Section 2

The article in this section is in the series of signed articles on monetary and general economic topics introduced in the autumn 1969 issue of the Bank's Bulletin. Any views expressed in this article are not necessarily those held by the Bank and are the personal responsibility of the authors.

The Chinese Economy: Emergence and Evolution

*by Rónán Hickey and Jenny Osborne**

1. Introduction

Since 1978 China has undertaken a series of economic reforms that have transformed the domestic economy, progressively opening it up to international trade and investment. As a result, China has grown rapidly to become the sixth largest global economy[1]. The long-term average rate of growth has been about 9 per cent, the fastest of any country on the globe during the two-decade-plus period, while per capita GDP has risen from about $300 in 1980 to $1000 in 2002. Moreover, China's GDP per capita is still only a fraction of levels in Japan, the NIE's, and most of ASEAN-4[2], suggesting that there is much more growth to come.

In many ways, China's importance is already apparent. China has been a leading engine of the world economy, accounting for a significant proportion of global growth since the mid-1990s. High and sustained economic growth is not only well above the regional average, it has been combined, until recently, with low inflation, and even deflation, and a strong external position. China has become the world's largest recipient of foreign direct investment and, reflecting its favourable external position, and its pegged exchange rate *vis-à-vis* the US dollar, China's foreign exchange reserves have reached record levels. However, some indicators signal problems. There are growing concerns that the Chinese economy may be overheating. High and rising economic growth is now being accompanied by a pick-up in inflation and there is also evidence of a credit and investment boom, which, in turn, is having some impact on the property market.

Against this background, this paper reviews China's economic performance, and examines from, both a domestic and global perspective, some of the issues that its rapid economic rise has brought to the fore. Section 2 takes a look at longer-term developments, while section 3 focuses on the more immediate past. The remainder of the paper then turns its attention to short

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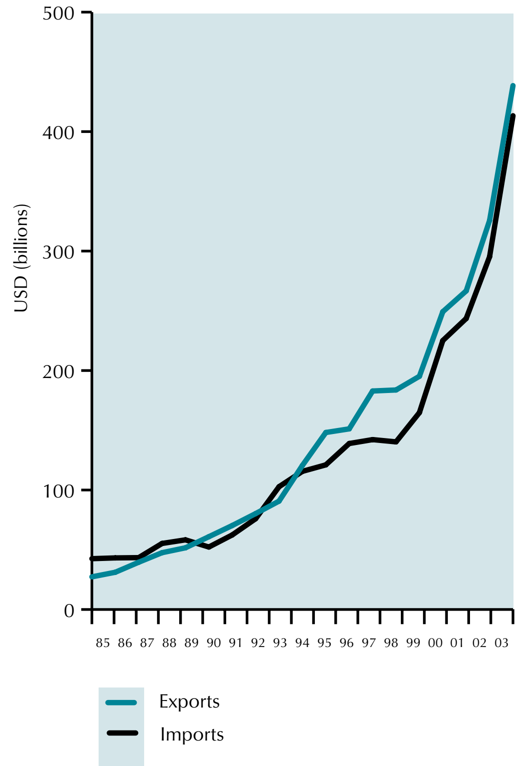
1 Using market exchange rates (Spatafora, 2004). China is the second largest economy measured at purchasing power parity, according to the Economist.

2 The ASEAN-4 comprise of Indonesia, Malaysia, Philippines and Thailand. The NIE's comprise of Korea, Singapore and Taiwan.

and medium-to-long term issues that have come about as a result of China's emergence, and outlines reforms that will be necessary to ensure the benefits of China's integration are maximised. Before beginning it is important to emphasise that any evaluation of the Chinese economy is based on data, the quality of which is regarded by many as indicative.

Chart 1

Value of exports and imports (USD), 1985-2003



Source: EcoWin

2. China's long-run economic and exchange rate performance

2.1 China's long-run economic performance

China has followed an 'export-led growth strategy', with external trade expanding at a more rapid pace than the economy, reflecting the substantial increase in openness in the last twenty years. Trade reforms and, over the past decade, commitments made as part of the World Trade Organisation (WTO) accession process have been crucial in increasing China's integration into the world economy[3] (chart one shows the evolution of Chinese exports and imports).

Table 1: China: Market share in major export markets

(Imports from China divided by total imports)

	1960	1970	1980	1990	1995	2000	2001	2002
Japan	0.5	1.4	3.1	5.1	10.7	14.5	16.6	18.3
United States	–	–	0.5	3.2	6.3	8.6	9.3	11.1
European Union	0.8	0.6	0.7	2.0	3.7	6.2	6.7	7.5

Source: IMF, Direction of Trade Statistics

In 1977, China accounted for only 0.6 per cent of world trade and was ranked thirteenth in the world, but by 2000 these figures had increased to 3.7 per cent and seventh in the world respectively. Since then it has continued to expand, surpassing Canada, the UK and France to become the fourth largest economy trading, and account for 25 per cent of the expansion in world trade in 2002.[4] Exports have been the main driver of growth, as well as the catalyst for economic developments, growing about 15.5 per cent a year between 1980 and 2002.[5] In 2002, both exports and imports increased about 21 per cent, faster than any other major economy, while global trade was evidently flat. More recently, China surpassed Japan to become the world's third biggest trading nation, behind only Germany and America. China is now a preferred destination for the relocation of global manufacturing facilities, and its strength as

3 China has been a member of the WTO since December 2001, but the impact of its membership has had an important influence on Chinese trade policies since the early 1990's. The accession process resulted in key reforms taking place – most notably the reduction of tariff barriers – and membership is expected to continue to facilitate China's global integration in the coming years, increasing access to foreign markets and opening up the domestic services sector to international trade.

4 Lardy (2003,3).

5 Trade as a share of GDP rose from 13% in 1980 to 50% in 2002.

an export platform has contributed to incomes and jobs. At the same time, imports have risen 40 per cent, making it a locomotive for growth in the Asian region.

As history has shown, China's business cycle appears to behave differently to many G-7 countries. Its rising share in world output and low correlation with G7 output growth, means that it has a growing influence in the global business cycle. Both during the Asian crisis and the recent global slowdown China behaved counter-cyclically[6]. A question remains as to whether it will continue to have a role in dampening cyclical swings, both in the region and globally.

