# Sustainability of China's Growth and Macroeconomic Policy


## Professor Ian Sheldon

**sheldon.1@osu.edu**
**http://aede.osu.edu/programs/Anderson/trade/**

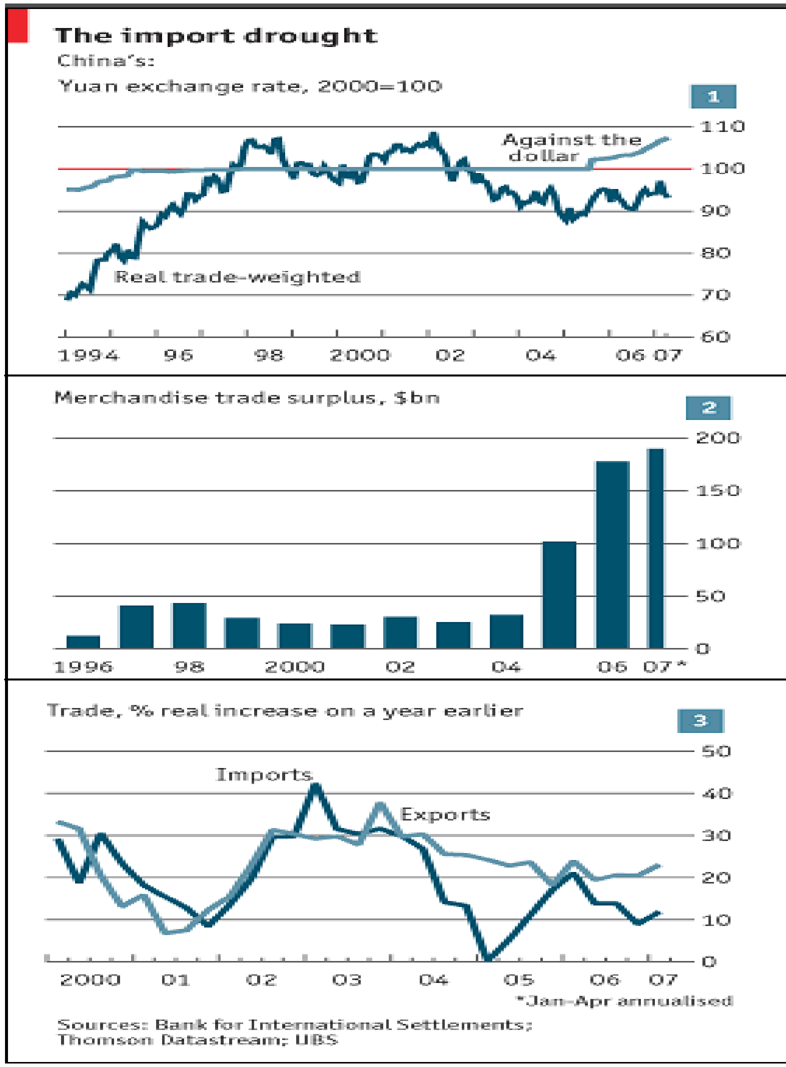

**Prepared for AEDE 439/IS 439**

**"China's Economic Reforms and Globalization"**

# China’s Growth

- China has grown at 10% a year in real terms since 1978
- Currently world’s 4$^{th}$ largest economy, and 3$^{rd}$ 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

