saving-domestic investment balance went in one direction: trade flows determined passive capital flows. The helpful emphasis on saving-investment imbalances as drivers of international trade in recent decades is not only vital to understanding patterns of trade but also the performance of each economy. My colleague Ron MacKinnon has been an important leader in this renaissance in international finance.

The argument that exchange rate changes cannot induce large changes in exports and imports is overstated. To be sure, the saving-investment imbalances are important determinants of trade as well as capital flows. But they themselves are driven by fundamental determinants of domestic saving and investment, which in turn can be directly and indirectly affected by exchange rates as well as other factors such as government budget deficits, relative income growth, demography, real net-of-tax rates of return, and cyclical conditions. In short, I think of international trade and capital flows, of net exports and saving-investment balances, as simultaneously determined.

Given empirical estimates of elasticities, the size of the exchange rate adjustments that would be necessary, by themselves, to balance trade is quite large and often resisted by governments and central banks. The last thing a weak global economy needs is what Bundesbank President Jens Weidmann calls a "currency war." "Rebalancing" trade will likely require adjustments both in saving-investment imbalances and exchange rates, not relying solely on one to drive the other. With central banks resisting appreciation given endless Fed quantitative easing, that means the U.S. saving rate rising, most importantly by the government borrowing less, and China's consumption share rising from very low levels.

Finally, in a world economy with global supply chains, exchange rates will only affect a portion of the value-added of exports. For example, much of China's exports of computers and cell phones involves re-exporting components from Japan, Taiwan, Korea, and so forth, embedded in goods assembled in China. Appreciation of the yuan would only affect the relative cost of the Chinese value-added component, unless the other currencies appreciated simultaneously. We must also consider the well-documented very incomplete pass-through of exchange rate changes to domestic prices and various home-country biases in consumption and investment.

The OECD and World Trade Organization have begun a project on integrating trade flows with national input-output tables (but for which the numbers are somewhat out of date and likely miss some of the rapid evolution of the global supply chain). The preliminary results paint a picture of many products combining parts or components from many countries, something that was less prevalent historically (but has always been the case to some extent, for example in Milton Friedman's famous example of the price system, including exchange rates, harmonizing many interests from around the world to produce something as simple as a pencil.)

Thus my conclusion is that both the saving-investment balance and exchange rates matter for the determination of trade flows, but the main route to reducing global trade imbalances lies in policies leading to adjustments in global saving and consumption patterns.

Much of McKinnon's thesis is valid.

BERNARD CONNOLLY
CEO, Connolly Insight L.P.

Much of McKinnon's thesis is valid. In a non-bubble world, trade balances would reflect relative rates of return on capital: a country with a high rate of return would appropriately tend to run trade deficits. The role of the exchange rate in this process is not to eliminate such trade deficits but to help ensure both that intertemporal prices (including relative interest rates adjusted for expected currency moves) remain in line with anticipated rates of return and also that swings in the anticipated rate of return on capital do not lead to unnecessary output gaps in one direction or the other.

Given that, why has China, which for the past couple of decades presumably had a relatively high anticipated rate of return on capital—though it is now falling rapidly—had large trade surpluses with the United States, an apparently "mature" economy? Of course, part of the answer is that one should not focus on bilateral balances. Even so, there have been other factors at work. During the mortgage bubble there appeared—wrongly—to be a high rate of return on U.S. residential and commercial construction and in the financial firms that financed such construction. When that bubble burst, the rate of return was revealed to be significantly lower than had been thought and U.S. demand to borrow from the rest of the world diminished. Dollar weakness has mitigated the impact of U.S. demand weakness on U.S. output and employment. In this interpretation of events, U.S. developments (and developments in other Western "bubble" economies, notably Spain—which before the crisis had the second-biggest current account deficit in absolute dollar terms, exceeded only by that of the United States)—are as responsible for the Chinese surplus as the other way around.