2.1.1 Sources of growth

While external trade and FDI flows have been the main drivers of growth, from a growth accounting perspective, capital accumulation has accounted for the bulk of the GDP expansion since 1978, contributing around 4-6 percentage points. Reflecting this, the investment ratio has been very high, around 40 per cent as a share of GDP. FDI flows have played a significant role in facilitating capital accumulation and subsequently growth in this period. By 2002 FDI flows were more than $50bn or 4 per cent of GDP. The other main engine of growth has been strong total factor productivity growth (TFP), rising from zero to close to three percent, with structural reforms having a significant impact. The liberalisation of the agricultural sector in the early 1980's and the acceleration of market-oriented reforms in the early 1990's led to strong growth in industrial enterprises and agriculture *(Heytens and Zebregs, 2003)*. Moreover, a more efficient allocation of labour, stemming from labour migration, has been a key contributor to output growth.

Growth since the late 1970's reflects in large part the expansion of labour-intensive industries. As reforms took hold, export growth became increasingly concentrated in labour intensive products, in which China has a relatively strong comparative advantage — these products included textiles, apparel, footwear and toys. For each of these products China captured a rapidly rising share of total world exports (see table 2 below), and between 1980 and 1998 exports of these items increased more than ten fold, increasing from roughly $4.3bn to $53.5bn. Today China is among the top five traders in several goods categories. More recently, China has been an important reprocessing centre and manufacturing hub of consumer electronics, computers and other IT products — the growing importance of which is reflected in the US market. In addition, while China is being used as a manufacturing platform for sales to the global market, foreign

6 China maintained its growth even in the face of a global growth recession in 2001 and an anaemic recovery in 2002. During 1997-2003 China's business cycle has displayed a correlation of only 0.0 and 0.2 with the business cycles of the world and the US respectively. (IMF World Economic Outlook, 2004)

firms are increasingly selling to the domestic sector — increasing competitiveness.[7]

Table 2: China's share of total world exports by product

	1980	1998
Textiles	4.6%	8.5%
Apparel	4.0%	16.7%
Toys	2.3%	17.9%
Footwear	1.9%	20.7%
Total*	6.9%	29.1%

Source: N. Lardy, "Trade Liberalization and its Role in Chinese Economic Growth", IIE, November 2003.
*Share of China's total exports accounted for by these four product categories.

Reflecting developments in the economy, the private sector now accounts for more than 60 per cent of China's GDP, and reflecting the scale of FDI flows, foreign funded enterprises now account for half of China's exports. This brings into focus, the extent to which FDI flows, facilitated by trade reforms and the general opening of the economy, have played a significant role in the export-led growth strategy. A significant proportion of these inflows have come from Asia itself, as countries outsource to China for the assembly of labour intensive goods (see table 3). While this relocation through FDI inflows was somewhat dampened by SARS in the first half of 2003, it has rebounded subsequently.[8] Albeit the bulk of FDI flows have been to the manufacturing sector, foreign investment in finance, insurance, education, and culture and media has also risen by a significant amount.

Table 3: China, FDI Flows, USD Billions (actually utilised, cumulative)

FDI flows	1999	2000	2001	2002	2003
Japan	2.97	2.92	4.35	4.19	5.05
Korea	1.28	1.49	2.15	2.72	4.49
US	2.03	2.61	2.61	3.36	4.06
Taiwan	2.60	2.30	2.98	3.97	3.38
Singapore	2.64	2.17	2.14	2.34	2.06
Germany	1.37	1.04	1.21	0.93	0.86
UK	1.05	1.17	1.05	0.89	0.75
Thailand	1.48	2.04	1.94	1.88	1.74
Total	40.40	40.77	46.85	52.74	53.51

Source: Ecowin

According to the *United Nations (2004)*, China's global ranking for FDI flows in the next two years appears very favourable. China and India are expected to lead, followed by the US, as the

7 Increased competition is having a transforming influence on China's domestic economy. The three areas most affected are; the decline in employment in the state sector, the shrinkage in the rate of inventory accumulation, and the upturn in profitability of China's state-owned manufacturing firms.

8 Despite FDI slowing down from the big increase in 2001 and 2002, there has only been a marginal let-up in industrial production and investment.

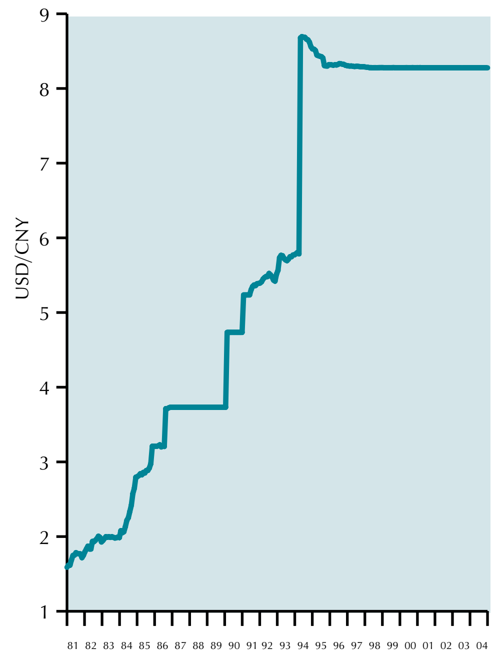
countries for which FDI prospects are the greatest. For many developed countries, especially in Europe, which have traditionally been among the largest FDI recipients, prospects appear less bright than for certain developing countries such as Thailand, Malaysia, Singapore and the Republic of Korea.

2.2 China's long-run exchange rate performance

China's decision to follow an export-led growth strategy has also been supported by its exchange rate policies. Its current foreign exchange system is made up of two components — a managed floating exchange rate pegged to the US dollar, and wide-ranging capital account controls that limit cross-border capital transactions (see Box 1). Chart two outlines the recent evolution of the renminbi (RMB), the official currency of the People's Republic of China[9], in nominal terms against the US dollar. Its development over this period can be divided into three broad phases: (1) a fixed exchange rate system during much of the 1980's; (2) the dual exchange rate regime that operated between 1988 and 1993; and (3) the managed floating system that replaced the dual system in 1994 and continues to operate today.

Chart 2

Renminbi/US Dollar exchange rates, 1981-2004



Source: EcoWin

For much of the 1980's the Chinese authorities operated a fixed exchange rate regime. As chart two shows, however, the RMB was devalued several times over this period, reflecting both economic developments and the adoption of the Asian-model of export-led growth, supported by a competitively valued exchange rate. In 1988, this system was changed to a complex dual exchange rate and currency regime. Foreigners wishing to obtain Chinese currency could still do so at a relatively unfavourable official fixed rate, but in China a market-determined exchange rate was used for trade-related transactions. Foreigners were forced to use foreign exchange certificates as a proxy for the currency, while use of the RMB was limited to domestic trades only. However with the domestic 'swap rate' lower than the 'official' international rate, a thriving black market in currency transactions emerged. To counter this, the official exchange rate was brought to more realistic levels over the course of the next five years, represented on chart two by the gradual devaluation over this time.

The dual system lasted until 1994 when it was replaced by a single currency and exchange rate. At the time the official and market swap rates stood at 5.8 and 8.7 against the US dollar respectively. The reform applied the market swap rate as the base rate, which, on paper, represented a sharp devaluation (explaining the sharp fall in the value of the RMB in the chart at the start of 1994) of the Chinese currency. In reality, however, given the proliferation of the black market, the actual devaluation was far less substantial. While officially described as a controlled

9 The currency name renminbi is often confused with its base unit, the yuan.

float, since mid-1995 the Chinese currency has been pegged against the US dollar within a very narrow range of plus or minus 0.3 percentage points from the central rate. In practice, the People's Bank of China (PBC) has intervened to limit actual fluctuations to just plus or minus 0.1 percentage points in recent years.

Box 1 — Capital controls in China[10]

For a currency to achieve full convertibility it must be easily convertible for both current and capital account transactions. Since 1996 the RMB has been fully convertible for the former of these — such as trade in goods and services — but significant restrictions on cross-border capital flows mean it remains, for the most part, unconvertible for capital account dealings. Full convertibility was a policy objective of the Chinese authorities as recently as late 1997 (when the aim was full convertibility by 2000), but following the Asian crisis, currency stability became the primary concern of exchange rate policy. In general, the severest controls are placed on riskier short-term items such as portfolio flows and foreign debt. Capital controls that are currently in place include restrictions on access to financial markets (both restrictions on access by foreign investors to Chinese markets and Chinese investors to foreign markets), restrictions on borrowing from overseas markets, and restrictions on outward direct investment by domestic enterprises. Inward direct investment, on the other hand, is strongly encouraged. Of the capital markets that have been partly opened to foreign investors, some segregation exists between residents and non-resident investors (for example separate equity and bond markets exist for non-residents and domestic investors), and between domestically funded and foreign funded enterprises (the latter can borrow overseas without approval). Whereas the Chinese authorities have come under increasing pressure to alter their current exchange rate policy, there have been fewer calls for them to liberalise capital controls in the short-run. China has made no commitment in the WTO negotiations to fully liberalise the capital account, though individual measures appear to be envisaged. This gradual approach reflects a concern that, given the combination of a high domestic savings ratio and domestic banking sector fragility, moving too quickly could trigger sizeable capital outflows.

Chart 3

China's real effective exchange rate, 1990-2003

Source: EcoWin

2.2.1 Real effective exchange rate developments

Adopting a peg does not automatically guarantee an improvement in an economy's competitiveness levels. How competitive an economy is depends as much on relative price levels as it does on its nominal exchange rate, and accordingly, to see how China's international competitiveness evolved over this period we need to observe how its real effective exchange rate[11] (REER) changed. Chart three outlines China's REER from the start of the 1990's[12]. Following the broad trend set in the previous decade, China's REER declined by almost a third between 1990 and 1993 (implying an improvement in competitiveness), as exchange rate devaluations compensated for an increase in the domestic inflation rate. This trend reversed

10 For a more detailed look at capital controls see *Neely (1999).*

11 A real exchange rate is a nominal exchange rate adjusted for relative prices. An effective exchange rate is a composite index of the value of the domestic currency, or to be more specific is the exchange rate of the domestic currency vis-à-vis other currencies weighted by their share in either the country's international trade or payments (OECD definition).

12 These are CPI based real effective exchange rates.

in 1994, and apart from a brief period in 1998 — when other Asian currencies rebounded from their Asian crisis lows — the Chinese REER continued to appreciate until the end of 2001 (increasing by 50 per cent over this period as a whole). This appreciation initially reflected a stronger inflation rate in China than in its main trading partners, but following the introduction of the peg in mid-1995 was primarily driven by a broad based appreciation of the US dollar. Movements in the US currency have also been the catalyst behind the REER's depreciation since early 2002, particularly last year when Chinese inflation picked-up once again.

Chart 4

Real GDP growth (year-on-year), 2000-2004

Source: EcoWin

3. Economic developments over the past decade

This long-term trend of rapid integration and strong economic growth has been sustained in recent years. However, these developments have not been altogether positive, as more recently, the strength of economic expansion has been coupled with growing concerns that the domestic economy may be overheating.

3.1 China and the Asian Crisis

Despite domestic uncertainties and the difficult world economic environment, China's GDP growth has remained resilient in recent years. Its external position has strengthened considerably, and given its increasing integration into the global economy, it has provided a significant impetus to world demand.[13] During the Asian crisis (1997-1998), China maintained relatively strong growth, while holding its peg between the RMB and the US dollar intact, despite a weak financial sector, sizeable currency devaluations in the rest of non-Japan Asia, and a rise in export competition from these countries. China was unmoved by the crisis for a number of reasons, highlighted by *Aherne, Fernald and Loungani, 2001*. Despite the large banking system and prevalence of bad loans and other institutional weaknesses, China did not experience the credit boom and bust that was common in many other East Asian countries, helped in part, by the fact that capital controls prevented Chinese financial institutions from borrowing excessively abroad. China was also less affected by relative price effects from depreciation in other countries, despite the increased export competition and the reduced incomes of Asian economies. As a consequence, China's external position remained relatively favourable compared to the rest of Asia. During this period, Chinese exports were supported by the strength of the US and European economies, which offset the impact of exchange rate depreciation and economic weakness elsewhere in Asia. This reflects a more general trend, whereby the state of demand in trading partner countries is a key determinant of demand for Chinese exports.

13 Since the country joined the WTO in December 2001, the economy's links to the outside world have accelerated.

3.2 More recent developments

In recent years, the Chinese economy expanded as a result of acceleration in fixed asset investment, a steady increase in consumption and strong export growth, all of which encouraged a sharp rise in production. China grew by 9.1 per cent in 2003 – the highest rate since 1997, driven by domestic demand and, in particular, private consumption and fixed investment. Industrial sector growth in 2003 was 12.5 per cent, while the services sector grew by 6.7 per cent. So far in 2004, the Chinese economy has continued to grow at a rapid rate – first quarter growth is estimated at 9.8 per cent, with investment, consumption and exports continuing to show solid growth.

Table 4: Real GDP growth 2003

	%	Structure of GDP, 2003	% of GDP	Growth
GDP	9.1	Agriculture	14.8	2.5
Investment	26.7	Industry	52.9	12.5
Retail Sales	9.1	Services	32.3	6.7
Exports	34.6			
Imports	39.9			

Source: National Bureau of Statistics, China

While robust growth has been accompanied by a strong increase in manufacturing and services employment, the rate of job creation is a key issue for the Chinese economy. Unemployment continues to be underpinned by structural job losses in rural areas and layoffs from state owned non-financial enterprises (SOE's), and a sizeable surplus of labour still exists in the rural sector (about 150m) and the SOE's (about 10-11m)[14]. One of the main challenges that remains is to absorb this surplus labour into sustainable employment. Nevertheless, robust growth made substantial contributions to reducing poverty last year, when the number of poor was estimated to be slightly over 150 million, compared to 360 million in 1990 (according to the World Bank[15]).

External demand, which has provided a significant impetus to Chinese growth, continued to expand strongly in 2003, with exports rising 34.6 per cent. Nevertheless, the trade balance shrank to US$25.4 billion in 2003, from US$30.4 billion in 2002, as a result of imports rising sharply (see table 5)[16]. This trend continued into 2004, with the trade balance for the first quarter negative, reflecting a 42 per cent (year-on-year) increase in imports.

14 Brooks (2004).
15 According to the World Bank, much of the global poverty reduction during the last two decades was accounted for by China.
16 Merchandise exports accounted for 5.9 per cent of world trade, while services exports accounted for 2.5 per cent. In relation to imports, merchandise imports accounted for 5.3 per cent of world trade, while services imports accounted for 3.1 per cent (Source: WTO).

Table 5: Trade (2003 and Q1 2004)

	2003		Estimates for 2004 Q1	
	US $bn	% Change	US $bn	% Change (y-y)
Exports	438.5	34.6	115.7	34.1
Imports	412.8	39.9	124.1	42.3

Source: Ministry of Commerce, People's Republic of China

As regards price developments, since deflation bottomed out in mid-2002 (prices declining 0.8 per cent in 2002, the result of strong productivity growth), there has been a continuous and accelerating pattern of price rises against a background of strong growth. While the official CPI inflation rate for 2003 as a whole was 1.2 per cent, more recently the year-on-year rate has accelerated above 4 per cent for the first time since 1997. The pick-up in inflation is the result of growing domestic demand, the expansion of the money supply and an increase in commodity prices.

3.3 Recent exchange rate developments

Following its introduction in 1995, the Chinese authorities' decision to operate a currency peg has played an important role in supporting the pick-up in domestic macroeconomic conditions (rapid economic growth, weaker inflationary pressures and stronger FDI inflows). More recently, however, there is growing evidence that the peg to the dollar may be having a detrimental effect on the domestic economy. The greatest concern surrounds the extent to which the current level of the exchange rate is encouraging an unsustainable rate of economic growth, not only by making Chinese exports relatively cheaper, but also through its impact on the domestic money supply. The exchange rate regime has primarily impacted on the money supply through foreign exchange market intervention to keep the peg intact. The combination of strong export driven Chinese economic growth and a depreciating US dollar has put upward pressure on the RMB in recent years, and forced the Chinese authorities to undertake substantial foreign exchange market intervention. This process of selling RMB and buying US dollars to maintain the peg has fuelled strong growth in liquidity, and attempts by the PBC at sterilisation have been only partly successful. As a result, the money supply has increased sharply, fuelling a credit boom.

Against this background, as already noted, inflation has started to rise rapidly. In effect, by pegging to the dollar, the Chinese authorities have given up their autonomy over domestic monetary policy, and consequently, many consider that domestic monetary conditions have become inappropriately loose. Given the stage of the business cycle that China finds itself at, this has encouraged over-investment and a worsening of the already sizeable NPL problem of Chinese banks. In a recent attempt to reduce credit growth, the government has favoured a

combination of increasing reserve requirements (a policy that has been significantly undermined by the impact of the increased money supply on banks reserves) and introducing measures to limit investment expenditure[17]. The latter include the consolidation of central government spending, a temporary lending moratorium on certain industries and increased equity requirements for shareholders in investment projects in four sectors identified as overheating (steel, cement, aluminium and real estate). The pattern that has developed of investment fuelled by bank lending, and visible and incipient price pressures, has led many to question the appropriateness of the present exchange rate regime and its reform. This is discussed in more detail in section six.

4. Short and long-term issues going forward

The emergence of China has brought to the fore a number of short and medium-to-long term issues for both the Asia region and the global economy as a whole. This section begins by examining the implications of China's expansion for its neighbouring economies, before focusing on global issues, both in the short and longer term.

4.1 China in the region

What have been the implications of China's economic growth for its neighbouring economies? There are two opposing views on the nature of the trade links between China and emerging Asia *(Aherne, Fernald, Loungani, Schindler, 2003)*. Firstly, that the economies are *comrades*, benefiting from expanding intra-regional trade in Asia. The second view is that they are *competitors* for market share in major export markets such as the US, since they produce goods that are relatively close substitutes.

The growing degree of interdependence is evidenced by the fact that *intra-regional trade* has accelerated in recent years, and China's role as a processing hub for exports from the region has increased significantly. The trade liberalisation triggered by China's accession to the WTO has had a considerable impact. The economic performance in China now has significant positive 'spillover effects' on the rest of the region, and China's fast growth has supported the recent recoveries in neighbouring countries, as imports have surged from the rest of Asia. In 2003, intra-regional trade accounted for almost half of the region's total trade, and was one of the main sources of export growth. Two-thirds of Chinese imports came from Asia (with just 17 and 8 per cent coming from Europe and the US respectively) while demand from China accounted for approximately 90 per cent of Taiwan's

17 There is some evidence to suggest that China's tightening measures are having some effect. Growth in fixed-asset investment slowed in May to 18.3% year-on-year, down from 47.8% in quarter one. Also, annual growth in industrial production, imports, money supply and bank lending slowed. However, retail sales continued to accelerate.

export growth, 70 per cent of Japan's export growth and 40 per cent of Korea's export growth (see table 6 for further information). The most noteworthy change in recent years is that industrialised countries in the region are increasingly shifting early and labour intensive stages of their production processes to China, while concentrating their own output on the more skilled and capital-intensive parts. As a result, China is running growing trade deficits with these countries while it is expanding its trade surplus with the US.[18] While these economies continue to be vulnerable to downturns in developed country markets, their increased dependence on the Chinese market puts the spotlight on the management of domestic demand in China.