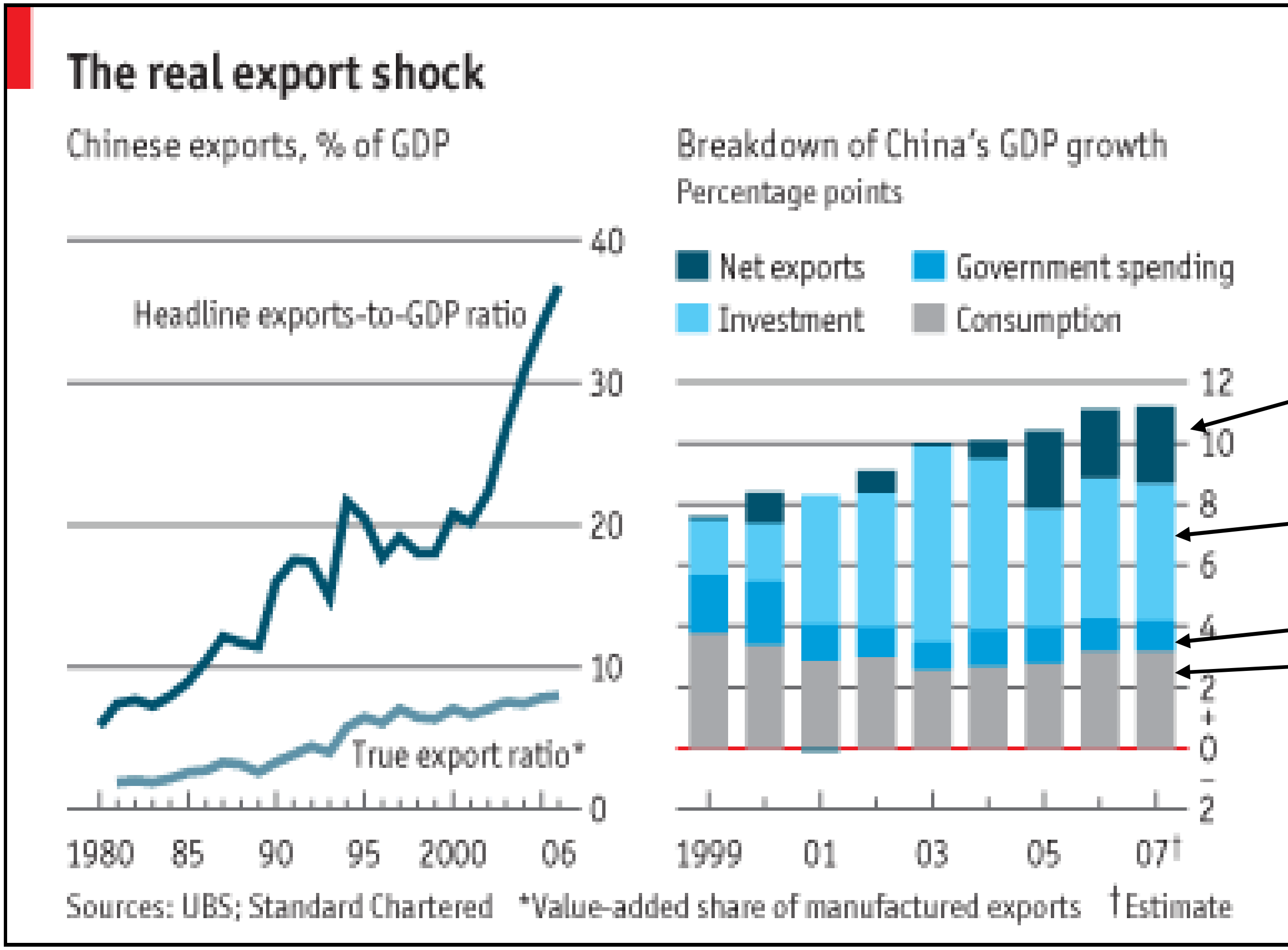
| US Trade Deficit (%) | 1985 | 2004 |
|---|---|---|
| China | 0 | 24 |
| Japan/Hong Kong Korea/Taiwan | 52 | 16 |

- 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 $\Delta GDP = \Delta\{C+G+I+(X-M)\}$
- 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




