China's Role in the Current Global Economic Adjustment Process

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Structure of the presentation

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II. Nominal Revaluation and the Sino-US Trade Imbalances
III. The link between overheating and the "undervalued" renminbi
IV. Optimal exchange rate regime for China
V. What's China's role in the current global imbalances

I. China's Currency Controversies

- China was first blamed for exporting deflation to the world economy because of its undervalued currency. Thus China was called to either revalue the renminbi (RMB) or reflate the economy (Kuroda and Kawai, FT, 12/2/02).
- While China's existing trade positions make it an unlikely force for world deflation, the calls for China to revalue gained attention in Washington DC.
- Despite China's overall trade surplus with the rest of the world is rather small, 2% of GDP (2001), Sino-US trade surplus remains large (10 percent of China's GDP).

- Because of large losses of US manufacturing jobs (2.7 million) and the politics of the presidential election year, the Bush Administration has been pressured to act.
- Trade front:
  - Quotas on 3 fast growing categories of Chinese textile/garments
  - Anti-dumping duties imposed on Chinese-made TVs (up to 78%)
  - Anti-dumping duties are under review on Chinese-made furniture

- Financial Front:
  - Pushing for RMB revaluation: Treasury Secretary John Snow and Commerce Secretary Don Evans spoke repeatedly in public that RMB needs to revalue to reduce the US-China trade deficit.
  - Fed Chairman Alan Greenspan also publicly raise the RMB valuation issue from the view that large inflow of capital will make the current RMB-dollar peg unsustainable. Therefore, RMB would have to be revalued to reflect the market pressure.

- Some have put a specific figure for RMB's revaluation:15-25% (Goldstein and Lardy, 2003) but the methodology is unclear. China is also suggested to move on to a flexible exchange rate regime by adopting a basket peg of dollar, yen and euro or a crawling peg.
- But a market based RMB-dollar exchange rate, the non-deliverable RMB-dollar future rate, does not indicate a large undervaluation of the RMB.

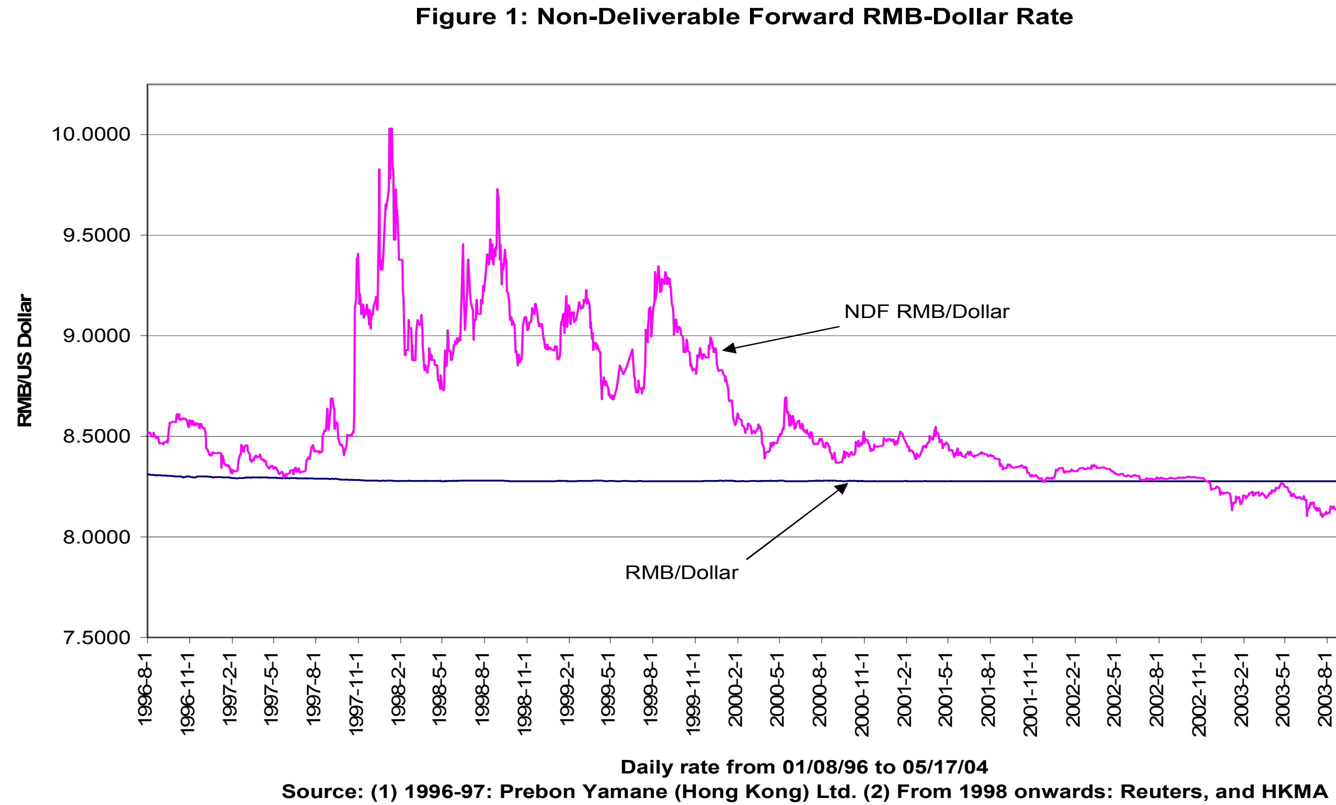
Figure 1: Non-Deliverable Forward RMB-Dollar Rate
RMB/US Dollar
10.0000
9.5000
9.0000
8.5000
8.0000
7.5000
NDF RMB/Dollar
RMB/Dollar
1996-8-1
1996-11-1
1997-2-1
1997-5-1
1997-8-1
1997-11-1
1998-2-1
1998-5-1
1998-8-1
1998-11-1
1999-2-1
1999-5-1
1999-8-1
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2001-8-1
2001-11-1
2002-2-1
2002-5-1
2002-8-1
2002-11-1
2003-2-1
2003-5-1
2003-8-1
2003-11-1
2004-2-1
2004-5-1
Daily rate from 01/08/96 to 05/17/04
Source: (1) 1996-97: Prebon Yamane (Hong Kong) Ltd. (2) From 1998 onwards: Reuters, and HKMA

- Indeed, China's underlying structural weakness does not warrant large RMB revaluation:
  - It's banking system is still fragile (Large NPLs and weak risk management).
  - It's medium-term fiscal sustainability remains a challenge (contingent fiscal liability exceeds 100 percent of GDP).
  - Domestic structural imbalances pronounced (significant rural-urban, regional, and income inequality and huge unemployment pressure).
  - Economic transition still unfinished and quality institution yet to emerge.