Table 6: Share of national exports going to China (in per cent)

	1990	1995	2000	2001	2002
Japan	2.1	5.0	6.5	7.7	9.6
Malaysia	2.1	2.7	3.1	4.3	5.6
Thailand	1.2	2.9	4.1	4.4	5.2
Korea	0.9	7.3	10.7	12.1	14.6
Taiwan	0.0	0.3	2.8	3.9	7.6

Source: CEIC

On the other hand, some indication of the degree of export competition within the region can be had by looking at the pattern of exports to the US. In the period 1989-2002, national shares of exports to the US from the region have changed dramatically. China and Hong Kong have doubled their share of exports, Asian NIE's have halved their share, while the ASEAN-4 have held their own. As a result, China's gains in market share have not displaced ASEAN-4 labour intensive economies, but they have had a negative effect on exports from the NIE's in industries such as apparel, footwear and household products. Nevertheless, exports from China and other Asian economies to the US tend to move together, suggesting that demand from developed economies is a more important determinant of Asian exports than competition with China. Additionally, the increasing vertical integration of product markets in several economies in the region, has helped provide value added to a single device — i.e. DVD.

While, on the one hand, evidence suggests that China and other Asian economies are competitors — since China is displacing other countries of emerging Asia in major export markets such as the US — on the other hand, there are two fundamental reasons which suggest they are also comrades. Firstly, China itself has emerged as a major importer of goods from countries of emerging Asia, and secondly, the ongoing specialisation which

18 Industrialised countries have shifted focus from labour-intensive manufacturing to high-value added manufacturing, services, logistics and research and development — i.e. Singapore has shifted from electronic production to pharmaceuticals industry, while Taiwan has shifted from manufacturing to research and development.

seems to be occurring suggests that Asian countries are, in effect, organising production of goods in a way that increases the efficiency with which they can export.

4.2 China and the global economy

4.2.1 Current issues

(1) Is China supporting global growth?

The rapid development of the Chinese economy over the last twenty years has injected vitality into the global economy and created the necessary conditions for economic growth in some countries. China's economy has become so large that it is beginning to serve as an engine of growth not only in Asia, but even globally (China accounted for one-quarter of global growth in the period 1995-2002). The long-term rate of growth has been about nine per cent, the fastest of any country on the globe during the two-decade plus period. Trade integration with the world economy has proceeded at a rapid pace, a trend that seems set to continue. Consequently, if China experiences significant economic problems in the future, this is likely to have a far greater impact on the global economy than it had in the past, for example, ten years ago, when China had its last overheating experience. The increased supply of low cost goods and services from China has significantly changed global trade patterns and relative prices. In addition, China has emerged as an important source of global demand, particularly for commodities and intermediate products, having become the world's second largest consumer of oil and fourth largest importer of steel.

Table 7: Real GDP *(annual percentage change)*

	1997	1998	1999	2000	2001	2002	2003	2004[f]	2005[f]
World	4.2	2.8	3.7	4.7	2.4	3.0	3.9	4.6	4.4
US	4.5	4.2	4.4	3.7	0.5	2.2	3.1	4.6	3.9
Euro Area	2.3	2.9	2.8	3.5	1.6	0.9	0.4	1.7	2.3
Japan	1.8	–1.2	0.2	2.8	0.4	–0.3	2.7	3.4	1.9
China	8.8	7.8	7.1	8.0	7.5	8.0	9.1	8.5	8.0

Source: IMF World Economic Outlook, April 2004

(2) Deflation/inflation — is China a source of price volatility for the global economy?

The past eighteen months has witnessed a considerable turnaround in the assessment of global price prospects, with the focus shifting from concern about the emergence of a global deflation risk in Spring 2003 to worries about the return of inflation more recently. While China is not seen as being central to these developments, it is seen by some as playing a contributory role in both cases. While deflation concerns in 2003 were largely related to the conjunction of low global inflation with ample spare capacity and the prospect of below potential

growth in the major economies, other factors were also highlighted as adding to the risks. Among other things, these included the potential for falls in the prices of traded goods to be a source of global deflation. This was seen as arising in a situation where emerging market countries with falling unit labour costs would be able to lower prices and, potentially, export deflation. With prices for manufactured goods in international markets having fallen significantly since the mid-1990s, and China rapidly increasing its share of global trade over the same period, attention came to focus on the extent to which China was contributing to global deflation risks. Studies suggest that the impact of Chinese exports on global prices, while non-negligible, has actually been fairly modest[19]. While there have been some effect of US imports from China on US import prices, the small size of this effect and the relatively low share of imports in US GDP has meant that, ultimately, the impact on US consumer prices has been modest. Moreover, imports from China have little apparent effect on US producer prices. In addition, China's record of very high export growth is by no means exceptional. East Asia, Hong Kong and Korea also posted very high export growth in the 1980s and 1990s, and there is no evidence that they contributed to global deflation. In general, it would appear that the main source of global deflationary concerns stemmed from developments in the major economies.

More recently, however, the focus switched from concerns about the risk of possible deflation to the potential return of inflation. While other factors, such as oil price developments and the sharp pick-up in global growth are seen as the main drivers of this change, once again, there has been a focus on the extent to which developments in China have played some role. In this instance, given that rising oil and commodity prices are seen as the main threat, the question has been asked to the extent to which a rapidly growing economy, which has experienced very strong growth in commodity-intensive industries, is adding to global price pressures. Once again, the prevailing answer would seem to be that it is having a moderate impact, but there are also many other factors at work in the major economies.

(3) China and industrialised country jobs?

A view taken by some is that the large loss in US manufacturing jobs between 2001 and 2003 was the result of the bilateral trade deficit that the United States has with China. On the whole, this is a somewhat difficult argument to sustain. While gradually changing, growth in production in China has largely occurred in labour-intensive industries, which produce mass-market low-value added output — textiles, clothing, footwear, toys, sporting goods. Although China is replacing some production in US and other industrialised countries, much of this had already moved out to other locations in Asia, and it is from there, by and large,

19 Kamin, Marazzi and Schindler (2004).

that it is now migrating to China.

As a result of rising real wages in Asia, firms in these economies have become less competitive in labour intensive manufacturing. This has seen a transfer of production to China, displacing exports from these economies. However, on the upside, China imports large quantities from Asia, and in the process runs large bilateral trade deficits with these countries, and consequently a triangular trade pattern occurs. Those likely to lose out are labour abundant regions, which have limited direct trade with China (i.e. supply it with few raw materials or intermediate goods), while, by in large, industrial countries should benefit from lower goods prices and an expanding market in the long run.

(4) Is the Chinese peg supporting global imbalances?

