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Why Aren't the Chinese Buying More American Goods?

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China's annual trade balance has risen from a small deficit (–$1.9 billion) in 1980 to a $400 billion surplus in 2009. The bulk of the surplus results from trade with the United States. During the same period, China's total foreign reserves (mostly U.S. dollars) increased from $2.5 billion to around $2.4 trillion. Trade would be more balanced if the Chinese bought more American goods. But why aren't they doing so?

Many people believe that the steady increase in America's trade deficit with China has occurred because Chinese currency is significantly undervalued. Namely, Chinese goods are too cheap relative to American goods. Hence, Americans can buy many Chinese goods while the Chinese cannot afford American goods. Indeed, many U.S. politicians have alleged that the Chinese government has manipulated its currency deliberately to achieve a trade surplus and excessive foreign reserves.[1]

Why would the Chinese government do that? One popular argument is that an undervalued home currency promotes employment. However, selling goods at significantly low prices to the United States and holding American dollars as a store of value is equivalent to lending goods to the United States in return for IOUs that pay little or negative interest (due to inflation). Chinese workers would be better off spending their dollars instead of saving them. Why would the Chinese tighten their belts so much and lend to American consumers when they are still struggling with very low per capita incomes themselves?

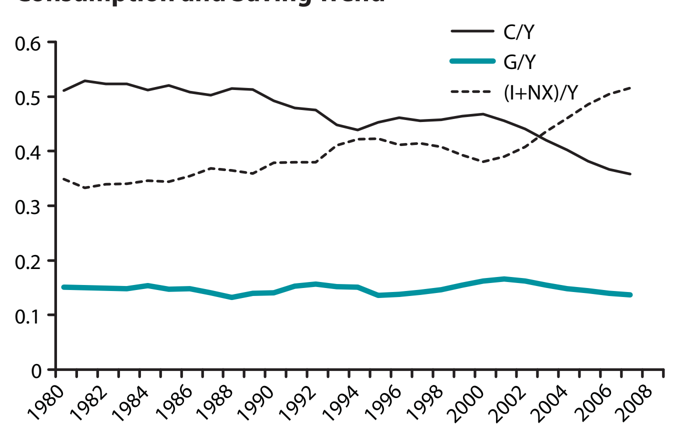
The standard economic theory of precautionary saving provides one plausible explanation: Even though China has had 30 years of impressive economic growth since its economic reform and globalization, its financial sector reform has not caught up with its economic growth. The lack of social safety nets and the country's severely underdeveloped insurance and financial markets have forced the Chinese to save excessively as insurance against idiosyncratic uncertainty, such as income shocks, unemployment, accidents, and other unexpected spending needs.[2]

The important point is that both the Chinese trade surplus with the United States and the amassed foreign reserves result from the savings decisions of Chinese consumers.

In fact, during the 30 years of rapid economic growth, China's private consumption-to-national income ratio (C/Y) has fallen from roughly 50 percent to 35 percent while the share of government spending (G/Y) has remained roughly constant at about 14 percent (see chart). Hence, Chinese consumers have significantly reduced their propensity to consume despite rapidly rising incomes. As a result, China's national saving rate (investment plus net exports) ([I+NX]/Y) has increased steadily despite low interest rates.

Chinese workers cannot invest their savings of foreign currencies directly in foreign assets because China has capital controls. The government meets the savings demands of its domestic residents by selling them Chinese government bonds and using the proceeds to purchase foreign

Consumption and Saving Trend



(especially U.S.) bonds.[3] In some sense, the Chinese government is functioning like a bank, enabling savers to invest. So the effective owner of the foreign reserves in China is not the government but the private sector.

The important point is that both the Chinese trade surplus with the United States and the amassed foreign reserves result from the savings decisions of Chinese consumers. If consumers want to spend more on American goods, they can sell their government bonds and thus siphon some U.S. dollars from the Chinese government's foreign reserves.

This analysis suggests that lack of financial development in China—not the fixed exchange rate—has created the huge trade imbalance between China and the rest of the world. Hence, only financial development within China will ultimately resolve it. ■

[1] For example, a bipartisan group of 14 U.S. senators announced new legislation in March 2010 to crack down on unfair currency manipulation by China (see http://schumer.senate.gov/record.cfm?id=323135&).

[2] Theory predicts that when people face large uninsured risks and are subject to borrowing constraints, not only do they save excessively but their marginal propensity to save increases with income growth despite low deposit rates. See Wen, Yi. "Saving and Growth under Borrowing Constraints: Explaining the 'High Saving Rate' Puzzle." Working Paper No. 2009-045B, Federal Reserve Bank of St. Louis, revised October 2009; http://research.stlouisfed.org/wp/2009/2009-045.pdf.

[3] Ironically, if Chinese savers were free to put their money anywhere in the world, there could be a large outflow of renminbi into other currencies and a resulting depreciation rather than appreciation.

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