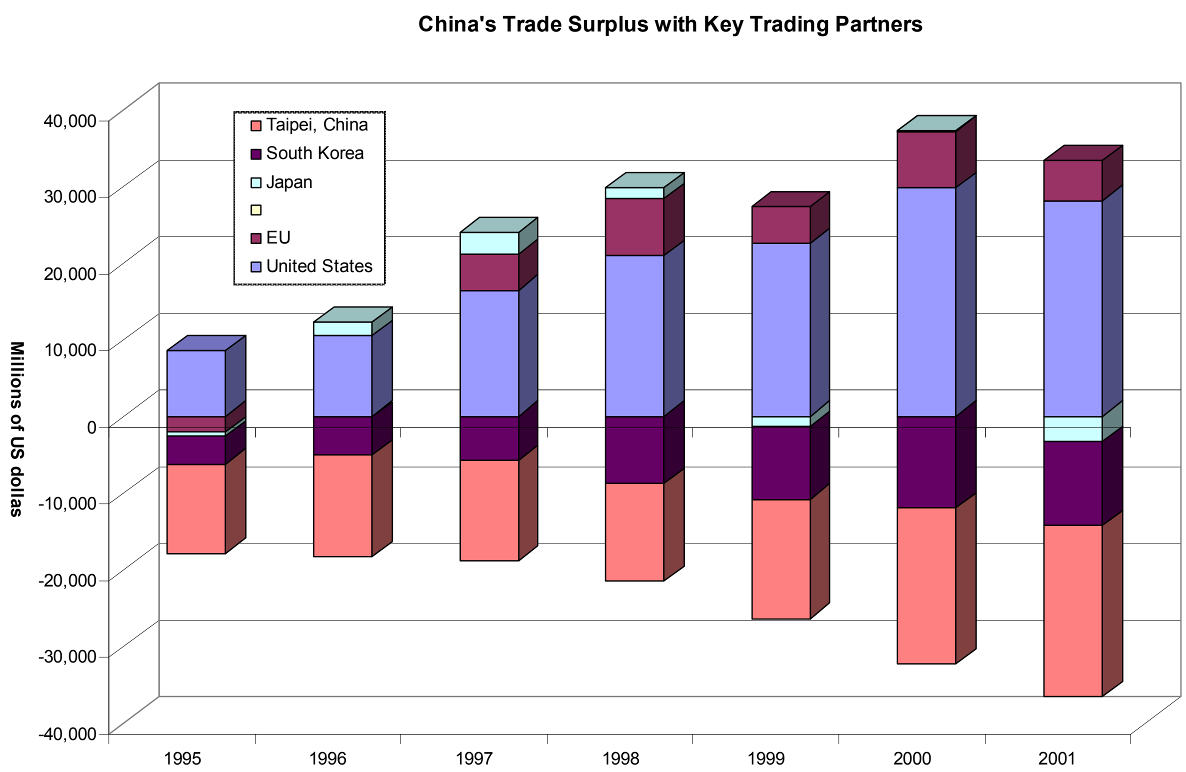
- China’s recent soaring growth and its insatiable appetite for raw materials from the rest of the world have also been blamed for causing rapid rise in commodity prices.
- “Undervalued” currency was thought as one of the causes of macroeconomic overheating.
- China’s renminbi has been blamed for both world deflation and inflation.

II. Dealing the Sino-US Trade Imbalances

- An RMB revaluation won’t help reduce the US trade deficit and won’t restore the Sino-US trade balance, either.
  - US savings-investment imbalances fundamentally determine its external imbalances.
  - Thus, an RMB revaluation will only have redistribution effect of US trade deficit with the rest of the world

- Four underlying factors help explain the Sino-US trade imbalances

1) China’s processed trade structure and the East Asian trade triangle (Processed trade dominates China’s trade structure and contribute to the trade surplus while the ordinary trade originated from domestic firms remains a weak link).


China's Trade Surplus with Key Trading Partners
Taipei, China
South Korea
Japan
EU
United States
Millions of US dollas
40,000
30,000
20,000
10,000
0
-10,000
-20,000
-30,000
-40,000
1995
1996
1997
1998
1999
2000
2001

2) The 1998 value-added export-rebate tax can be removed before considering a nominal revaluation.

- The rebate is outmoded and too expensive to maintain ($24 billion or a quarter of China's trade surplus)
- Big fiscal burden and backlogged, endangering government credibility
- Bad for China's terms of trade.

Declining Terms of Trade with Key Trading Partners (1993-2000)

Products	USA	EU	Japan	NIEs	ASEAN	Other LDCs
All products	-23	-28	-26	-17	-8	-3
Non-fuel Primary Products	0	-36	4	5	34	15
Manufactured Goods	-24	-27	-28	-20	-24	-21
Labor or Resource Intensive Product	-48	-12	-37	-2	-9	7
Low-tech Products	-27	-36	-15	-5	-14	-13
Medium-tech Products	-42	-28	-31	-28	-26	-59
High-tech Products	13	-23	-35	-29	-43	-7

Source: Zheng and Zhao (2002) based on statistics from the Chinese Customs Statistical Year book

3) Large reserves of labor exert downward wage flexibility and upward wage rigidity.