During the period 2002-2003, the value of the US dollar declined significantly against a number of currencies — by over 30 per cent against the euro and Australian dollar, and by over 20 per cent against sterling — as concerns grew about the ability of the US to fund their massive current account deficit. Crucially however, the dollar's nominal effective exchange rate (NEER) depreciated by just 11 per cent during this time, as foreign exchange market intervention by some of the US's major trading partners restricted their currencies movements against the dollar. By limiting the size of the NEER's decline, these economies were essentially minimising the potential reduction of the US's external deficit, and accordingly supporting the persistence of global imbalances. Table 8 outlines how the dollar moved against a number of currencies in 2002 and 2003, and, for each currency, the corresponding economy's bilateral goods balance with the US. Despite imports from China playing a leading role in the deterioration of the US external balance, the pegged exchange rate has meant that the RMB remained unchanged against the dollar throughout this period.

Table 8: The dollar against international currencies (percentage change 2002-2003) and corresponding trade balances in 2002-2003 (USD billions)

Currency	% change	Goods balance
Australian dollar	−32.5%	+13.3
Euro	−31.7%	−142.2
Sterling	−21.1%	−16.5
Yen	−19.8%	−136.0
Canadian dollar	−18.8%	−99.8
South Korean won	−8.6%	−26.2
Renminbi	0.0%	−227.1
Mexican peso	+22.9%	−77.8

Note: (–) = dollar depreciation, (+) = dollar appreciation
Source: Ecowin

Aside from preventing a smooth global current account adjustment, intervention activity has effectively meant that

countries with flexible exchange rates have had to bear the impact of the dollars decline. This has raised the issue of burden sharing — the 'fair' contribution of the various trade partners of the US to the correction of its current account deficit, reflecting a concern that a sharp market driven adjustment for some countries, but not for others, has had adverse implications for the former, through negative shocks to competitiveness levels.

Initially it might appear the optimal (not to mention the equitable) solution for the global economy would be for each country's adjustment share to be related to the size of the country's goods deficit with the US. However, the fact that exchange rates are also determined by capital flows and trade in services complicates the picture. Nevertheless it would seem the current outcome — where the dollar fell by an average of just 5 per cent against currencies of countries who made up more than half of the goods deficit in the last two years[20] — is not an optimal solution. Evidence suggests the most advantageous outcome lies somewhere in between these two scenarios, and as a result could only come about if currently managed currencies were to become more flexible.

4.2.2 Long run issues

In the long run, as growth continues, China is likely to be affected by global issues; including current account imbalances, the transition to higher interest rates, emerging market debt and the ongoing fiscal situation. However, China differs in a number of ways to its comparators, which will work to its advantage — GDP per capita is still at a low level, it has an untapped labour source and domestic demand can support growth. In addition, China benefits from a high savings rate, which will aid physical capital formation in the medium term, and human capital, while remaining lower than its comparators, is expected to continue increasing (there is scope for soaking up untapped labour supply as we see continued capital investment and FDI flows). On the downside the fiscal outlook remains a source of vulnerability. As trade integration proceeds, China's impact will be most likely felt through three key areas — trade effects, world prices and financial channels.

- ***Trade effects*** — Studies attempting to quantify the impact of China's accession to the WTO generally agree that economies will tend to benefit, or lose, in proportion to how complimentary their trade patterns are with China's. The increase in the supply of labour intensive manufactures from China will reduce their relative price on world markets, benefiting countries that import a substantial amount of these goods. Furthermore, as

20 China, Japan, South Korea, Mexico and Canada accounted for over half the cumulative US trade in goods deficit in 2002 and 2003, but the dollar depreciated by an average of just 5 per cent against their respective currencies.

domestic demand increases, countries that export capital and skill intensive goods, as well as food and energy, are likely to gain from increased prices for their exports. However, some developing countries may face a ''hollowing out'' of domestic manufacturing. Countries that have an abundant supply of unskilled labour, and who trade little with China but who compete with them in export markets will possibly experience reduced demand and lower prices for their own manufactures. In addition, countries that are net importers of commodities whose prices are driven up by Chinese demand may lose out. Finally, there may be a significant impact on the sectoral composition of output and on the income distribution within, as well as across countries. For example, China's abundance of less-skilled labour could lower the relative rewards for unskilled labour.

- ***World Prices*** — Rapid growth in China, and the shift in production to China, may significantly affect prices of raw materials and manufactured goods and services, while it will put upward pressure on commodity prices, given the relatively fixed supply of raw materials. The rapid investment in infrastructure and certain industries has contributed to increased prices of iron ore, copper and oil, while shipping rates have also risen, given the increased shipment of raw materials to China. However, in the long run, as infrastructure improves, some of the pressure on raw material prices should recede. In contrast, the price of output should fall as we see an improvement in efficiency, which should benefit consumers.

- ***Financial Channels*** — Over the past fifteen years, inward FDI has benefited both China and foreign investors. It has given investors the opportunity to diversify their holdings, while also earning potentially higher returns. The extent to which these benefits will remain, will depend on the pace and precise form of China's capital account liberalisation. While, as a whole, the world economy is likely to gain, some developing countries may suffer from Chinese competition for scarce international capital. For instance, higher FDI inflows to China may reduce FDI to other developing countries. However, an alternative, more positive view, is that increased FDI going to China will complement flows to the rest of the region, and there are possibilities that outward FDI from China to other countries will expand even further.

Overall, the balance of these three effects is likely to be positive for the global economy. However to ensure that they maximise the benefits and minimise the costs of China's integration, it is imperative other countries increase their flexibility by

accelerating structural reforms. Furthermore, the maximum gains can only be attained if the Chinese economy reaches its own full potential. This itself will require a number of reforms, which are discussed in detail in the following two sections.

5. Structural reforms

China has undertaken economic reforms that have liberalised agricultural production, allowed the growth of a dynamic private sector and gradually opened up the economy to international trade and FDI. However, it still faces many significant structural hurdles and its medium to long-term growth prospects will be strongly influenced by the manner in which structural reforms occur.

5.1 State involvement in production and banking

Prior to the economic reform process, economic activity was dominated by state owned enterprises (SOEs) which geared production to meet development goals and which automatically received credit from the banking sector according to a national development plan, regardless of their profitability or risk. While much has changed since the reform process began, the banking sector still exhibits the legacy of central planning, with the government, at both central and local levels, continuing to play an important role in credit allocation and the pricing of capital. Commonly, priority is given to the state sector rather than private enterprise with regard to both the availability and price of credit.

