International Adjustment under the Dollar Standard: Japan and China Versus the United States

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Motivation

- After 1997-1998 crisis, the high-saving East Asian economies:
  - Returned to “soft” dollar pegging of exchange rates
  - Ran consistent current account surpluses
  - Accumulated very large foreign-currency claims: private and official, largely in dollars.

- Foreign criticism
  - Intensified pressure from the U.S. and European governments for China to appreciate.
  - The IMF’s institutional position favoring exchange rate flexibility
    - “There should be more flexible currencies, not only for China but the whole of Asia” Rodrigo de Rato, IMF Managing Director, 29 Sept 2004 at IMF-World Bank Meetings

- On 21 July, 2005, China abandons its 10-year-old fixed exchange rate
Current account surpluses as a percentage of GDP in EA countries

Source: IFS, IMF; some of the 2004 GDP data were obtained from statistic bureaus of various countries
Current Account Surpluses: US and East Asia

Source: IFS, IMF; some of the 2004 data and estimates were obtained from EIU
The Dollar Standard and East Asia’s Trade Surplus: The DFG Interpretation*

• “Revived Bretton Woods”
  – EA Exchange Rates deliberately undervalued to generate a trade surplus.
  – Exports are desired to promote “development”, particularly in manufacturing.
  – Asian governments are willing to invest in very low yield US Treasuries, and to accept American FDI with high profit repatriation.
  – US gets finance for its fiscal deficits

• The ongoing US current-account deficit need not be corrected in the near future

The current regime:

- With the dollar as international money, the efficiency of world trade and payments increases.
- With a stable U.S. price level, peripheral countries will peg to the dollar to anchor their own price levels—particularly East Asian countries highly integrated in trade.
- Converges to relative purchasing power parity (PPP) if nominal exchange rates remain fixed: China’s exchange rate is not “undervalued”.
Figure 3
China - US Inflation Differential and Exchange Rate, 1993-2005

Source: IMF
Exchange rate appreciations in creditor economies.

- Appreciation slows economic growth because of negative export, wealth, and investment effects: import growth falls
- Thus, no predictable effect on net trade balances.
- But loss of credibility to maintain the exchange rate at any level
- Floating could lead to an indefinite upward spiral in the creditor’s currency against the dollar and to deflation, as in Japan in the 1980s into the 1990s
- Might China now follow the earlier path of Japan?
The Dollar Standard and the United States: MCK Interpretation

- The unlimited US credit line with the rest of the world in dollars softens borrowing constraints on US households, and the federal government.

- Federal fiscal deficits are easily financed by selling dollar bonds to foreigners at low interest rates.

- Large current account deficits are sustainable “indefinitely” because of the central international monetary position of the United States.

- The upshot of easy foreign borrowing is:
  - falling US saving, both government and private, for more than 20 years.
  - deindustrialization, loss of jobs in manufacturing, leading to protectionist pressure.
US Current Account and Manufacturing Sector Trade Balance: 1965 - 2004

(Percentage of GDP)

Source: Bureau of Economic Analysis
Projection of Labor Growth in Manufacturing under Balanced Manufacturing Trade: 1965 - 2004

(Share of US Labor Force)

Source: Bureau of Economic Analysis, Survey of Current Business
Figure 1
Bilateral Trade Surpluses of Japan and China with the US, 1955 - 2004
(proportion of U.S. GDP)

Source: Kenichi Ohno
Restraining American Deficits?

• The Fed creates the definitive international money. An attack on the dollar is unlikely because US debts are denominated in its own currency.

• But heavy US foreign borrowing is transferred in real terms through large American trade deficits, mainly in manufactures.

• The American concern with de-industrialization, i.e., unduly rapid job losses in manufacturing, should be linked to Federal fiscal deficits and low American personal saving.
Reforming US Economic Policy

• In the long run, U.S. must increase private saving and reduce fiscal deficits of the federal government.

• But such adjustments must be gradual to avoid a downturn in the world economy.