- Large urban unemployment (10 to 15 percent) and the rural under employment (150-200 million) determines China's comparative advantage in labor intensive industries for a long time to come.
- Real wages in the export sector have not seen much change ($100 for more than 10 years).

4) Fiscal incentives in its FDI regime further underscores the trade competitiveness.

- Both central government and local government fiscal incentives provided are generous: 2 years of no income tax and the following 3 years by half, in addition to generous local government concessions in land, energy, bank loans, raw materials, and labor usage.
- Such fiscal incentives may help China's quantity success in attracting FDI but not quality success in attracting large-scale and tech-heavy FDI.

- The Four structural factors ought to have contributed to RMB's competitiveness in international trade.
- China could indeed first address these distortions before considering any nominal appreciation of RMB since no one knows the equilibrium exchange rate with these distortions in place.
- It is also in China's interest to address these distortions because they are potential impediments for China's long-term growth.

- These structural factors are bad for China's TOT which may lead to immiserizing growth, brought by biased anti-trade technical progress (Harry Johnson, 1958).
- They are also bad for regional and income distribution because fiscal subsidies biased toward fast growing and profitable export sector and individuals.
- Furthermore, these policies are also not in line with China's WTO commitments.

What China could do to address the Sino-US trade imbalances?

- In the short-run, phase out or even revoke the export tax rebate tax since it is out of date and too expensive to maintain as China's export growth is fast growing and no need of further stimulus.
- The policy also removes distortions: other sectors are subsidizing the most profitable and faster growth sector of the economy. It does not make any economic sense.
- In response to the pressure from the US, China can simply draw a shopping list and deal with the US deficit bilaterally (import diversion).

- Improve FDI regime: China needs to take steps to make its FDI policies in line with the *Trade-Related Investment Measures (TRIMs).*
- Fiscal incentives are less important than a predictable, mature, and transparent FDI regime (JBIC Survey and McKinsey Study)
- Less emphasis on fiscal incentives and more on enforcement of contract, investment transparency, and policy predictability.
- Ensure FDI's <u>quality</u> success (High-tech contents of OECD FDI).

III. The link between overheating and the "undervalued" renminbi

- The current cycle of rapid growth is no different from the previous cycles mainly spurred by rapid bank credit growth.
- Bank lending to property sector and automobile sector, facilitated by mortgage and consumer finance, led to way.
- Five sectors (real estate development, steel, electricity generation, automobile, and chemical sector) accounted for 59 percent of total fixed asset investment
- Fixed asset investment reached to 43 percent of GDP, one of the highest in history.
- Electricity consumption, a good measure of GDP activity, soars.

