



A New Global Balance in the Offing?

Arvind Subramanian argues that a potential wave of capital flows to China and other developing countries could add pressure on them to consider capital controls and appreciate their currency.

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Steve Weisman: Global imbalances are deemed by many economists to have contributed to the financial crisis. This is Steve Weisman at the Peterson Institute for International Economics with Arvind Subramanian to talk about recent trends on global imbalances that could lead to changes in the future. Arvind, thank you for joining me.

Arvind Subramanian: Thanks for having me, Steve.

Steve Weisman: Many economists have predicted that with recovery there will be a return to these imbalances—that China will compile current account surpluses, and the United States may go back into current account deficits. But some recent trends indicate that we might have to adjust our predictions. What is happening?

Arvind Subramanian: Yes, Steve, first of all, you know that once upon a time China was running a current account surplus of 11 percent of GDP, and once upon a time the US was running a current account deficit of about 6 percent of GDP. This was huge.

Steve Weisman: Once upon a time being just a few years ago.

Arvind Subramanian: Exactly. It's about two or three years ago. But the surprising thing that's happened just in this first phase of the recovery is that China's current account surpluses come down from about 11 percent to 6 percent last year. For this year, people are forecasting maybe 3 percent, 4 percent of GDP. So that's a big reduction. And similarly, the United States has come down to about 3 percent from 6 percent. Now, the open question is, will we go back to the 11 percent range for China and the 6 percent range for the United States or something smaller? I think it's fair to say that people are saying that these numbers are going to be smaller even if they return, like in the past.

Steve Weisman: There are new trends in capital flows as developing countries experience high growth, with inflation fears leading to the raising of interest rates. Tell me about this phenomenon.

Arvind Subramanian: We just spoke about what I would call the conventional global imbalance, right? I think now there's a new imbalance that's emerging [that] relates to these capital flows. Very simply capital looks for the best returns, right? Now, if you look at growth in emerging market countries and growth in the advanced economies, they are very different. Asia is growing very rapidly; Europe is growing anemically. So if you're an investor, where would you put your money? You'd put it in Asia. Similarly, interest rates are increasing in Asian economies because countries are tightening because there's more inflation. Interest rates are likely to remain low here [in the West] for some

considerable time because the recovery is still to take hold. So even in terms of where you'd put your money, where the interest rate is higher, emerging market economies seem much more attractive. I think these factors are combining to create what I call a tidal wave of capital going to emerging-market economies.

Steve Weisman: Is that healthy?

Arvind Subramanian: Well, yes and no. On the one hand, poorer countries need more capital to grow, but that can be too much of a good thing. There is a sense in which we're crossing that line from what is ample and adequate and desirable to something that could be excessive and frothy. And so managing that excess is really the challenge.

Steve Weisman: You and I have discussed this before in the context of some countries imposing capital controls, which has run counter to the philosophy of the last 10, 20 years. Are we seeing more of that?

Arvind Subramanian: We're seeing some of that in Taiwan and Brazil; other countries are thinking about it. But we're also seeing another manifestation, which is what I call competitive nonappreciation. You don't let your currency go up and you're just piling up reserves. And all these countries are doing it because the biggest competitor, China, has fixed its currency. One way of limiting these inflows would be to let the currency rise so that investors realize, well, the party is over in terms of return, so let's be careful about investing in these countries.

Steve Weisman: But if the Chinese currency is appreciating, according to some predictions, why wouldn't investors see that as a factor to increase their investments in China?

Arvind Subramanian: Let's say India is getting an interest rate of 8 percent and the United States is getting something like 1 percent. So that's a 7 percent differential, right? Now, on top of that, investors expected that Indian currency is likely to go up rather than down because there's so much capital coming in. So, it's like a one-way bet. Not only do you get the higher interest differential but you're also going to get the currency appreciation. Now, if the currency appreciates, then investors are a little bit unsure. From having appreciated, the currency could go up a little bit more or it will also come down because it appreciated too much.

Steve Weisman: Because appreciation would affect trade balances?

Arvind Subramanian: Among other things. So, you need the currency to appreciate to make investors a little bit more cautious about investing because they think now it can also go down. But now we're in a situation where currencies can only go up, so it's a one-way bet. And China, being so central to everything, when it fixes its currency, other countries also don't want to let their currency appreciate because they lose out on trade in terms of being outcompeted by Chinese exports and Chinese products. And they don't allow their currencies to appreciate, which means investors know that this is only likely to go up so let's put more money into these countries.

Steve Weisman: If China doesn't allow its currency to appreciate and doesn't introduce some kind of capital controls, what is the danger for China?

Arvind Subramanian: For China, of course, the danger is that it just starts accumulating so much [in] reserves—and reserves are a kind of waste of money. I mean, you could otherwise have been investing it in profitable projects, Chinese consumers could be consuming more and running down these reserves, so that's the problem for China. And you know the process of accumulating creates distortions in the financial system for China. So these are building up. But that's a problem for China.

Steve Weisman: And China then has less control over its own economy, monetary policy, and growth strategy.

Arvind Subramanian: Yes. I am a China hawk but I'm a China hawk with a difference. I feel very uncomfortable telling China that there are other things that you could do that would make your economy do even better for a country that's posted the most fantastic rates of growth for the longest periods of time—kept inflation in control. To come along and say, hey, I know where you can do better, I think that almost borders on stupidity. But my problem with the Chinese exchange rate is therefore much more what it's doing to the other countries.

Steve Weisman: Especially developing countries.

Arvind Subramanian: Especially other emerging-market countries and developing countries. And in this case, what it's doing to these other countries in terms of being able to manage this tidal wave of capital.

Steve Weisman: Arvind, what are the prospects for this being discussed at upcoming meetings of finance ministers in Washington?

Arvind Subramanian: Very good question, Steve. In fact, today's *Financial Times* reports that for the first time the governors of the central banks of Brazil and India have actually publicly said that China needs to do something about its currency. So I think it's going to be high up on the agenda or very high on the agenda of finance ministers. How do you deal with what I call the new imbalance and the role of China as a first mover in addressing this new imbalance?

Steve Weisman: Something that you have been calling for the last few months now may be happening.

Arvind Subramanian: Steve, if you say something long enough, then it might come to pass. It's not obvious that China will actually move immediately but I think the more the world community says this is a problem, the more difficult it will be for China to postpone action on this currency issue.

Steve Weisman: Thanks very much, Arvind.

Arvind Subramanian: Thanks, Steve.

