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Global Challenges Facing China

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Despite the sudden surge in negative views from foreign pundits, the Chinese economy has continued to forge ahead. In the second of quarter of 2011, the economy registered a growth rate of 9.5% and the inflation rate fell from 6.5% in July to 6.2 % in August, a first fall after consecutive increases for more than 12 months. The consensus view among Chinese economists is that in 2011 the Chinese economy will grow at a rate of more than 9% and inflation will fall below 6%. It is not likely that China will suffer either a hard landing or runaway inflation in the foreseeable future.

Of course, all is not well. China's growth and economic stability face serious challenges. Any misstep by the Chinese government surely will derail the high-speed train that is the Chinese economy. In the short run, the most serious threat to the economy is still inflation. The monetary overhang left over by the excessive monetary expansion in the wake of the Lehman Brothers fiasco has yet to run its course. With the M2 to GDP ratio approaching 190%, the economy is still abundant with liquidity, which is evident in the ubiquitous speculative fever on everything from houses, antiques to wine and rare stamps. Rises in commodity prices was another important contributing factor to China's inflation in the first half of 2011. Though the pressure of imported inflation has reduced, a rebound in commodity prices caused by further loosening of monetary policy by the Federal Reserve still worries China. In recent years, the growth rates of wages and salaries have been accelerating strongly, surpassing income growth. It is very likely that wage-push inflation will become a pertinent feature of the Chinese economy in coming years. Last but not least, though the government has achieved some success in reining in investment, especially, investment in real estate development, the growth rate of fixed asset investment is still high and can bounce back to a higher level, generating inflationary pressure on the economy.

While the threat of inflation seems to have begun to recede since August, the danger of a more than desired slowdown of the economy is increasing. Thanks to the European sovereign debt crisis and the faltering American economic recovery, China's exports may take a hard hit, and pull down China's growth substantially. Hence, the government has to manage the economy carefully to achieve a desirable trade-off between growth and price stability.

It seems that the Chinese government will not reprioritize the objectives of its macroeconomic policy, until inflation falls to something less than 5%. However, as a result of the abrupt monetary tightening since late 2009, small and middle-seized enterprises, which contribute to almost half of China's GDP and more than half of its employment, are suffering from increasingly acute liquidity shortages and credit crunch. As a result, informal financial intermediation by illegal financial institutions has mushroomed, and interest rates in informal financial markets have gone through the roof. The recent collapses of some of the informal financial institutions have cast a shadow on the stability of China's financial system.

The government has been walking on a tightrope in its effort for controlling housing prices. For many years, investment in real estate development accounted a quarter of total fixed asset investment and more than 10% of GDP, the consequences of a collapse in real estate investment on growth surely will be serious. A more worrying issue is real estate bubbles in China. As a result of the government's clampdown, house prices in first and second tier cities have stabilized recently. But the prices in third tier cities are still rising. Despite the progress in stabilizing the housing market, the specter of the burst of the bubbles with its dire consequences on China's banking system is still haunting the economy.

However, it should be emphasized that, due to China's strong fiscal position, whatever happens, the Chinese government should still be able to re-ignite the economy, though, on a smaller scale in comparison with the efforts made in 2008 -2009. Despite all its problems with its financial system, a serious financial crisis is not very likely. The current pessimism over China's financial stability by some foreign investment banks is not warranted. "To short" China is definitely an unwise business strategy.

In short, unless the government shoots itself in foot by doing things such as over-tightening its monetary policy and allowing the renminbi (the Chinese currency) to be fully convertible too early, one sees no reason why the Chinese economy will not be able to maintain its growth momentum while bring inflation under control in the next few years. The real challenges facing China are medium-and- long- term structural problems.

The list of structural problems is long, which include over-dependence on investment and exports for growth, lack of ability of innovation and creation, widening gap of income distribution, serious environmental pollution and reckless use of resources. More fundamentally, lackluster progress in institutional reforms, which in turn is attributable to the path-dependency created by China's gradualist approach to reforms, contributes to the persistence of the structural problems.

China has been accused for running large current account surplus. But it should be noted that, while China has exported a large amount of capital via running current account surplus, most of which has been invested in the US government securities, it has imported an equally large amount of capital mainly in the form of FDI. One of the reasons why instead of using savings to invest in domestic projects with high returns, China invests so heavily in low return US government securities is that, due to China's highly concessional FDI attraction policy over the past 30 years, which in turn is a result of the fierce competition for FDI among local governments at all levels, local investments are crowded out from high return projects and have to settle in less profitable ones. Encouraged and facilitated by China's export promotion policy, the excess resources, which are attributable to FDI crowding-out as well as low consumption, translate into current account surplus and, due to lack of investment choices, are invested in the US government securities.