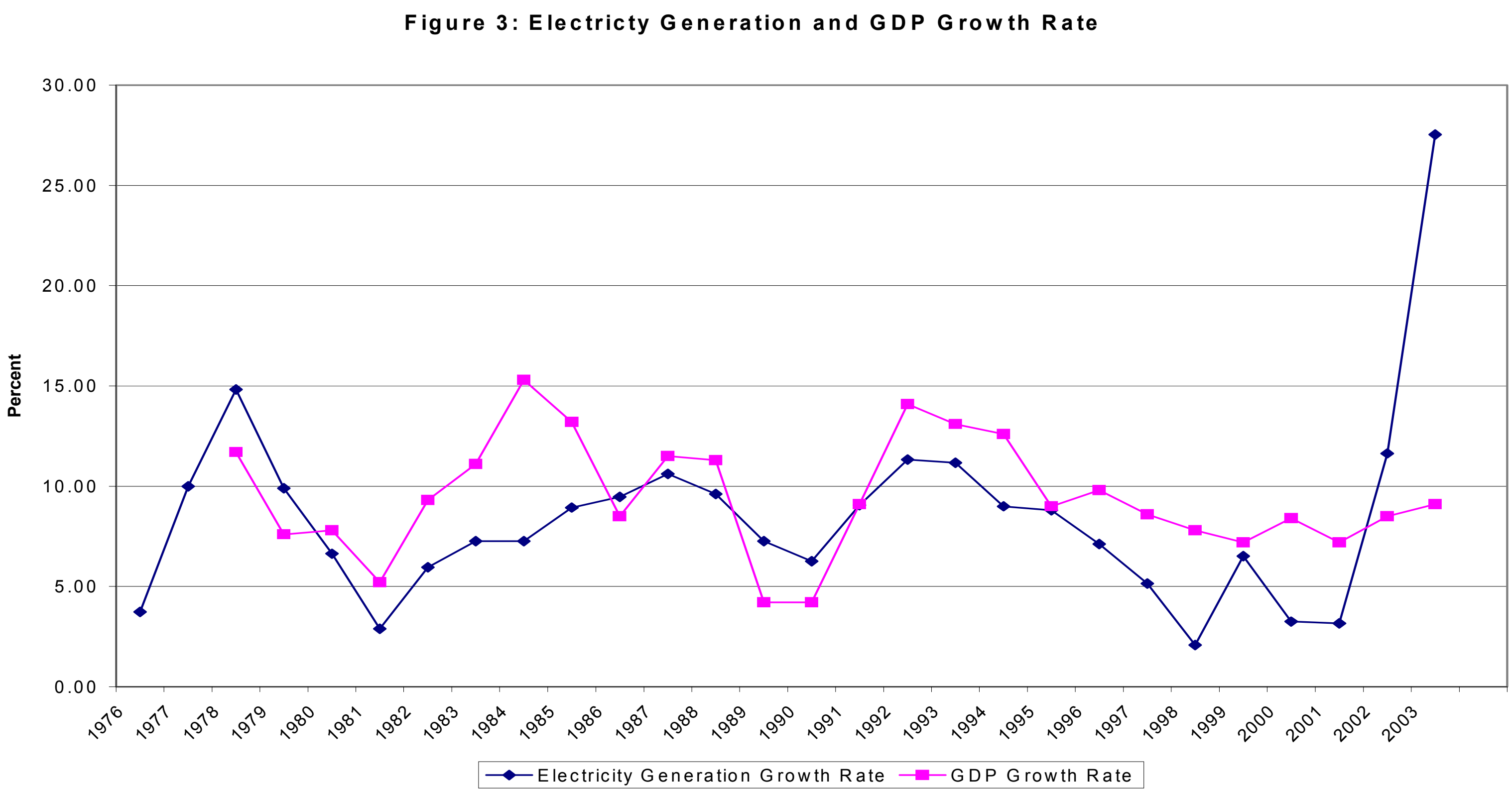
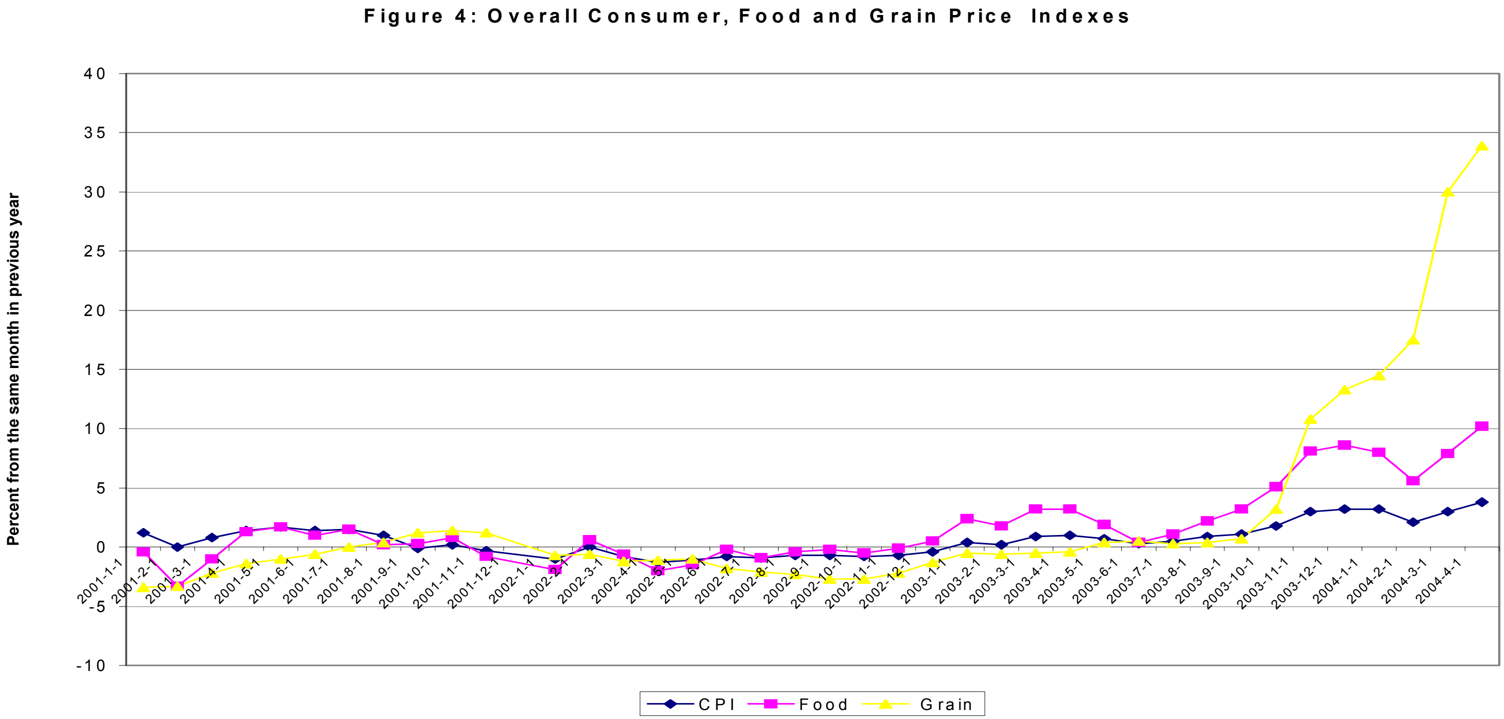


Figure 3: Electricty Generation and GDP Growth Rate
30.00
25.00
20.00
15.00
10.00
5.00
0.00
Percent
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Electricity Generation Growth Rate
GDP Growth Rate

Inflation rate accelerates



- Food price, in particular, grain price increased sharply, largely due to reduced incentives to plant grains and consequently the land devoted to grain production.
- But the current inflation will not become a run-away one, unlike the previous ones.
  - Consumer goods supply still exceeds demand (473 out of 600 consumer products still face oversupply)
  - There is no sign of wage led inflation
  - Domestic demand still weak (consumption share in GDP is only 60%, compared with74% for LDCs and 80 for DCs).
  - Increased grain imports and increased acreage to grain production

Does an “undervalued” currency cause rapid M2 growth?

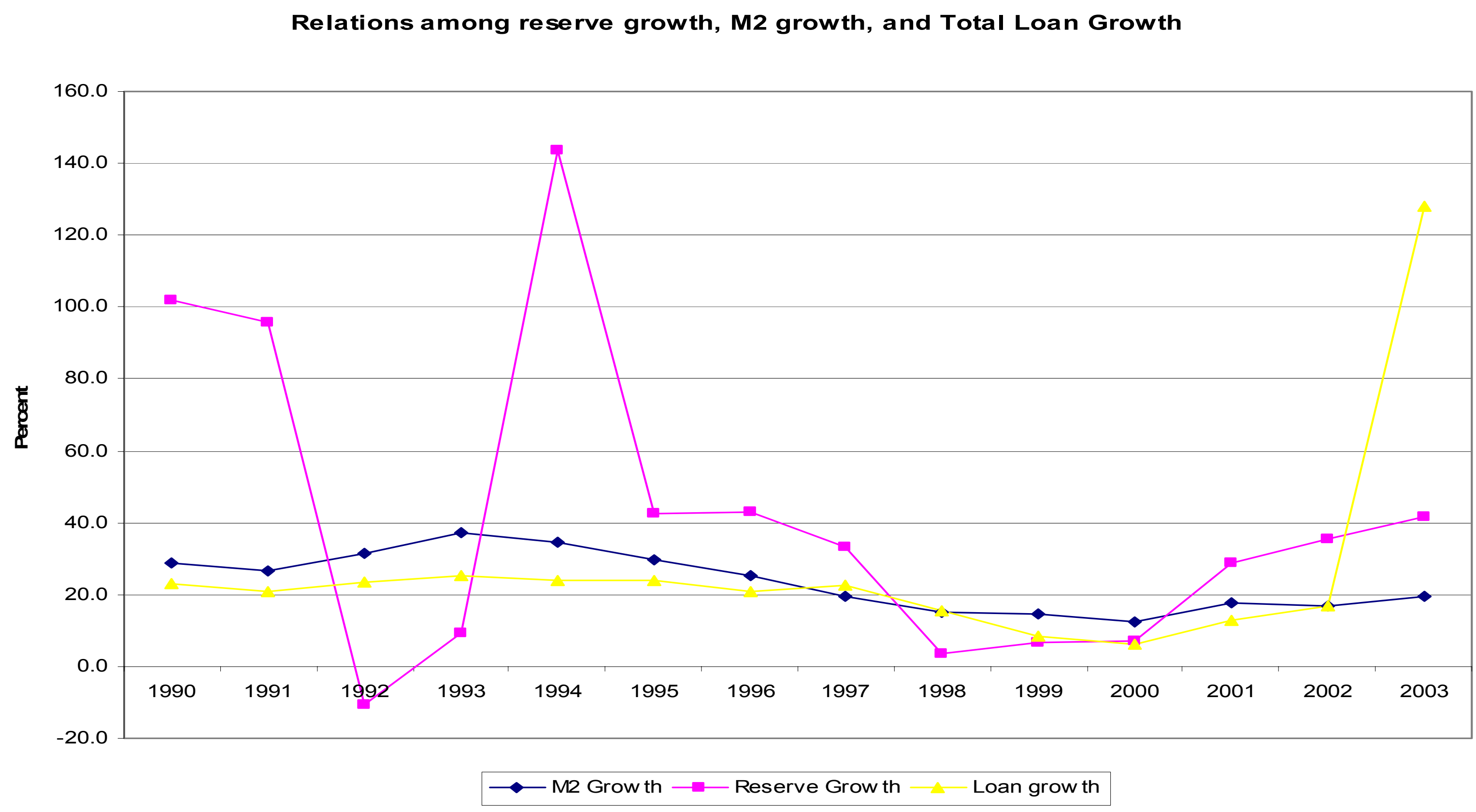
- Conventional wisdom links rapid M2 growth rate to the undervalued currency: An expectation of revaluation led to capital inflows, thus increase the central bank asset base and monetary supply if it becomes difficult to sterilize.

Table 8: Current account balance, capital account balance, reserves accumulations and M2 Growth (Billions of US Dollars)

	1998	1999	2000	2001	2002	2003	2004[a]
Current Account	29.3	15.7	20.5	17.4	35.4	29.5	-7.8
Capital Account	-22.8	-7.1	-10	29.9	40.1	90.5	n.a.
Foreign Direct Investment	43.8	38.8	38.4	44.2	49.3	54.7	n.a.
Other capital flows	-66.6	-45.9	-48.4	-14.3	-9.2	35.8	n.a.
Change of Reserves	6.5	8.6	10.5	47.3	75.5	120	113.5
Total Reserves	146.3	154.9	165.4	212.7	288.2	408.2	439.8
Reserve Growth	4.6	5.9	6.8	28.6	35.5	41.6	39.2
M2 Growth	14.8	14.7	12.3	17.6	16.9	19.6	19.1
Credit Growth	15.5	8.3	6.0	13.0	16.9	21.1	18

Source: Calculated from data publised on PBOC's website.

Note: a. Figure for 2004 is for January to March 2003.



Relations among reserve growth, M2 growth, and Total Loan Growth
Percent
160.0
140.0
120.0
100.0
80.0
60.0
40.0
20.0
0.0
-20.0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
M2 Grow th
Reserve Grow th
Loan grow th

But empirically, the linkage is weak

Table 9: Granger Causality Test between M2 and Foreign Exchange Reserves

Dependent Variable: M2		
Variables	F-Statistics	Significance
M2	10.53	0
Foreign Exchange Reserves	0.67	0.75

Dependent Variable: Foreign Exchange Reserve		
Variables	F-Statistics	Significance
M2	2.57	0.04
Foreign Exchange Reserve	52.7	0

Source: Calculated by the author

Rapid M2 growth has more to do with

1. Competition to get listed: Incentive to grow out of NPL problem by expanding the balance sheet (if loan growth is 10 a year, 7 years NPLs will be halved).
2. Interest rate liberalization: lending rate first (at a range of --10 percent and 170 percent from 5.31) and deposit rates (1.98%) lead large interest rate margin. Thus it is profitable to lend.
3. Local government influence on bank lending remains.

Will China have a hard landing?

- Other than the central bank efforts to use OMO and raise reserve requirement, a coordinated administrative efforts, which are perhaps more effective, have been taken to cool down the economy.
- Various indicators such as fixed asset investment growth, industry output, money supply and bank credit have all shown signs of slow down.
- Capital inflows is likely to reverse because the high probability of interest rate hike by the Fed.
- The end result of the overheating in some sectors will be more NPLs in the banking sector and deflation may also resume.