• In the short run, the Federal Reserve Bank should tighten monetary policy to alleviate dollar weakness, curb excess consumption, and rein in inflation.

• A general depreciation of the dollar will not correct the US current account deficit, but could threaten a surge of inflation in the United States itself as in the 1970s.

Exchange Rate or Wage Changes in International Adjustment?

• Two Contradictory Views
  1. A flexible exchange rate is useful for adjusting the net trade balance because the wage level is inflexible.
  2. A fixed exchange rate can anchor the domestic price level and induce flexibility in money wage growth to balance differences in rates of productivity growth across countries.

• Because 1. can be false and misleading for open economies, McKinnon and Ohno (1997), the rest of this presentation focuses on 2: differential wage growth that balances international competitiveness.
The Scandinavian Model (SM)

- Wage adjustment and relative Purchasing Power Parity (PPP) under a fixed exchange rate – balancing international competitiveness

  - Sweden, 1948 to 1971
    5.17 kronor per dollar

  - Japan, 1949 to 1971
    360 yen per dollar

  - China, 1994 to July 21, 2005
    8.28 yuan per dollar
Scandinavian Model

Assumptions:

- Inflation in the tradable manufacturing sector converges to world inflation when the exchange rate is fixed (relative PPP).
- Wage bargaining is initiated in the high-productivity-growth tradables sector (manufactures) subject to the exchange rate constraint.
- Labor “solidarity”: wage growth in other sectors with lower productivity growth follows that in tradables.

Result:

- International competitiveness between fast- and slow-growing economies is automatically balanced by differential growth in wages.
Determinant SM Wage Bargaining with a Fixed Dollar Exchange Rate

- Dollar is the key currency: most trade is invoiced in dollars with “pricing to market”
- U.S. price level is stable with relative PPP
- Wage bargaining
  - Bidding for workers in tradables constrained by the fixed exchange rate.
  - Money wage growth reflects ongoing productivity change in the tradables sector
  - Wages then grow similarly in other sectors
- Compare Japan 1949 -1971 to China 1994 - 2005
Table 1: Key economic indicators for Japan and the U.S. under a fixed yen/dollar exchange rate, 1950-1971
(average annual percent change)

<table>
<thead>
<tr>
<th>Wholesale prices</th>
<th>Money wages</th>
<th>Consumer prices</th>
<th>Industrial production</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>Japan</td>
<td>U.S.</td>
<td>Japan</td>
</tr>
<tr>
<td>1.63</td>
<td>0.69&lt;sup&gt;a&lt;/sup&gt;</td>
<td>4.52</td>
<td>10.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Real GDP</th>
<th>Nominal GDP</th>
<th>Narrow money</th>
<th>Labor productivity</th>
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</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>Japan</td>
<td>U.S.</td>
<td>Japan</td>
</tr>
<tr>
<td>3.84</td>
<td>9.45&lt;sup&gt;a&lt;/sup&gt;</td>
<td>6.79</td>
<td>14.52&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

<sup>a</sup> 1952-1971.
<sup>b</sup> 1953-1971.
<sup>c</sup> 1951-1971.
Figure 1: Nominal Manufacturing Wage Growth for US and Japan: 1950 – 1971
Figure 2: Inflation and Wage Differentials between Japan and US, and Yen/Dollar Rate: 1950-2004
Indeterminant Wage Bargaining in the SM with a Floating Exchange Rate

- When the exchange rate fluctuates:
  - Relative PPP will not hold continuously
  - Exchange rate no longer anchors the domestic price level to world inflation.
  - Need for an independent national (demand-side) monetary policy.
  - Money wage bargaining over productivity gains now is in limbo. Employers cannot judge the course of domestic inflation relative to, say, an erratically appreciating exchange rate. A negative risk premium in wage growth?
  - The tradables sector need no longer be the leading sector for wage determination.
Table 2: Key economic indicators for China and the U.S. under a fixed yuan/dollar exchange rate, 1994-2003

(average annual rates of change)