It can be seen that rebalancing the Chinese economy is not just a simple matter of exchange rate policy. Instead, it involves comprehensive adjustment of a policy regime consolidated over the past 30 years. More importantly, the adjustment inevitably will encounter fierce resistance from various interest groups that have established themselves during the long-drawn process of gradualist reforms over the past 30 years. But China must make the necessary adjustment and shift its growth paradigm from investment and export-driven to a balanced and innovation and creation-based growth.

Unpleasant Choices Facing the Renminbi

The recovery of the global economy is faltering. To escape double-dip, increasingly more countries are resorting to money printing and engineering the decline of their currencies. Now China perhaps is the only country that lets its currency—the renminbi strengthen gradually. In the midst of competitive non-appreciation, China is faced with very difficult choices indeed.

China has run a current account surplus and a capital account surplus almost uninterruptedly for more than two decades. In 2010, China's current account surplus and capital account surplus were $300 billion and $220 billion, respectively. The pattern of China's international balance of payments so far this year is similar. The huge "twin surpluses" create strong appreciation pressure on the reminbi. To control the pace of renminbi appreciation, the People's Bank of China (PBOC, China's central bank) has been intervening in the foreign exchange market tirelessly. This has led to a rapid accumulation of foreign reserves. In 2010 alone, China added $ 4700 billion into its foreign exchange reserve stock.

With the rapid worsening of fiscal position, the temptation for the US government to inflate away its debt burden is likely to become irresistible. With the danger of double-deep looming large, the US government would be happy to see the dollar weakening. All these developments inevitably will result in large capital losses for China's foreign exchange reserves.

It is clear that China should have brought to an end to the endless piling up of foreign exchange reserves long time ago. There have been two basic approaches for achieving this objective. The first approach is to reduce current account surplus indirectly via narrowing the saving-investment gap. The second one is to reduce current account surplus directly by dismantling trade promotion policy, such as abolishing tax rebate and allowing renminbi to appreciate. China has tried the two approaches at the same time with a very cautious fashion. To reduce the saving gap by lowering the saving rate could be an ideal solution. Unfortunately, due to various reasons, to achieve the balance between saving and investment may take long time. By the time when the Chinese economy has been rebalanced, no one knows how much more foreign exchange reserves China would have accumulated. Since 2005, with some interruptions, China has let the RMB to appreciate in a gradual way. This gradualist appreciation encourages one-way bet by international investors. As a result, huge among of capital that has no profitable uses in China, has flown into China and contributes in a big way to the building up of China's foreign exchange reserves.

To stop the further accumulation of foreign exchange reserves, the most direct and effective way is to stop the PBOC's intervention in foreign exchange market and allow the renminbi to float freely. To float the renminbi is not costless. First, as a result of the end of intervention, the renminbi may rise significantly, China's current account will suffer and so will economic growth and employment. Second, due to speculative capital inflows, an overshooting can happen and hence China's current account and growth may be hit hard though temporary. Third, because China holds a large stash of dollar-denominated foreign assets vis-à-vis a significant amount of renminbi-denominated liabilities, reminbi appreciation may cause large revaluation losses for China.

Hence, China is faced with a stark choice between bearing increasingly large capital losses in its foreign exchange reserves and tolerating immediate losses in terms of significant drop in current account surplus and large revaluation losses. Certainly, neither choice is pleasant. However, this is the bitter fruit of China's past hesitating and dithering and it has to swallow now. The longer the delay, the higher the costs it has to pay. Historical experience shows that a slow appreciation plus a leaky regime of capital controls is the most costly way of adjustment. If China had taken decisive actions many years ago, it would have not fallen into such a trap. Devil is in details. If China decide to stop intervention in foreign exchange market—which is unlikely at the moment, careful preparation should be made so that costs of such change can be minimized as much as possible.

It seems that the pressure on the reminbi appreciation may diminish eventually in the future, for whatever reasons. However, no matter what have happened and will happen, China should redouble its efforts to rebalance its economy. Only with a balanced economy, can China maintain its growth momentum and benefit the rest of the world as well.