IV: An optimal exchange regime for China

Which exchange rate regime performs better in the long run?

Table 11: Performance of Exchange Rate Regimes

Classification Scheme	Peg	Limited Flexibility	Managed Floating	Freely Floating	Dual or Multiple Exchange Rates
Annual Inflation Rate					
Standard	38.8	5.3	74.8	173.9	n.a
Dual Rates	20.7	10.1	29.7	45.5	167.4
Per-Capital GDP Growth					
Standard	1.4	2.2	1.9	0.5	n.a
Dual Rates	1.7	2.6	1.5	1.1	0.8

Source: IMF, World Economic Outlook.

What exchange works better for China?

Table 10: Exchange Rate Regimes

I. Fixed Arragements

a) Currency Unions

b) Currency Boards (Dollarization)

c) Truly Fiexed Exchange Rates

II. Intermediate Arrangements

a) Adjustable Pegs

b) Crawling Pegs

c) Basket Pegs

d) Target Zone and Bands

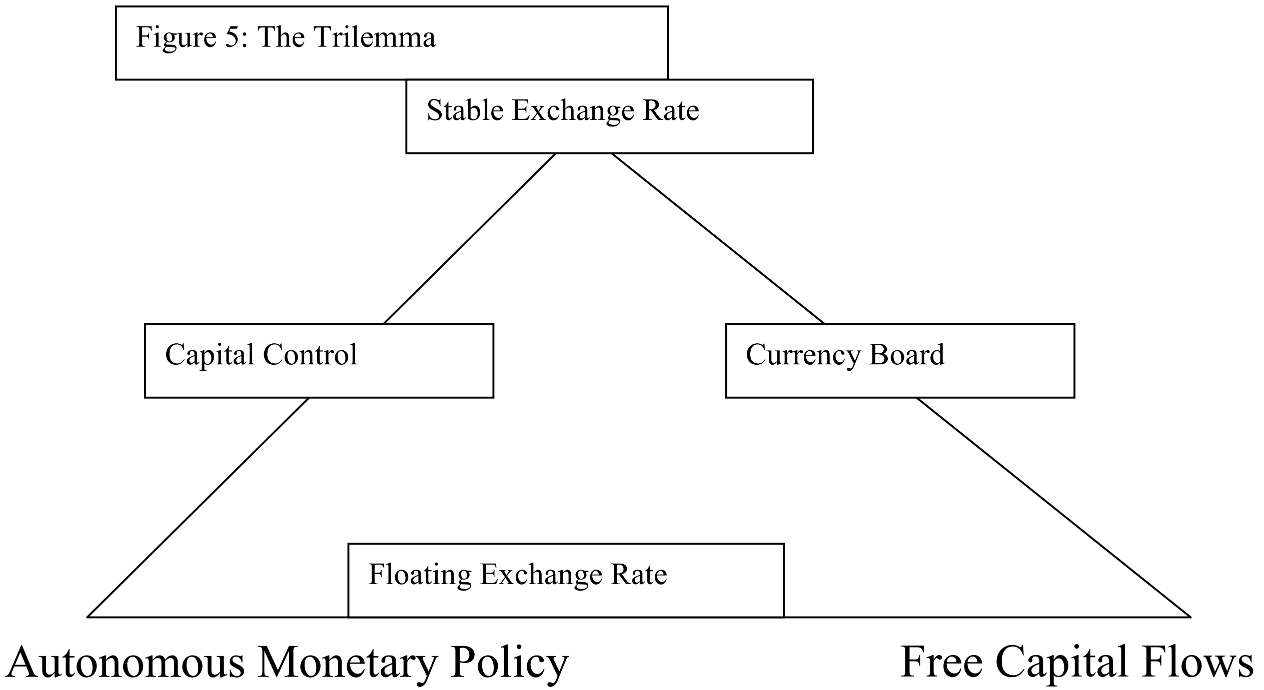
III. Floats

a) Managed Floats

b) Free Floats

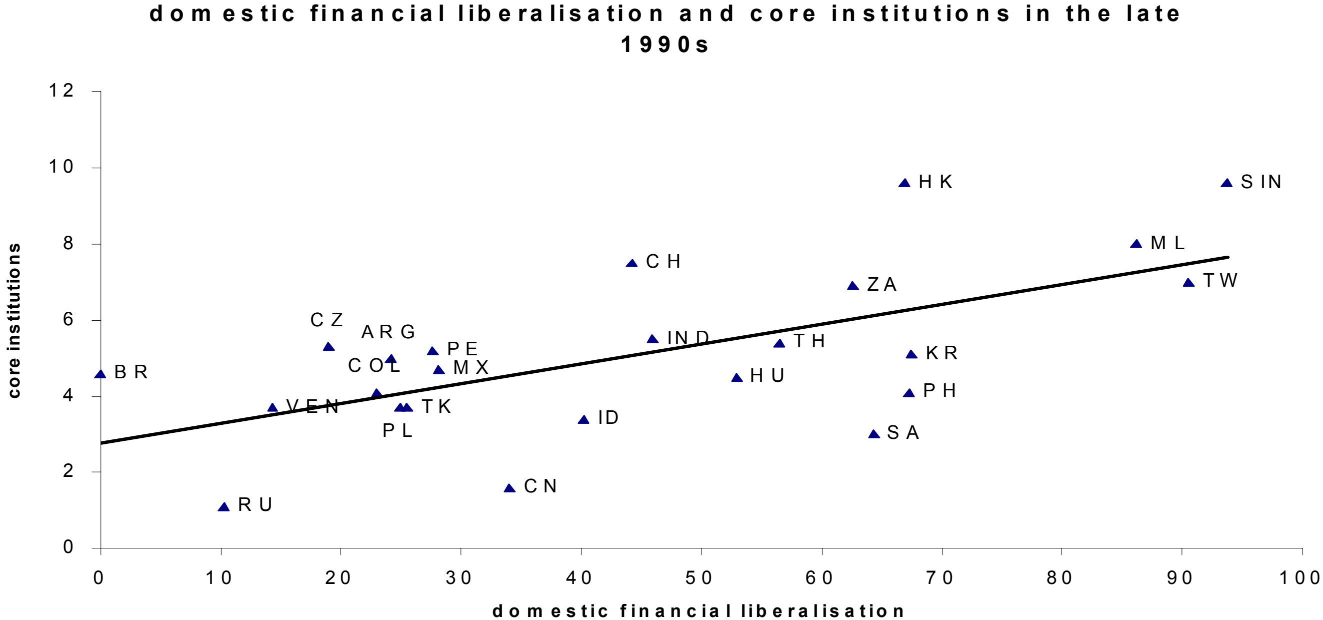
Source: Frankel (1999)