Nonetheless, the "China-bashers" are not entirely wrong. China's surpluses may have been necessary from that country's point of view, given structural impediments, such as the one-child policy, to domestic demand. But if China had had a stronger exchange rate and stronger domestic demand, avoiding or minimizing output gaps in the United States might have been consistent with somewhat less need for bubbly domestic demand in the United States. That may have been a relatively minor component in what went wrong—and is still wrong—in the United States. But, starting from here, a path towards full equilibrium in the United States would have to involve higher real interest rates—and less bringing forward of domestic demand from the future—and a weaker dollar. To achieve that combination, there needs to be a "jump" onto a different forward curve—a loss of "confidence" in the dollar. Unfortunately, one can say much the same thing about several major economies. As Bank of England Governor Mervyn King keeps insisting, the pattern of trade surpluses and deficits in the world cannot be made consistent with non-bubble conditions except through changes in relative domestic demand levels compensated for by currency-driven swings in net exports. That has to be recognized, despite elements of validity in McKinnon's thesis. But doing it will be almost impossible.

Saving adjustments and exchange rate adjustments are not alternatives.

MARTIN N. BAILY
Senior Fellow, Economics Studies, Bernard L. Schwartz Chair in Economic Policy Development, and Director of the Business and Public Policy Initiative, Brookings Institution

It is a mistake to pose saving adjustments and exchange rate adjustments as alternatives. If there is to be greater balance in the global trading system, the United States, China, and other countries have to change both their saving rates and their exchange rates.

In the United States, national investment has exceeded national saving for much of the last thirty years, with the gap covered by inflows of capital that push the value of the dollar above the level consistent with trade balance. Going forward, the United States should save more and be less dependent on foreign capital. Reducing the federal budget deficit is the obvious way to do this and increasing household saving would be helpful, too, but hard to accomplish. Because of the weakness of the U.S. and global economic recoveries, deficit reduction should be done slowly, making sure it does not undermine growth in demand. The U.S. dollar has depreciated substantially in

recent years. If policymakers manage deficit reduction well and the economy returns to full employment, further depreciation may occur.

China is the opposite of the United States. Even though its rate of investment is huge, it saves more than it invests domestically and the extra saving, working with a pegged exchange rate, generates a trade surplus. China needs to stimulate domestic spending, especially consumption, which would both help the global recovery and avoid a return to the massive trade surpluses China has run in the recent past. As it expands domestic consumption, it must appreciate its currency.

China and the United States are not the only countries that should adjust. Other Asian countries have used high saving rates and undervalued currencies to run sustained trade surpluses. Germany needs to stimulate domestic demand and tolerate some inflation in order to appreciate its effective real exchange rate within the euro area. (The euro precludes any other form of relative exchange rate adjustment within the zone).

The most important global economic problem today is the lack of adequate demand and the resulting high level of unemployment, but getting back to full employment with huge trade imbalances would be a flawed victory. Trade surplus countries should take the lead in stimulating domestic demand and letting their real (inflation-adjusted) exchange rates adjust upwards. China has participated in this effort, should be applauded for doing so, and encouraged to continue.

With the U.S. trade deficit, it is unwise to focus only on those drivers that are comfortable and ignore others.

GREG MASTEL
Senior International Tax and Trade Adviser, Kelley Dry & Warren LLP

Is China's exchange rate the only problem? Some scholars point out that China's manipulation of its currency is not the sole cause of U.S. trade and economic imbalances with China. It would, of course, be misguided to suggest otherwise. It would be equally misguided, however, to turn a blind eye to China's currency manipulation.

The drivers of U.S.-China trade and investment imbalances are complex and interrelated. Although there is a fundamental accounting relationship between U.S. high spending/low saving and the U.S. trade deficit, it is both politically and substantively unwise to focus only on those drivers that are comfortable and ignore others.

Currency manipulation for trade gain is not a problem unique to China. It is a problem recognized from the beginning of the world economic system. Unfortunately, many countries have tried to game the system over the years and effectively export unemployment to their trading partners. For some years, most observers, including the International Monetary Fund, the U.S. Treasury, and most outside observers, have agreed that China was systematically suppressing the value of the renminbi (though some shied away from the term manipulate). This artificially low value of the renminbi is part of a web of policies including lax protection of intellectual property, selective tax rebates, and other measures aimed at discouraging imports and building export industries.