China can break free of the dollar trap

Chinese officials are understandably angry about the irresponsible brinkmanship demonstrated by their American counterparts in recent weeks. Unfortunately, anger counts for little in international finance. The danger facing the US is that after Tuesday's debt deal any sense of urgency over a dire fiscal situation will dissipate. The danger for China is that it does not learn the right lesson – namely, that now is the time to end its dependency on the US dollar.

China is worried about the possibility of a US default for obvious reasons. As the largest foreign holder of US Treasuries, either a default or a downgrade would bring huge losses. Even after this week's debt deal, however, the risk remains that US debt will continue to grow to the point where its government is left with no option but to inflate the burden away. While there is little China can do about its existing Treasury holdings, it can rethink past policies – and ask both how it fell into this trap, and how it might free itself.

China has run a current account surplus and a capital account surplus almost uninterruptedly for more than two decades. Inevitably this has led to an accumulation of foreign reserves. It is clear, however, that running these surpluses persistently is not in China's best interests. A developing country, with per capita income ranking below the 100th in the world, lending to the world's richest country for decades is not reasonable. Even worse is the fact that, as one of the largest foreign direct investment-absorbing countries in the world, China essentially lends money it borrowed at a high cost back to its creditors, by buying US Treasuries, rather than importing goods and services.

China holds a large stash of dollar-denominated foreign assets, as well as significant amounts of renminbi-denominated liabilities. Clearly this currency structure of assets and liabilities makes its net international investment position very vulnerable to any devaluation of the dollar against the renminbi.

The Chinese government has admitted that its foreign-exchange reserves have already exceeded its needs. It has tried various measures to slow down the growth of these reserves and protect the value of its existing stock. This has included demand stimulation, allowing the renminbi to appreciate gradually and creating sovereign wealth funds. It has also promoted reform of international monetary systems and the internationalisation of the renminbi. Sadly, none of these has worked. With large capital inflows and a current account surplus, China's foreign exchange reserves have continued to rise rapidly.

These policies failed because they did not address the real cause of the rapid increase in foreign exchange stocks, namely state intervention aimed at controlling the pace of renminbi appreciation. The question is: what losses is China willing to bear in its foreign exchange reserves in order to slow the pace of the renminbi appreciation?

One further factor is that any losses in the financial assets held by China will not be realised until their holders decide to cash out. If the US government continues to pay back its public debt, and China continues to pack its savings into US securities, this game may continue for a very long time. However, the situation is ultimately unsustainable. The longer it continues, the more violent and destructive the final adjustment will be.

If there is any lesson China can draw from the US debt ceiling crisis, it is that it must stop policies that result in further accumulation of foreign exchange reserves. Given that many large developed countries are simply printing money (and the recent rumours are that the US might return to quantitative easing) China must realise that it can no longer invest in the paper assets of the developed world. The People's Bank of China must stop buying US dollars and allow the renminbi exchange rate to be decided by market forces as soon as possible. China should have done so a long time ago. There should be no more hesitating and dithering. To float the renminbi is not costless. However, its benefits for the Chinese economy will vastly offset those costs, while being favourable to the global economy as well.

The "Asset Crisis" of Emerging Economies

In theory, the difference between capital inflows and outflows in developing countries should be positive – they should be net capital importers, with the magnitude of the balance equal to the current-account deficit. Since the 1997-1998 Asian financial crisis, however, many East Asian countries have been running current-account surpluses – and hence have become net capital exporters.

Even odder is the fact that while they are net capital exporters, they run financial (capital) account surpluses. In other words, these countries lend not only the money they earned through current-account surpluses, but also the money they borrowed through capital-account surpluses – and they do this lending mainly to the United States. As a result, East Asian countries are now sitting on a huge pile of foreign-exchange reserves in the form of US government securities.

While China has attracted a large amount of foreign direct investment, it has bought an even larger amount of US government securities. Whereas the average return on foreign direct investment (FDI) in China was 33% for American firms in 2008, the average return on China's investment in US government securities was a mere 5% over the past 10 years, and it is much lower more recently. So, why does China invest its savings so heavily in low-return US government securities, rather than in high-return domestic projects?

One answer lies in the fact that China's highly concessional FDI policy over the past 30 years, which in turn is a result of fierce competition for FDI among local governments at all levels, has crowded out many Chinese investors from high-return projects, forcing them to settle for less lucrative projects. But there are still potential investors who cannot find break-even investment opportunities in China, generating excess resources, which, being facilitated by a competitive currency, tax rebate and other measures, translate into current account surplus and then are invested in US government securities.