As a result there would appear to be a serious misallocation of resources, with the bulk of bank credit channelled to the least profitable and least efficient productive sector in the economy. Their low profitability leaves SOEs financially vulnerable, which has a second set of consequences — exposure to poor-performing SOEs has had a major impact on bank performance. Consequently Chinese banks have found themselves burdened with a high level of non-performing loans (NPLs) — with the most exposed banks being the four state commercial banks (SCBs), which account for around 85 per cent of the assets of the banking sector. While the actual level of NPLs is subject to much debate, there is general agreement that it is relatively high. According to IMF estimates, non-performing loans in the Chinese financial system amounted to 43 percent of GDP in mid 2003. Of this, NPLs in the banking system accounted for 21 per cent of total loans, the four SCBs held close to half of all NPLs, while rural credit cooperatives reported 32 percent of their loans as being NPLs.

There is little doubt that high NPLs are the result of state-directed lending to unprofitable SOEs, which have been unable to repay these loans. Bank vulnerability is accentuated by pressure on NPLs to increase. While there have been some reforms aimed at

consolidating the SOE sector, SOEs cannot easily reduce their costs (e.g. there are impediments to shedding workers), which limits their competitiveness and profitability, as well as their ability to service their debts. At the same time, because of their continuing importance and the fact that they employ around 40 million workers, it is not seen as possible to cut off financing to SOEs. As a result, banks have found themselves having to roll over SOE loans, even when SOEs have defaulted on their debt, which has reduced funding for more worthwhile investment projects.

In short, what emerges is that the banking sector in China has significant structural problems, which are intrinsically linked to another structural problem, the level of state involvement in production. Against the background of the current credit boom this is a serious weakness. In effect, it raises the threat of an even more pervasive misallocation of capital and the triggering of a crisis in the banking sector. While there has been some attempt to address the NPL problem through the creation of asset management corporations (AMCs), to buy and manage bad loans from the big four banks, the progress made by the AMCs has been slow. Neither the legal nor the market infrastructure is there to deal with this problem. Moreover, even after the transfer of sizeable amounts of NPLs to AMCs, the banking sector still has large bad loans on its books.

The banking sector in China faces major issues, namely, how to resolve the NPL problem and how to transform Chinese banks into viable, financially sound organisations. Transforming the Chinese banking system will be far from straightforward. Given the magnitude of the tasks involved, it could take a considerable period before the banking system could be made sound. There are a number of necessary requirements, which include the capital adequacy of Chinese banks being radically improved[21], banks being run on a commercial basis, complementary reforms in other areas (in particular, reform of the operations of SOEs will be required) and interest rate liberalisation, to end the discrimination with regard to both the availability and cost of credit between the public and private sectors.

5.2 Labour market

In the past twenty years a more market-orientated labour market has emerged in China. The urban private sector has grown in importance, while, even if more remains to be done, SOEs have downsized. As the transition from a predominantly rural and agrarian society to a more urban one continues, a number of labour market issues are raised. It is estimated that more than 100 million rural workers have migrated, but despite the progress

21 This is likely to require significant state intervention, and as a result can only be brought about at a sizeable fiscal cost.

on reforms, a sizeable surplus of labour still exists. According to IMF estimates, there is a surplus of about 150 million workers in the rural sector and 10 million in SOEs — despite downsizing *(Brooks, 2004)*. This compares to an estimated total labour force of around 740 million and total employment in the industrial and services sector of around 370 million. Last year, the strength of the export platform contributed positively to incomes and jobs, and urban employment rose by a buoyant 8.6 million jobs. However, unemployment rose on the back of structural job losses in rural areas and layoffs from SOEs.

One underlying issue in the labour market is the need to build a 'social safety net'. There is increasing pressure on social stability stemming from the high level of unemployment, inadequate pension and social security systems, and significant income disparities. To date, social protection has been provided mainly through the SOEs, which maintained jobs and provided a wide range of social services for employees (including housing, healthcare, education and pensions). As SOEs continue to downsize, the government has been strengthening social support systems in urban areas — expanding availability to all urban residents and covering more rural residents.

Looking ahead, to ensure strong productivity growth, China needs to create quality jobs for new entrants to the labour force (via the private sector), as well as facilitate the surplus of labour. For a more efficient and less segmented labour market, China will need to allow greater mobility (i.e. restrictions on internal migration reduced), improve worker skills, improve job search services and strengthen the social safety net.

5.3 Fiscal issues

Chinese government debt is currently low by international standards, especially in comparison to other emerging market economies, increasing to 26 per cent of GDP in 2002. However this data is slightly deceptive, and looking forward, concerns persist about the sustainability of the Chinese fiscal position. As table 9 shows, government debt has actually grown rapidly since 1997, and more than doubled in relation to GDP within the five-year period 1997-2002. This increase reflected a sharp deterioration in the budget position, as despite strong economic expansion, revenue growth has been slow relative to expenditures. The bulk of government debt — almost 85 per cent in 2002 — is domestic based.

Table 9: Chinese government debt and budget balances, 1997-2002 (in per cent of GDP)

	1997	1998	1999	2000	2001	2002
Govt Debt	11.4	17.8	20.9	22.8	24.0	25.6
Budget Deficit	−1.8	−3.0	−4.0	−3.6	−3.2	−3.3

Source: IMF

The risks to the longer-term financial sustainability of the country are connected, above all, with the costs of restructuring the banking sector, restructuring other state-owned enterprises, and the partially resulting strains on the social security systems. As mentioned above, there will also be growing pressure in the coming years for additional expenditure on establishing a social safety net, and improving health and educational resources, especially in lower income provinces. The authorities acknowledge these problems, and have already pledged to reform the tax system, improve fiscal management and allocate more resources to areas such as education, health and social security. They have also initiated a rolling three-year fiscal framework to assure future policies are formulated in a medium term context. However more will need to be done to make the banking sector financially sound (see section 5.1) and reform the current 'pay-as-you-go' pension system. The IMF recently noted that the transition costs of moving to a fully funded system would be significantly reduced if the shift were to be accompanied by parameter changes, such as raising the retirement age and indexing pensions to inflation rather than wages.

6. Exchange rate reform

The Chinese exchange rate system represents another area where reform has become a necessity. In time, as China moves to liberalise capital flows, it will also have to move to a more flexible exchange rate regime. A relatively fixed exchange rate target would be vulnerable in an environment of liberalised capital flows and, in any event, even in present circumstances China needs greater monetary policy independence to respond to changing economic developments and conditions. Given the restrictions on capital transactions that currently exist, however, few observers have suggested the Chinese authorities should allow their currency to float freely[22]. Nevertheless, there is a general belief that China should reform its exchange rate system as soon as possible, with two of the more prominent proposals coming from Goldstein and Lardy of the Institute for International Economics and Eichengreen of the University of California.