One only needs to read the statements of China's leaders to see admission that China has manipulated the renminbi exchange rate for trade gains. In 2010, China's Premier Wen Jiabao argued that China could not allow the renminbi to appreciate because "We cannot imagine how many Chinese factories will go bankrupt, how many Chinese workers will lose their jobs." This is the core reality of China's renminbi policy stated from the top.

Just as is apparently the case in Wen Jiabao's China, currency manipulation is not a purely academic discussion in the United States. "We cannot imagine" how many U.S. factories and workers are touched by renminbi manipulation. If U.S. policymakers ignore confessed cheating by China, political support for open trade with China will inevitably dissolve with attendant economic consequences for Washington, Beijing, and the world.

It is entirely fair to suggest that the United States should also focus on reining in spending and increasing saving for its own long-term economic health. But it is every bit as fair to suggest that China stop trying to restrict imports, manipulate investment, and artificially boost exports. Appreciating the renminbi would boost the standard of living of Chinese citizens by allowing them to afford more imported goods and, at the same time, boost imports, which would ease economic frictions while aiding in the economic recovery of China's trading partners, including the United States.

Though there is good reason to be skeptical that it represents a true shift, China has allowed modest appreciation of the renminbi over the last two years. There is no doubt that both Washington and Beijing have other economic challenges to address, but those other challenges are no reason to ignore or excuse China's admitted manipulation of the renminbi.

Conclusions for the real world based on an identity like the savings balance are generally questionable.

HEINER FLASSBECK
Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

My first objection against McKinnon's point is a rather abstract but important one: conclusions for the real world based on an identity like the savings balance are generally questionable. There is no direct link between a current account deficit and the saving behavior ("saving deficiency") of certain sectors of a country other than an accounting identity. If we look at the economies involved with the benefit of hindsight, we will find that by definition of our bookkeeping rules, no country can have run a current account deficit that was not financed by (the net "savings" of) other countries. "Savings deficiency" is the visible result of something but not necessarily the result of too little savings in the first round. The identity is totally silent on causality and the mechanisms leading to such an outcome. However, as in most cases where savings are involved, the conjecture of neoclassical theory—automatically assuming that savings have been in the lead position and investment is following—is not tenable. Just look at the paradox that most of the poorer countries nowadays are surplus countries. Is that the result of a surplus of savings in the proper sense of the word or just fear to run into current account deficits again, given their painful experience with financial crises and creditor conditionality?

Second, once the identity is rejected as explanation, it is difficult to understand why the market mechanism should not be applicable for the world's biggest market economy. If exchange rates change and the real exchange rate moves, trade is influenced including the balances of trade, what else? For example, why did Germany and not France dramatically increase its surplus with the United States during 2012? Evidence regarding trade relations in the European monetary union in general and between Germany and France in particular tells us that a huge divergence in competitiveness has emerged in the last ten years, favoring German products due to a wage-driven real depreciation inside EMU.

Financing of trade imbalances induced by price divergences is normally no problem. In the case of financial crises, it is. And here lies a core of truth in McKinnon's "fallacy." The United States never goes into a financing crisis as result of high current account deficits because their currency is—up until now—not questioned as means of payment. In a world where every country tries to become a creditor because debtors are treated so badly by the creditors in case of crisis (look at EMU!), the United States is globally more and more the only reliable debtor.

Exchange rates matter.

RICHARD C. KOO
Chief Economist, Nomura Research Institute

I have not read Professor McKinnon's book, but for decades, Japan's academic thinking on international trade was dominated by one person, Professor Ryutaro Komiya of Tokyo University, who argued that savings and investment, not exchange rates, determine trade balances. Based on this view, he argued that the U.S. pressure on Japan to open its market or push the yen higher was totally meaningless. With every elite bureaucrat in the country indoctrinated at the same university and by the same set of professors, the Japanese government steadfastly opposed the U.S. effort to open its market. While they were mostly successful in fighting individual battles on semiconductors or auto parts, the mounting pressure from trade imbalances on the foreign exchange market kept on pushing the Japanese currency higher, from ¥360 to the dollar in the early 1970s to ¥79 to the dollar by the middle of the 1990s. That exchange rate finally pushed even the most domestically minded Japanese companies out of Japan. With regional economies devastated by one factory closure after another, even the hard-core believers of Komiya had to think about opening the market to ease the pressure on the exchange rate. Today, the Japanese market is dramatically more open than it was just fifteen years ago, and the once-ridiculed *naigai-kakakusa,* or differential between domestic and foreign prices, is a dead phrase in Japanese now. Japan moreover is now running a trade deficit thanks to the excessively strong post-Lehman real effective exchange rates adjusted for export composition. So yes, exchange rates do matter.