It is worth noting that, while China's foreign assets are denominated in US dollars, its liabilities, such as FDI, are mostly denominated in renminbi. When the dollar depreciates against the renminbi, the value of China's foreign liabilities increases in dollar terms, while that of its foreign assets remains unchanged. As a result, China's net international investment position (NIIP), which is the difference between China's gross assets and its gross liabilities, automatically worsens. The deterioration of China's NIIP is a reflection of the transfer of wealth from China to the US.

Since the 2000's, China's gross assets and gross liabilities have increased dramatically, owing to the success of China's trade-promotion and FDI policies. In 2010, China's capital-account surplus stood at $230 billion, and capital inflows remain large this year. Consequently, China's net international investment position has becomes very vulnerable to the devaluation of the dollar. With ever-increasing gross dollar assets and gross renminbi liabilities, a stronger renminbi means that on top of the welfare losses due to "twin surpluses", China will suffer additional welfare losses from the valuation effect of exchange-rate movements.

Capital inflows into developing countries have surged in the wake of the global financial crisis. Welfare losses due to the valuation effect are not solely a Chinese phenomenon; all major emerging-market economies are faced with the same challenge. During the 1997-1998 Asian financial crisis, East Asia's economies paid heavily for excessive accumulation of dollar-denominated debts. Governments tried but failed to defend their currencies and hence lost hundreds of billions of dollars in foreign-exchange reserves to international speculators.

Whether for self-insurance or to maintain a competitive exchange rate, East Asia has since then accumulated huge amounts of dollar-denominated assets—mainly US government securities. This time around, thanks to the deterioration of the US fiscal position and the Federal Reserve's expansionary monetary policy, "the long-term risk [for] emerging markets' external balance sheets is shifting," as Eswar Prasad of the Brookings Institution has pointed out, "to the asset side."

Rather than confronting a debt crisis, as in 1997-98, emerging-market economies now face an "asset crisis," but essentially the result will be the same: great welfare losses. Indeed, the magnitude of the losses can be on par with that of the Asian financial crisis, if not higher.

While China's government should make greater efforts to rebalance the economy by conventional measures, it also should pay adequate attention to adjusting the currency structure of the country's gross assets and gross liabilities. In particular, China should try to replace a good portion of its dollar-denominated assets with renminbi-denominated assets, and its renminbi-denominated liabilities with dollar-denominated liabilities.

If China cannot do very much about existing gross assets and gross liabilities, it should address the currency structure of new assets and liabilities. In short, China must take into consideration the ongoing asset crisis facing emerging economies, especially when considering highly consequential questions such as full renminbi convertibility and the currency's internationalization.

Undoubtedly, the valuation effect will complicate China's policy on renminbi appreciation. The ideal solution is to eliminate excess saving gap without resorting to renminbi appreciation. Unfortunately, over the past 10 years, this approach has failed to work. The truth of the matter is still that the longer the adjustment progress takes, the higher the costs will be.

White knight comes to rescue?

Since the beginning of the European sovereign debt crisis, China has repeatedly expressed its wish to offer "a helping hand" to Europe. A strong Europe is always welcome by China for geopolitical reasons. Furthermore, as China's most important trade partner, a financially sound and economically prosperous Europe certainly is in the interests of China. Last but not least, setting on a pile of $3.2 trillion of foreign exchange reserves, China is in a position to help. In fact, China has added its holding of sovereign bonds of Eurozone countries after the crisis, though only in a limited way.

After one odd year of waiting and watching, China is increasingly bemused by the inability of the EU to bring an early end to the European sovereign bond crisis, despite its financial and economic strengthen as a whole. China's confidence in EU leadership is waning. Many Chinese begin to believe that EU may break up and Euro may no survive this crisis.

China still wishes to help, but not without prerequisites. As pointed out by Premier Wen Jiabo at 2011 Dalian World Economic Forum, to encourage China to help, EU should put its own house in order. Europe still has no credible plan to resolve the crisis and individual countries continue to squabble amongst themselves over how to proceed. Why can China show faith in a situation where even the Europeans are expressing doubt? China's faith in the dollar has been proven misplaced, it cannot afford to make same mistake again.

From the perspective of domestic politics, buying eurozone periphery debts is hard to accept for the Chinese people. The tens of millions of elderly Chinese will demand to know why they should pay for rich Europeans to retire early when they do not have a decent pension system of their own. Chinese savers will be very unhappy about bailing out reckless European banks that are being dishonest about their debt exposures.

