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The Money Game

How Will US Savings Rates Rise If You Don't Penalize Consumption?

Michael Pettis | Apr. 2, 2010, 11:23 AM | 410 | 7

(This guest post previously appeared at the author's blog)

There seems to be a thaw in the currency war. President Obama and President Hu had a long telephone conversation today and my guess is that the Treasury will hold off on naming China a currency manipulator in two weeks.

I hate to be a pessimist, but this might be very temporary. Unless the US and China, with the involvement of Japan, Germany, and deficit Europe, don't work out very quickly a real agreement, in which surplus countries make serious efforts to create domestic demand over the next several years, and to reduce their surpluses, in exchange for which the deficit countries agree to slow down their domestic adjustments, the fight will only be very temporarily postponed, and the next round will be much angrier.

Any agreement must deal with more than the RMB. It must involve the whole range of issues which depress consumption in the surplus countries and force it up in the deficit countries. That means that not just the currency, but also interest rates and credit expansion (and workers wages, if anyone dares to address that). I suspect an important part of the discussion will involve Chinese attempts to reduce savings by improving the social safety net, since this is widely believed to be a reason for China's high savings, but as I have written many times, I think this issue is largely irrelevant.

My guess is that, unfortunately, along perhaps with promises on the social safety net, the currency will be the main topic. On that topic, Daniel Ikenson of the Cato Institute has an OpEd piece in today's Wall Street Journal in which he worries that "forcing China to appreciate its currency through sanctions will impose higher prices on American consumers, thereby reducing Americans' real incomes." Steve Roach made the same point in his Financial Times OpEd piece last week, and this is one of the most widely-cited reasons for opposing RMB appreciation or, what amounts to the same thing, dollar depreciation. But while it may be true that a depreciation of the dollar reduces the real value of current household income, it only reduces household income overall if you assume it has no employment effect.

But why make that assumption? I am pretty sure Paul Krugman, who recently had a spat with Roach on the subject of RMB revaluation, would agree 100% with both Roach and Ikenson that dollar depreciation, or RMB appreciation, would have no beneficial effects for the US if he also believed that it would have no impact on reducing US unemployment.

But of course he doesn't believe that. Nor does Beijing, for that matter. For Krugman, and most trade economists, including those in China, an undervalued currency shifts domestic demand away from imported goods to domestically-produced goods, and so increases domestic employment, although in the case of the RMB appreciation this will not occur as a simple substitution of Chinese-produced goods for US-produced goods, as I argued in last week's posting. The way to think of it, as Krugman points out, is simply to focus the relationship (an accounting identity, and so inviolable in both practice and theory) between net capital exports and the current account surplus. Forced capital exports are a way of forcing domestic absorption of foreign net demand, and of course it is through currency intervention that China forcibly exports capital to the US, which shifts demand from US producers to Chinese producers.

In the US, with its high unemployment rate, if this shift in demand causes unemployment to fall, it will cause nominal US household income to rise. If the positive impact on overall household income of depreciation (the rise in employment) is greater than the negative impact (higher prices for imported goods), which is very likely, the net effect will be a real increase in household income, not a reduction.

But there is a second, perhaps more important, reason to wonder whether concern about the adverse effect on consumers of dollar depreciation is relevant. Almost everyone agrees that the US saves too little and consumes too much and conversely almost everyone agrees that China consumes too little and saves too much. And how could they not agree? These countries probably have the highest and lowest consumption rates, respectively, ever recorded.

An important part of the reason for both problems is that Chinese consumers are effectively subsidizing American consumers. An undervalued exchange rate and repressed interest rates mean that Chinese households have transferred part of their income to Chinese producers to lower the cost of production. This cheap cost is transferred via exports to American and other consumers. This effect is magnified by the stupendous ease with which the American financial system can convert recycled capital inflows into incredibly foolish consumer lending.

Given the magnitude of the effective subsidy for American consumers, and the even greater magnitude of the penalty for Chinese consumers, it is perhaps not so surprising that US households are consuming too much and Chinese households too little. Now here comes the politically tricky part. If you want US savings rates to rise, it is a waste of time pleading for it. The only way the savings rate can rise is, by definition, if production growth exceeds consumption growth – after all savings is just production minus consumption.

So like it or not, if you want Americans to save more you must agree that either it must make production relatively easier, or consumption relatively more difficult, or both, and as it does this, as long as investment rises more slowly than the increase in savings, the aggregate impact will be a decline in the US trade deficit and, forcibly, a decline in the rest of the world's trade surplus. A depreciation of the dollar does both.

But of course it is not painless. When people argue that the US savings rate must rise, and at the same time argue that it is unfair to penalize US consumers (which in this context mean removing foreign subsides for consumption), I am always seized with a sense of unreality. We are saying that we must correct the imbalances but it must be done at no cost to the consumer.

I am not sure that is going to be easy. If we subsidize producers to make them produce more, it will be done at someone's expense – either US taxpayers or foreigners. If we penalize consumers (by removing the existing implicit subsides), clearly they are bearing the cost directly. By eliminating sub-prime lending, we penalized American consumers, and willingly or unwillingly we are going to continue doing so until consumption returns to a more reasonable level. One way or the other, rebalancing the US economy means tilting away from consumption and towards production, and although we can theorize about painless ways of doing it (Get Washington to stop wasting money! Improve education and infrastructure investment!) the fact is that in the short run it will be very hard to do so without penalizing consumption.

By the way China faces the obverse problem. For years Beijing has insisted that it wants consumption to rise as a share of national income, and instead it has declined. Why? Because Beijing wants to tilt the balance towards consumption without having producers pay the cost. In other words it wants producers to continue benefiting from excessively low interest rates and an undervalued currency while exhorting consumers, who pay for the low interest rates and undervalued currency, to buck up and consume more.

That seems to me why this whole rebalancing process is going to be a lot more difficult for both countries than we currently expect. Both countries are eager to rebalance, and even more eager to avoid the price of rebalancing – or better yet, to shift it onto someone else. Perhaps there is a realistic way to achieve both, but it isn't obvious to me.

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Nick on Apr 2, 11:49 AM said:

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Letting the Chinese Yuan float freely against the US dollar would cause a rise in consumer prices in USA, when the Yuan rises against the US dollar. Because a lot of Chinese companies would have no choice but to raise their prices in US dollars or go out of business.

Increasing consumer prices would motivate the Fed to raise the interest rates. And this would definitely encourage people in USA to consume less and save more. Higher consumer prices discourage spending, and higher interest rates encourage saving.