While exchange rates affect trade, trade also affects exchange rates. Since international portfolio flows were deregulated starting in the late 1970s, trade flows no longer determine exchange rates in the short run. But no foreign exchange dealer worth his salt will totally ignore trade and current account developments because portfolio investors can always change their minds, whereas Toyota and Volkswagen have no such choices: they have to sell all their foreign exchange earnings to pay their workers and suppliers at home. When investors are not sure of the direction of the exchange rate, which is often the case, trade flows dominate the market because those flows cannot wait. Even though trade accounts for less than 5 percent of foreign exchange trades these days, the fact that those involved in the remaining 95 percent keep an eye on trade statistics before taking positions means that trade flows do have an impact on exchange rates in the long run.

With exchange rates and trade affecting each other in complex and variable ways, no simple economic model is likely to provide all necessary guidance for policymakers. Policymakers must look at all indicators, including *naigaikakakusa,* to see which impediments should be corrected in order to better the lives of the largest number of constituents.

Manipulating exchange rates is an exercise fraught with risk.

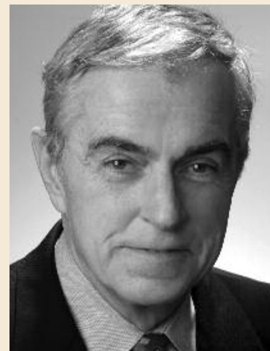
CLAYTON YEUTTER
Senior Advisor, Hogan Lovells, LLP, and former U.S. Trade Representative

Exchange rate intervention (manipulation, if you will!) can certainly affect trade flows and investment flows (the flip side) in the short run. Some governments have demonstrated that with some regularity over the years. In the long run, however, such efforts are destined to fail, perhaps ignominiously, often doing more harm than good.

The global marketplace is just too large for governments to be able to sustain an intervention program of "matching size" indefinitely. The private sector marketplace is in itself too large for governments to succeed in such an endeavor in the long term. Notwithstanding the recent global recession, worldwide trade and investment flows are still massive, and they'll increase over time as national economies recover. Hence, the message to governments is to stay on the sidelines, but deal vigorously and decisively with any private sector desires to manipulate any of these markets—exchange rate, investment, or trade in goods and services.

An additional reason for governments to remain on the sidelines is that they do not have factual bases adequate for intervention decision making. Export and import trade numbers are of questionable usefulness, in all countries, because they only reflect the locale of final shipments (for exports) and arrival points (for imports), not the countries of origin for intermediate products or services. Is a Samsung television truly a Korean export? Or, upon its arrival in the United States, the import of a Korean product? Is a Boeing aircraft truly a U.S. export? Or, upon its arrival in China, the import of a U.S. product? Both contain scores of intermediate products from other countries.

Manipulating exchange rates is an exercise fraught with risk. The ultimate outcome just might be the opposite of what was intended.



Large trade imbalances cannot be reduced without adjustments in domestic savings and investment. But there is potential for real effective exchange rate adjustments to facilitate necessary savings and investment adjustments.

RICHARD ERB
Former Deputy Managing Director, International Monetary Fund, and Instructor, University of Montana-Missoula

I recall my graduate days at Stanford and a price theory course I took from a young Ron McKinnon. I also recall that it was during the 1960s that McKinnon began exploring the financial and monetary dimensions of economic development. McKinnon's 1973 *Money and Capital in Economic Development* and later publications developed new ways of thinking about economic development.

I agree with McKinnon that large trade imbalances between countries such as China and the United States cannot be reduced on a sustained basis without adjustments in domestic savings and investment, and that both deficit and surplus countries need to adjust. I also agree that countries cannot rely on exchange rate adjustments alone to catalyze the necessary domestic savings and investment adjustments.