As China's capital account has become more porous, its objective of maintaining stable exchange rate and autonomous monetary policy simultaneous becomes increasingly untenable

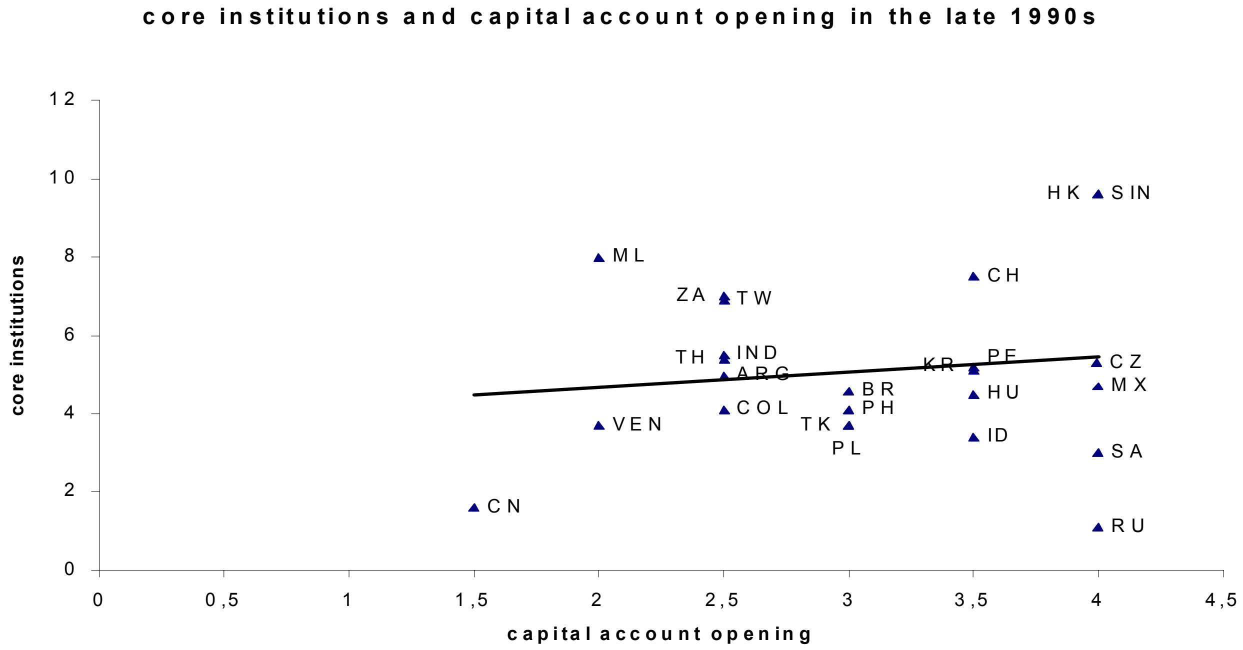


- Indeed, in order to maintain stable exchange rate and conduct independent monetary policy, China should strengthen, rather than weaken, capital controls.
- The existing pegged exchange rate regime offers advantages:
  - To prevent time inconsistent policies because of the lack of credibility of domestic institutions
  - Leverage on better institutions for credibility
  - Allow time to build domestic institutions and convergence to center

China's institution quality is not up to handle domestic financial liberalization



China's core institutions are not up to the job of capital account liberalization, either.



China's core institutions are generally weaker than some of the crisis economies.

Table 1: Crisis Economy Profiles circa 1990s

Country	Core Institutions Index Scale 0 – 10	International Leveraging Int'l bond & bank debt/GDP % 1998 Q2	External Liquidity Constraints Short-term debt/FX reserves % Sept 1998	Functional DFL % Since 1980s	KAO 1998-99 Scale 0 – 4
Argentina	5,0	23,1	159,0	24,2	2,5
Brazil	4,6	17,3	114,0	0,0	3,0
Peru	5,2	13,2	74,0	27,6	3,5
Mexico	4,7	26,0	82,0	28,1	4,0
Indonesia	3,4	42,2	75,0	40,2	3,5
Korea	5,1	29,9	173,0	67,5	3,5
Malaysia	8,0	36,5	27,0	86,2	3,0
Philippines	4,1	28,3	64,0	67,3	3,0
Thailand	5,4	40,8	480,0	56,5	2,5
Turkey	3,7	24,3	101,0	25,5	3,0
Russia	1,1	16,1	140,0	10,3	4,0
Crisis Economies	4,6	27,1	135,4	39,4	3,2
Other EMEs	3,8	16,0	31,1	32,2	2,8
Of which China	1.6	10.2	13.0	34.0	1.5
Control Group	7,5	11,8	59,7	68,5	3,3

Note: Other EMEs include the PRC, India, Colombia, the Czech Republic, Poland, Saudi Arabia and Venezuela. The Control group includes Hong Kong (China), Singapore, Taipei (China), Chile, South Africa and Hungary. Source: Chan-Lee 2002.