<table>
<thead>
<tr>
<th>Wholesale prices</th>
<th>Money wages (Mfg)</th>
<th>Consumer prices</th>
<th>Industrial production</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>China</td>
<td>U.S.</td>
<td>China</td>
</tr>
<tr>
<td>1.53</td>
<td>1.26(^a)</td>
<td>3.03</td>
<td>13.04(^b)</td>
</tr>
<tr>
<td>Real GDP</td>
<td>Nominal GDP</td>
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<td>Labor productivity</td>
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<tr>
<td>3.17</td>
<td>8.55</td>
<td>5.03</td>
<td>10.74</td>
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\(^a\) Ex-factory price index.
\(^b\) 2003 data on manufacturing wages is projected from overall average wages from 1997-2003.
\(^c\) 1994-2002.
\(^e\) 1994-2002. R. Fernholz
Figure 3: Nominal Manufacturing Wage Growth for US and China: 1994 – 2003
Figure 4: China: Nominal Wages Across Different Sectors: 1994 – 2002
Reconsidering the Scandinavian Wage Bargaining Model: A Summary

<table>
<thead>
<tr>
<th>Relative PPP</th>
<th>Wage Bargaining Process</th>
<th>Money Wage Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Dollar Exchange Rate</td>
<td>Yes</td>
<td>Determinant</td>
</tr>
<tr>
<td>Floating Exchange Rate</td>
<td>No</td>
<td>Indeterminant</td>
</tr>
</tbody>
</table>
China’s New Exchange Rate Policy

Will China Follow Japan into a Liquidity Trap?

Ronald McKinnon
Stanford University

Federal Reserve Bank of San Francisco Conference
*External Imbalances and Adjustment in the Pacific Basin*
Sept. 22-23, 2005
Figure 1

Bilateral Trade Surpluses of Japan and China with the US, 1955 - 2004
(proportion of U.S. GDP)

Source: Kenichi Ohno
Figure 2

Source: Funke (2005)
Figure 3
China - US Inflation Differential and Exchange Rate, 1993-2005

Yuan/USD Exchange Rate (RHS)

CPI Inflation Differential: China - US (LHS)

Policy Change July 21, 2005

Source: IMF
Figure 4
Real Growth and Inflation in China, 1980-2005

Source: Gunther Schnabl
Figure 5
Short-Term Interest Rates: China, Japan and the United States

Source: IMF, Gunther Schnabl
Conclusions for East Asia

- Mutual exchange stability is a public good among integrated economies.
- Because an “Asian euro” is but a distant possibility, keying on the dollar is the only feasible way for securing intra-East Asian exchange stability and price-level alignment.
- Collective dollar pegging enlarges the zone of stable dollar prices far beyond trade with the United States: stronger mutual anchoring of national price levels.
- East Asian governments do not have well-defined portfolio targets for “optimizing” their stocks of dollar reserves.
- When forced to run (collective) balance of payments surpluses by U.S. deficits, indefinite reserve accumulation becomes residual to exchange rate targeting.
I. Conclusions for China
Before July 21, 2005

• Exchange rate fluctuations outside of a very narrow band disrupt international adjustment in money wage growth—as in the earlier Japanese experience.

• Foreign pressure on China to appreciate or float the renminbi is misguided, and will not correct international saving-investment imbalances.

• A credibly fixed central rate for the yuan/dollar balances international competitiveness by
  – anchoring China’s domestic price level, and
  – inducing growth in money wages to match differential labor productivity growth between China and the U.S.

  – Helping secure exchange stability in neighboring countries.
II. Conclusions for China
Post July 21, 2005

• After July 21, 2005, monetary-exchange policies are in limbo
  - No principle initiated for guiding monetary policy
  - No clear goal for the highly managed float

• Serious threat of zero-interest liquidity trap because of
  - expectations of a series of small appreciations
  - further liberalization of controls on foreign exchange flows and on domestic interest rates

• Threat of outright deflation once appreciations cumulate and are sustained: Japan déjà vu?