Goldstein and Lardy (2003, 2) have suggested the Chinese exchange rate regime should undergo a two-stage reform. The first stage would involve revaluing the RMB by 15-25 per cent, while simultaneously widening the band the authorities allow the Chinese currency to float in (from plus or minus 0.3 per cent to around 5 per cent), and replacing the unitary dollar peg with a three-currency basket peg, incorporating the dollar, euro and yen (with roughly equal weights). The second stage would see the adoption of a managed float, to occur once the financial system had been strengthened and the capital account significantly

22 And as was mentioned in section two, there is also broad agreement that the Chinese authorities should not rush into liberalising their capital account.

liberalised. A managed float would allow the currency to adjust depending on market forces, but keep the option of official intervention open to the PBC, to prevent overly volatile movements. The authors believe this approach would remove the burden of an undervalued RMB on the global economy in the short-term, but would not rush the Chinese authorities into liberalising their capital account too soon.

Eichengreen (2004), on the other hand, has proposed that the Chinese authorities should ignore the first stage described above and move straight to a managed float. While acknowledging that the currency peg played a vital role when exports were the primary growth producing sector in the economy, and instruments of monetary management were under-developed, Eichengreen believes that the Chinese authorities should now adopt an inflation targeting strategy, based around a heavily managed exchange rate. Under such a strategy the exchange rate would remain a key policy instrument, and exchange rate intervention would continue to occur in order to limit the impact of currency fluctuations on inflation and the growth rate. The key difference between this proposal and the current Chinese peg is that there would no longer be a fixed centre rate or fixed bands around which the exchange rate could fluctuate. Instead the desired exchange rate, and permissible fluctuations around this rate, would be constantly changing, depending on economic developments and the impact that these developments were having on the targets for growth and inflation.

By allowing the RMB to appreciate, adopting either of these approaches would have a desired cooling effect on the domestic economy. A re-valued RMB should make domestic exports somewhat less competitive on global markets[23], and would also place downward pressure on the domestic money supply — and temper investment expenditure — by reducing short-term capital inflows and the accumulation of foreign reserves[24]. Adopting one of the two approaches should also have a positive impact on global imbalances, placing downward pressure on China's trade surplus with the US, and weakening some of the burden on economies with more flexible economies[25]. These global effects could be reinforced if other Asian economies, taking China's lead, were to also allow their exchange rates appreciate against the dollar.

23 However, the impact could be limited by strong growth in China's main export markets. If this were the case, the positive income effect in these countries could outweigh the negative price effect.

24 Reflecting weaker speculative activity and less foreign exchange intervention respectively.

25 It is important to note however, that, irrespective of the exchange rate system adopted by the Chinese authorities, reform will only have a limited impact on global imbalances. This reflects the fact that exchange rate adjustment will probably have to be combined with growth differentials — weaker US growth compared to the rest of the world, or stronger growth in the rest of the world compared to the US — to bring the US current account deficit to more sustainable levels.

The divergence between the two approaches reflects more general differences about when an economy should allow their currency to float. While *Goldstein and Lardy* suggest that this should not happen until the economy's capital account has been fully liberalised, *Eichengreen* believes that a closed capital account only rules out adopting a free floating currency, and not a more flexible one[26]. Moving straight to a floating regime would remove the limitation of the two-stage reform — not giving the Chinese authorities any greater autonomy over monetary policy for as long as they remain in stage one. However, *Eichengreen's* proposal is also not without its problems. The major concern in any reform of the RMB's exchange rate must be the impact that it would have on the underdeveloped Chinese financial system. While the paper assures that tight capital controls would insulate the banking system from a more flexible exchange rate, a risk would remain that the latter could not be fully relied upon as the capital account appears to be growing increasingly porous. The key question is whether the returns from the Chinese authorities having an autonomous monetary policy would be of a magnitude to make this a risk worth taking. On the one hand, these gains are likely to be sizeable, but on the other, there would be a significant global fallout should the Chinese financial system collapse. Accordingly the answer to this question, and the decision over which regime the authorities should adopt, is far from straightforward.

7. Conclusion

China's role in the global economy has increased considerably in the last 25 years. Over this period it has grown rapidly to become the third largest trading nation in the world, and the sixth largest global economy. This improving position has been driven by a number of factors, including structural reforms, FDI inflows and a favourable exchange rate regime. Furthermore, the trend of rapid integration and strong economic growth has continued into the more immediate term, despite the difficult world economic environment. Real GDP grew by 9.1 per cent in 2003, picking up to 9.8 per cent in the first quarter of this year, on the back of solid growth in consumption, investment and exports.

This has led to concerns that the Chinese economy may be overheating, an issue of greater importance today than in the past. Given the Chinese economy is now serving as an engine of growth for the international community, any temporary but dramatic economic setback would have a far greater impact on the global economy than it would have done ten years ago. This is one of a number of issues that China's integration has brought

26 Eichengreen notes that the principle rationales for delaying the move to a managed float — negative consequences for the banking system, excessive exchange rate volatility and the inability of firms to insure against exchange rate movements — do not apply in China's circumstances.

to the fore. Developments in China are likely to have positive effects on some economies and negative ones on others — reflecting terms of trade effects, its impact on world prices and through financial channels. Countries will tend to benefit, or lose, in proportion to the degree of complementarity between their trade patterns and China's. The impact is likely to be felt within as well as across countries, but overall, the gains are likely to outstrip the losses, and China's emergence is expected to be a broadly positive development internationally.

To ensure the global economy maximises the benefits and minimises the costs of China's integration, vital reforms are required domestically and internationally. The outlook for the Chinese economy depends critically on the pace of structural reforms, most notably to the industrial and banking sectors, and to the current exchange rate system. In other economies, greater flexibility is necessary to limit the inevitable adjustment costs that are likely to emerge as China continues to develop.

In conclusion, China's emergence has brought to the fore many challenges, which are likely to necessitate adjustments in some economies. These adjustments are likely to include changes to a number of real and nominal macroeconomic variables, including exchange rates, prices, wages, domestic production levels, returns to capital and trade balances. However, overall the impact for the global economy should be positive, facilitating cheaper labour intensive imports, a greater demand for skill intensive goods and services, and crucially, higher global output. China's emergence will act as a large and positive boost to global productive capacity, the equivalent to a large positive supply shock. In the long run, it is important for the world economy that comparative advantages of countries such as China are not hindered.

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