History rhymes — a comparison of China today with Japan in the 1920s

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The Chinese currency has been depreciating since January 2014, and the balance of payments has weakened. There has been a substantial decline in the current account surplus relative to gross domestic product (GDP) since 2010 and more recently persistent private sector capital outflows.

The question is: how long the Chinese yuan (RMB) will continue to depreciate; and how much will China's exchange reserves decline? In this context it is useful to consider some interesting parallels between the economic experience of Japan in the 1920s and the recent experience of China, which seem to suggest that China's currency and external account problems could continue for several more years.

Large external surpluses and distortion in the economy

During the First World War, Japan experienced large surpluses on its external accounts which, via monetary expansion, drove up Japanese prices, making the country's exports uncompetitive compared with other leading economies such as the US & UK.

Similarly, following China's devaluation of the RMB in 1994, and the adoption of a fixed rate against the US dollar, China gradually built up huge external surpluses, which continued even after the 2005-14 appreciation of the currency.

For Japan in the 1920s, the result of the overvaluation was a decade of financial crises, slow growth, agricultural depression and deflation. Only in December 1931 when the authorities finally abandoned the pre-war fixed parity with gold, and devalued the yen, did Japan's external accounts return to equilibrium.

Back in China, while the country is not committed to any particular exchange rate, two problems exist. First, China allowed the external surpluses to build for so long that large distortions in the economy were created – principally massive excess capacity in many basic industries and heavy indebtedness which will take a long time to eliminate. Second, there are distinct limits to China's willingness to allow the RMB to depreciate. Together these factors suggest that China's problem of external disequilibrium will take much longer than just a year or two to resolve.

China's choices

China today is faced with essentially the same set of choices as Japan in the 1920s. One option is to maintain the current USD fixed rate (or a stable RMB against a basket), preserving the status quo in the domestic economy—i.e. state ownership of large-scale enterprises, state direction of credit, extensive capital and financial controls etc. Such an adjustment path would imply a long, slow disinflation (relative to foreign economies) with a persistent decline in foreign reserves.

The second option is to move much more quickly to external equilibrium, allowing the RMB to fall in line with market forces, to lift a whole range of controls while re-structuring the state-owned sector and thereby ending the distortions that have built up over the past two decades. Such a strategy would enable China to emerge as a far more market-oriented economy, able to adjust to external challenges more rapidly in the future.

In practice, China appears to be adopting a middle road closer to the first option than the second. This middle road will inevitably imply conflicts between means and ends, but to the Chinese authorities it will nevertheless be preferable to the second option.

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