Sustainability of China’s Growth and Macroeconomic Policy

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“China’s Economic Reforms and Globalization”
China’s Growth

- China has grown at 10% a year in real terms since 1978
- Currently world’s 4th largest economy, and 3rd largest trader
- Concern among Chinese leadership that growth path is unsustainable
- Outsiders argue it is contributing to global economic imbalances (Lardy, 2007; Blanchard and Giavazzi, 2006)
China’s Trade

- Growth in merchandise trade surplus
- Rose to $262 billion in 2007 – 11% of GDP
- Some appreciation of renminbi (RMB) against the US $ – 18% since July 2005
China - US Trade

- U.S. bilateral trade deficit with China running at over $230 billion
- Accounts for almost a third of total US trade deficit
- Members of US Congress argue this is due to Chinese “manipulation” of its currency (Frankel and Wei, 2007)
- However, revaluation of RMB will likely benefit China more than US
## US and China’s Currency

<table>
<thead>
<tr>
<th>US Trade Deficit (%)</th>
<th>1985</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>0</td>
<td>24</td>
</tr>
<tr>
<td>Japan/Hong Kong</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea/Taiwan</td>
<td>52</td>
<td>16</td>
</tr>
</tbody>
</table>

- China at end of East Asian supply chain
- Only 20% of export value captured by China - has trade deficit of $130 billion with East Asia
- 20% appreciation of RMB would reduce US trade deficit by only $40-55 billion
Basis of China’s Growth

- Expansion of an economy based on $\Delta \text{GDP} = \Delta \{C+G+I+(X-M)\}$
- China’s growth, until recently, driven by investment *not* exports
- Investment based on high total savings – 42% of GDP, households (16%), firms (20%), government (6%)
- Chinese consumption is quite low by international standards
China’s Growth

The real export shock

Chinese exports, % of GDP

Headline exports-to-GDP ratio

True export ratio*

1980 85 90 95 2000 06

Breakdown of China’s GDP growth
Percentage points

<table>
<thead>
<tr>
<th>Year</th>
<th>Net exports</th>
<th>Government spending</th>
<th>Investment</th>
<th>Consumption</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>4</td>
<td>2</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>2000</td>
<td>6</td>
<td>4</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>2005</td>
<td>10</td>
<td>8</td>
<td>12</td>
<td>2</td>
</tr>
</tbody>
</table>

Sources: UBS; Standard Chartered  *Value-added share of manufactured exports  †Estimate

20%
40%
9%
31%

Source: “The Economist”
China’s Low Consumption

Source: “The Economist”
Why Rebalance China’s Growth?

- Low productivity of investment
- Depressed wages
- Rural-urban income inequality
- Regional inequality
- Environmental damage
How to Rebalance?

- Reduce investment
- Fiscal policy to reduce precautionary savings and raise consumption:
  - provision of health care, education
  - universal pension coverage
- Change macroeconomic policy
  - flexible exchange rate regime
  - better able to set interest rates and control inflation
China’s Exchange Rate

- China continues to intervene in foreign exchange market (Goldstein, 2007)
- Foreign exchange reserves still growing - $1.43 trillion
- Net result – increased liquidity in Chinese banking system
- People’s Bank of China (PBC) forced to “sterilize” inflows to prevent inflation
Macroeconomic Policy

- Tying Chinese inflation to exchange rate will make sustainable growth harder
- Independent monetary policy also inconsistent with exchange rate policy
- As capital account becomes more open, harder to target inflation
- Also requires reform of Chinese banking sector, i.e., proper use interest rates as opposed to financial repression
Macroeconomic Policy

- China should switch from fixed exchange rate to inflation-targeting
- Targeted range for rate of inflation
- Key focus of monetary policy is inflation
- Benefits: price and employment stability, tying down of inflation expectations
- Requires strong fiscal, financial and monetary institutions
Inflation Targeting

✧ There has to be fiscal stability, i.e., no large government deficits

✧ If large deficits – either have to be underwritten through increase in money supply or eroded via currency devaluation

✧ Monetary policy cannot be subservient to fiscal policy – “fiscal dominance”
Inflation Targeting

- Also necessary to have a sound financial system, especially banking sector
- If banking sector is weak, central bank will be constrained in its ability to raise interest rates
- Fear of provoking a collapse of financial system – “financial dominance”
- Serious issue in many LDCs
Inflation Targeting

- Needs to be a commitment to an independent central bank
- No underwriting of fiscal deficits,
- Insulation from government interference and political process
- “Constrained discretion” – flexibility to stabilize employment subject to inflation objective (Bernanke and Mishkin, 1997)
Inflation Targeting

- Will policy work in China?
- No obvious problem of fiscal dominance – fiscal deficit and government debt low
- However – there are unfunded liabilities in banking system, i.e., non-performing loans (NPLs)
- Banking system requires further reform (Goodfriend and Prasad, 2007)
China’s Financial System

- Under central planning, financial system was “shallow” and “passive” – dominated by government-run banks

- China now has most institutions of a modern financial system, e.g., central bank, commercial banks, stock markets

- System “deeper”, i.e., money supply 162% of GDP in 2005, but “narrow” with banking system dominating - 78% of funds raised from banks in 2005
China’s Financial System

- Banking system 23 trillion RMB of assets in 2003, consisting of:
  - state-owned commercial banks “big-4”, ICBC, ABC, CCB and BOC (53%)
  - joint-stock commercial banks (JSCBs), 11 set up 1986-2001 (15%)
  - city commercial banks, 100 since 1998 (5%)
  - others, e.g., credit cooperatives, rural banks (27%)
Reform of Banking System

- 1978-1993 saw bank lending to unviable firms – growth of NPLs
- Spread between lending/savings rates narrow and often negative
- Low profitability, erosion of capital
- Banking system in poor shape by mid-1990s
Reform of Banking System

- Policymakers recognized frailty in late-1990s - two key issues:
  - “Stock” problem of clearing up existing NPLs - extensive efforts to write-off NPLs and recapitalize banks since 1998
  - “Flow” problem of ensuring new loans are commercially sound - banks still inefficient at providing funds and enabling transactions
Reform of Banking System

- 2005, further bank restructuring and reform program started
- Foreign-bank entry mandated late-2006 under WTO accession
- Citibank and HSBC partnering with JCSBs
- Likely to be period of bank shakeout
- System has to be financially robust to fluctuations in interest rates
China Needs to Rebalance

- To rebalance growth, China must address internal/external imbalances
- Independent monetary policy
- Allow exchange rate to appreciate
- Other Asian currencies will also appreciate – allowing for “orderly correction” of US external imbalance
How to Get Global Adjustment

- China wants to move at its pace
- US Congress convinced RMB is being manipulated
- China and other Asian countries need to let currencies appreciate
- US should raise its savings rate
- Probably requires international cooperation brokered by the IMF
References:


References:

