The End of China's Surplus

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CAMBRIDGE – China's current-account surplus – the combination of its trade surplus and its net income from foreign investments – is the largest in the world. With a trade surplus of $190 billion and the income from its nearly $3 trillion portfolio of foreign assets, China's external surplus stands at $316 billion, or 6.1% of annual GDP.

Because the current-account surplus is denominated in foreign currencies, China must use these funds to invest abroad, primarily by purchasing government bonds issued by the United States and European countries. As a result, interest rates in those countries are lower than they would otherwise be.

That may all be about to change. The policies that China will adopt as part of its new five-year plan will shrink its trade and current-account surpluses. It is possible that, before the end of the decade, China's current-account surplus will move into deficit, as the country imports more than it exports and spends its foreign-investment income on imports rather than on foreign securities. If that happens, China will no longer be a net buyer of US and other foreign bonds, putting upward pressure on interest rates in those countries.

Although this scenario might now seem implausible, it is actually quite likely to occur. After all, the policies that China will implement in the next few years target the country's enormous saving rate – the cause of its large current-account surplus.

In any country, the current-account balance is the difference between national saving and national investment in plant and equipment, housing, and inventories. This key fact is not a matter of economic theory or an historic regularity. It is a fundamental national-income accounting identity that must hold for every country in every year. So any country that reduces its saving without cutting its investment will see its current-account surplus decline.

China's national saving rate – including household saving and business saving – is now about 45% of its GDP, which is the highest rate in the world. But, looking ahead, the five-year plan will cause the saving rate to decline, as China seeks to increase consumer spending and therefore the standard of living of the average Chinese.

The plan calls for a shift to higher real wages so that household income will rise as a share of GDP. Moreover, state-owned enterprises will be required to pay out a larger portion of their earnings as dividends. And the government will increase its spending on consumption services like health care, education, and housing.

These policies are motivated by domestic considerations, as the Chinese government seeks to raise living standards more rapidly than the moderating growth rate of GDP. Their net effect will be to raise consumption as a share of GDP and to reduce the national saving rate. And with that lower saving rate will come a smaller current-account surplus.

Since China's current-account surplus is now 6% of its GDP, if the saving rate declines from the current 45% to less than 39% – still higher than any other country – the surplus will become a deficit.

This outlook for the current-account balance does not depend on what happens to the renminbi's exchange rate against other currencies. The saving-investment imbalance is fundamental, and it alone determines a country's external position.

But the fall in domestic saving is likely to cause the Chinese government to allow the renminbi to appreciate more rapidly. Higher domestic consumer spending would otherwise create inflationary pressures. Allowing the currency to appreciate will help to offset those pressures and restrain price growth.

A stronger renminbi would reduce the import bill, including prices for oil and other production inputs, while making Chinese goods more expensive for foreign buyers and foreign goods more attractive to Chinese consumers. This would cause a shift from exports to production for the domestic market, thereby shrinking the trade surplus, in addition to curbing inflation.

China's trade surplus and the renminbi's exchange rate were high on the list of topics that President Hu Jintao and US President Barack Obama discussed when Hu visited Washington earlier this month. The Americans are eager for China to reduce its surplus and allow its currency to appreciate more rapidly. But they should be careful what they wish for, because a lower surplus and a stronger renminbi imply a day when China is no longer a net buyer of US government bonds. The US should start planning for that day now.

Martin Feldstein, Professor of Economics at Harvard, was Chairman of President Ronald Reagan's Council of Economic Advisers, and is former President of the National Bureau for Economic Research.

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