But I think there is potential for real effective exchange rate adjustments to facilitate necessary savings and invest-

ment adjustments. I also have been concerned that large-scale intervention over many years to prevent renminbi appreciation has had negative consequences for China's domestic economy because of the need to offset that intervention with various forms of domestic sterilization. Among other things, I believe it has delayed the implementation of domestic monetary and financial reforms.

In spite of the political and theoretical debates in the United States, the Chinese continue to do their own thing. The 2012 IMF Article IV Staff Report for China devoted almost four pages to describing China's exchange rate policies since 2005. The report also described a 30 percent real effective appreciation of the renmimbi since 2005. Looking ahead, as China continues to implement domestic financial and foreign exchange market reforms, I believe it will find it increasingly difficult to "manage"—or "manipulate" as others might say—its exchange rate.

I believe that countries pay a lot more attention to what other countries do and experience rather than what Washington experts say. A lesson that was learned during the Asian financial crisis and reinforced by China's exchange rate policies over the past decade is that it is far better to have an undervalued exchange rate than an overvalued exchange rate. That's a major change from the period of the 1970s to the 1990s when many countries experienced balance of payments crises because of an overvalued exchange rate. But the risks of political and trade conflicts over exchange rate policies and adjustment asymmetries between deficit and surplus countries are higher today than at any time since my graduate days at Stanford.

Yes, McKinnon is right, again.

STEVE H. HANKE
Professor of Applied Economics, Johns Hopkins University

Since the demise of the Bretton Woods system, the world has operated under what Ron McKinnon dubs "the unloved dollar standard." McKinnon argues that there are good reasons why the world can't kick the dollar standard, and he then shows us why we should, and how we can, learn to love a greenback standard. Yes, McKinnon is right, again.

That said, he is swimming against a strong current of wrong-headed thinking emanating from Washington. Let's take a look at where the contra-McKinnon illuminati stance on the dollar's role has led us.

The United States has recorded a trade deficit every year since 1975. This is not surprising because savings in the United States has been less than investment. The trade deficit can be reduced by some combination of lower government consumption, lower private consumption, or lower private domestic investment. But you wouldn't know it from listening to the counterproductive trade and currency warmongering coming out of Washington.

From the early 1970s until 1995, Japan was the enemy. The mercantilists in Washington asserted that a weak yen was at the root of the U.S. bilateral trade deficit with Japan and that it could be reduced if the yen appreciated against the dollar.

Washington even tried to convince Tokyo that an ever-appreciating yen would be good for Japan. Unfortunately, the Japanese complied, and the yen moved from ¥360 to the greenback (1971) to ¥80 (1995). The yen's great appreciation caused the Japanese economy to sink into a deflationary quagmire. In consequence, the United States stopped arm-twisting the Japanese government. But it was too late—even today, Japan continues to suffer from the mess created by the yen's appreciation.

What about the U.S. trade deficit? As the yen appreciated against the greenback, Japan's exports to the United States surged and so did its contribution to the U.S. trade deficit. Indeed, from 1978 to 1991, when Japan's contribution to the U.S. trade deficit peaked, the yen appreciated by 74 percent against the dollar, and the Japanese contribution to the trade deficit moved from 27 percent to almost 60 percent.

Did this fantastic failure of American-induced "currency manipulation" stop the Washington illuminati? Hardly. Once China started to overtake Japan as the biggest contributor to the U.S. trade deficit, China and the yuan became Washington's favorite whipping boys.

What to do? Here I differ in detail, but not spirit, from McKinnon. The world's two most important currencies—the dollar and the euro—should, via formal agreement, trade in a zone ($1.20–$1.40 to the euro, for example). The European Central Bank would be obliged to maintain this zone of stability by defending a weak dollar and the Fed would be obliged to defend a weak euro.

The East Asian dollar bloc, which was torpedoed during the 2003 Dubai Summit, should then return—with the yuan and other Asian currencies tightly linked to the greenback. As for other countries (Brazil, for example), they should adopt currency boards, linked to either the dollar or euro.

Let's put an end to the "currency wars." When it comes to exchange rates, stability might not be everything, but everything is nothing without stability.