- If China opts for a flexible exchange rate regime, it would have to build domestic institutions that can act as credible nominal anchors.
  - Central bank independence
  - Inflation targeting
  - Risk management skills of its financial institutions
  - Efficient financial markets

Some sequencing is still needed!

Table 1: A Roadmap for Financial Reform

Policy Goals	Existing Strategy	Problems and Limitations	Proposals	Possible New Risks	Institutional Requirements	Implementation Issues	Time-Frame for Implementation
I. Restore Banking Sector Solvency and Reduce Banking Sector Risks	Hybrid Approach: Carving out a portion of NPLs and growing out the rest; contingent liabilities are not fully recognized and need high growth to maintain fiscal sustainability	Undermining sustainable economic growth and possible medium-term fiscal stress	Quick resolution of NPLs via large-scale ownership diversification. Sustaining high, medium-term growth via viable banks and SOE restructuring	Fiscal costs, moral hazard without ownership changes and weak corporate governance; NPL resolution will entail short-term high debt to GDP ratio	Better functioning government bond markets and better equity market for privatization; transparent budget institutions and strengthening tax administration	SOE ownership diversification and restructuring must accelerate. Rationalizing central and local fiscal arrangments; widening tax base.	Start now and accelerate existing programs to maintain fiscal sustainability in the medium term.
II. Change Incentive Structures	Attempt to build an incentive structure without clear property rights	Severe agency problems; increased state assets stripping and related corruption	Clear property rights through ownership diversification	Possibility of transitional unemployment and social dislocation	Effective legal system to enforce property rights	Converting private savings into ownership claims via shareholdings	Start now as it may take decades
III. Independence of the Central Bank and Supervisory Agencies	Under control of the State Council; multiple supervisory agencies subject to political interferences	Perpetuates government inteference and poor standards; politicized exit policies	Full independence	Difficulties in coordinating fiscal and monetary policy and accountabilities	Competent technocrats and regulators; enforcement of rules-based supervision; better accountancy, transparency and disclosure standards	Appoint independent central banker and regulators and improve the court system; develop indirect monetary policy instrument via better interbank and money market	Short to Medium term
IV. Staged Interest Rate Liberalization	Adminstratively controlled interest rates	Improper pricing of risks	Phased interest rate deregulation with a balance on competition and banks' franchise value	Tips maturity structure to short term owing to distorted yield curve	Functioning inter-bank and money markets; capacity to actively monitor credit growth to speculative sectors	Lending rates first followed by deposit rates	Start now
V. New Domestic and Foreign Bank Entry	Administrative requirements for entry and restricted foreign entry	Maintain oligopoly rents, but limit financial innovation and competition	Encourage entry of reputable foreign financial institutions through joint ventures or M&A, as a part of WTO commitment	Weaker competition maintains domestic monopoly power; de facto acceleration of KAO via relabeling of capital flows	Level playing field for regulatory control; "Fit and proper" criteria for entry. Higher prudential oversight and transparency standards; monitor net positions of banks and be aware of off-balance sheet risks	Encourage foreign financial institutions entry to improve information processing and enhance risk management skills; National treatment for foreign banks	Start now
VI. Open the Capital Account	Relatively restricted	Approppriate in the short run but with distorting capital costs	Risk-based sequencing	Currency and maturity mismatches	Better long-term debt markets and capacity to monitor short-term capital inflows	FDI, trade credits, followed by portfolio investment and bank loans depending on institutional capacity; be aware of labeling of capital flows via derivatives	Medium term
VII. More Flexible Exchange Rate and Active Participation in Regional Financial Arrangement	Pegged to the US dollar. China has signed bilateral swap arrangements with key countries in the region based on the Chiang-Mai Initiatives	Illusion of FX guarantee discourages hedging practices	Currency Basket System and formalized multilateral monetary arrangement	Greater volatility; management of expectation; Difficulties of monitoring and moral hazard	Greater transparency and consistency of economic policy; Regional monetary arrangement	Use Dollar/Yen/Euro as key basket currencies; Actively participate in regional monetary cooperation	Short-term for the exchange rate regime and medium term for the formal regional lender of last resort arrangement.

- Sequencing steps
  1. Resolving the banking sector risks
  2. Change domestic incentive system
  3. Building credible domestic institutions
  4. Staged interest rate liberalization
  5. Allow domestic and foreign entry
  6. Staged capital account liberalization
  7. Flexible exchange rate regime and participating the regional financial arrangement

What is an optimal exchange rate regime for China?

- The current exchange rate regime is not bad as long as capital control can be strengthened
- China's capital control is still likely to remain for some time
- But flexible exchange rate regime is inconsistent with capital controls
- BBC (band, basket peg, and crawling peg) are susceptible to big shocks, stabilizing speculation, and furnishing credible nominal anchors.
- Managed floating with close monitoring of currency mismatches? (Goldstein, 2002, Bordo, 2003)
- It remains a theoretical and empirical issue!

V. China's Role in the World Economic Imbalance

China is not yet a world locomotive. A drop of Chinese growth has limited impact on the rest of world (WEO, 2004).

Exports of Selected Countries to China
(In percent of their total exports)

	2000	2002	2003
Japan	6.3	9.6	13.6
Korea	10.7	14.7	20.5
Singapore	3.9	5.5	7.0
Indonesia	4.5	5.1	7.4
Malaysia	3.1	5.6	10.8
Philippines	1.7	3.9	12.0
Thailand	4.1	5.2	7.1
India	1.8	4.1	6.4

Source: IMF Direction of Trade Statistics.

- China's policy priorities are still within its domestic sector and its continued structural reform will make it *normal* economy.
  - Reduce the urban-rural inequality and speed up urbanization process.
  - Unify its domestic market and remove non-tariff barriers
  - Reduce the tyranny of distance to facilitate market integration
  - Need domestic long-term bond market for these funding needs and foreign capital!