China buying periphery debt can be case of out of the frying pan and into the fire. How can China swap dollars-a currency whose credibility has been greatly damaged with a currency that may not exist in a few years' time. There is already talk of haircuts on periphery debt, which is an implicit acknowledgement of default in one form or another. Why should China buy assets, which are effectively in default already.

Nonetheless, it doesn't mean China should stay on the sidelines. There are many ways to help without exposing itself to sovereign debt. China's sovereign wealth funds can buy shares in solid European nonfinancial and financial companies, and help them to grow. Chinese enterprises can inject billions of euros worth of FDI into the Eurozone economy, including in southern Europe. China's potential in this front should be very great indeed.

Though China should continue its bilateral cooperation with individual European countries, as far as financial rescue packages are concerned, the Chinese government should not negotiate with individual Eurozone countries but with the collective. Otherwise, it may sow discord within Europe as the attitudes of individual countries towards Chinese actions are bound to differ. China can purchase at the margins for the sake of financial stability, but if they commit to a sizable amount upfront, the governments in question will lose incentives to continue with their austerity measures. Furthermore, though the purchase of sovereign bonds of individual countries may provide higher yields. But it also means higher risks. There is no way for China to judge by itself how high the risks of those bonds really are. China would prefer to deal with Eurozone as a whole. China would be happy to invest in EFSF and future ESM securities, when they are available. If a common bond should emerge in the future, China should also invest as the Eurozone's financial position as a whole is much more favorable than the US' that not only running huge fiscal deficits but also huge current account deficits. When China is considering buying European bonds, the 1945 US led rescue of Mexiao is of an interesting reference. China would need collateral for its lending. Here IMF or EU and ECB can play should play important role, to impose conditionality's and enforce reforms effort that could help reduce the investment risks. To support Euro countries, besides purchasing European sovereign bonds, there are many other ways. For example, China should allow the renminbi to appreciate against the euro and give european companies greater access to Chinese markets, which of course needs to be reciprocated. An improved eurozone current account through trade and Chinese investment into Europe will free up funding within Europe and allow more savings to be directed towards governments.

China should not give the impression that it is taking advantage of the misfortune of others. This would breed resentment and hinder the healthy development of Sino-European relations. However, recently we have seen in the European press accusations that China is engaging in financial colonialism. This kind of an attitude is disgraceful as it deflects from Europe's own mistakes. For China, financial decision should be based on financial considerations, such as risks and returns, and aimed at global and regional financial stability. To link them with non-financial issues may create unnecessary complications.

As the second largest economy, the largest trade nation and the largest reserve holding country in the world, China has an important role to play in reviving the growth momentum of the global economy and stabilizing international financial markets. First of all, China should put its house in order and lay a solid foundation for sustainable growth. Second, China should redouble its efforts in rebalancing Chinese economy. This means that China should dismantle its trade promotion and FDI attraction policy, including making the renminbi exchange rate more flexible and further liberalizing the financial service sector. But it is worth emphasizing that China still has a long way to go to make the renminbi fully convertible. Third, China should try its best to help European countries to overcome the Sovereign Debt Crisis. The EU is China's largest trade partner. It is in China's self interests to help the EU. Unfortunately, the squabbling within the Eurozone makes China confused and hesitant to get involved. Fourth, China should play a more active role in the reform of the international monetary system. The current international monetary system is flawed with a fundamental contradiction: a national currency, that is the US dollar, serves as the key international reserve currency. It is one of the most important conditions for the global imbalances. The dramatic deterioration of the US fiscal position and the faltering recovery of the US economy may make the temptation for the US government to resort to printing press irresistible. If the worst happens, retaliatory measures by emerging markets may prove inevitable, escalating global trade and political tensions. The G20 and the IMF must do something to prevent the nightmare scenario from coming true. In this context, a supranational currency along the lines of the SDR should be contemplated.

Conclusions

In a globalized world, while conflicts of interests amongst countries or country groups are unavoidable, common interests dominate. Therefore, politicians and technocrats of different countries should sit at the table to negotiate bargains both bilaterally and multilaterally. The G20 has provided a good platform for multilateral bargains. Surely, in Cannes this coming November, China will come to listen and to be heard with an open mind.

China is rising. With much stronger economic strength, China has to resume more global responsibilities. How China plays such role and EU countries reciprocate is a serious test to the wisdom of leaders in both sides of Atlantic.