20%

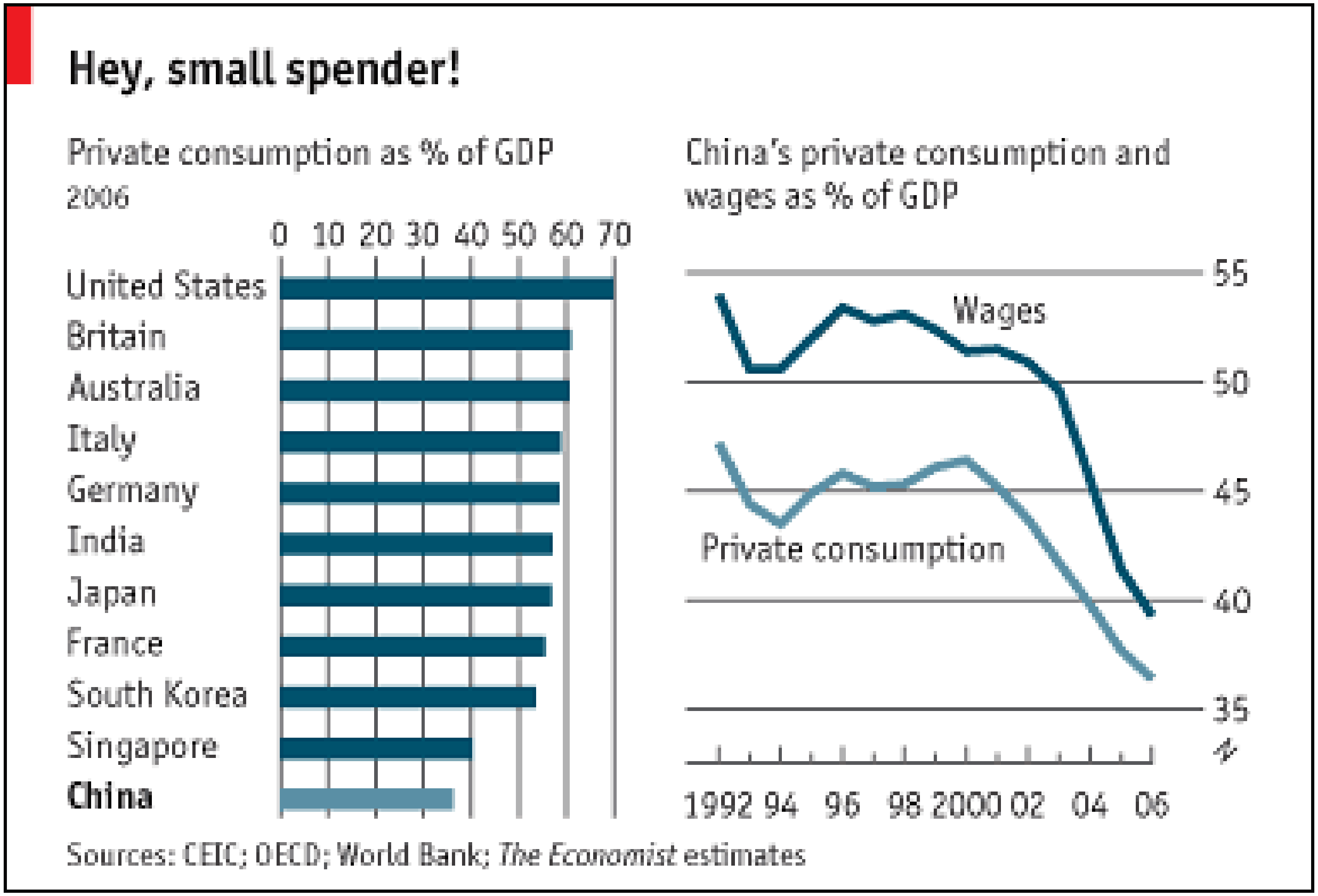
40%

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

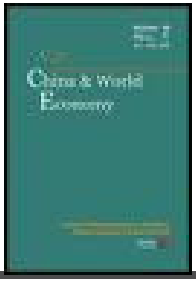
# China Needs to Rebalance

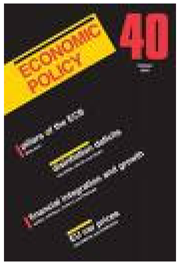
- To rebalance growth, China must address internal/external imbalances
- Independent monetary policy
- Allow exchange rate to appreciate
- Other Asian currencies will also appreciate – allowing for “orderly correction” of US external imbalance

# 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:





- Bernanke, Ben S. and Frederic S. Mishkin, 1997, "Inflation Targeting: A New Framework fro Monetary Policy?" *Journal of Economic Perspectives*, 11(2): 97-116.

- Blanchard, Olivier and Francesco Giavazzi, 2006, "Rebalancing Growth in China: A Three-Handed Approach," *China & World Economy*, 14(4): 1-20.

- Frankel, Jeffrey A. and Shang-Jin Wei, 2007, "Assessing China's exchange rate regime," *Economic Policy*, 51(July): 577-627.

- Goldstein, Morris, 2007, "A (Lack of) Progress Report on China's Exchange Rate Policies," Working Paper 07-5, Peterson Institute for International Economics: Washington DC.

# References:




- **Goodfriend, Marvin and Eswar Prasad, 2007, "A Framework for Independent Monetary Policy in China," *CESifo Economic Studies*, 53(1): 2-41.**

- **Lardy, Nicholas, 2007, "China: Rebalancing Economic Growth," Paper presented at Conference on The China Balance Sheet in 2007 and Beyond, May 2, 2007, Peterson Institute for International Economics: Washington DC.**

- **Naughton, Barry, 2007, *The Chinese Economy: Transitions and Growth*, MIT Press: Cambridge, MA – Chapter19.**