Conference Report

Chinese Economic Development: Implications for the Global Economy

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Japan Economic Foundation
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Introduction

On October 15, the Japan Economic Foundation (JEF) and the Center for Strategic and International Studies (CSIS) co-sponsored a full-day conference entitled, "Chinese Economic Development: Implications for the Global Economy" at CSIS in Washington D.C. With currency revaluation on the agendas of both Treasury Secretary Snow and President Bush on their recent Asian trips, the timing of the conference could not have been better.

The four panels, composed of some of the most expert observers of international and Asian economies, spoke on a wide variety of issues related to China's growth. Both opportunities for investment and challenges for China's leaders were extensively examined. The question of an undervalued renminbi – and what to do about it, if anything – was also on the agenda.

With China rapidly growing as an economic power, CSIS and JEF convened this conference to offer experts from both sides of the debate a chance to weigh in on its current and potential future impact on the United States, Asia, and the rest of the world. A summary of the proceedings is contained below.

Executive Summary

KEYNOTE SPEECH

Dr. Lawrence Lindsey
Former Assistant to the President and Director of the National Economic Council

According to Dr. Lindsey, the bottom line is that it will be difficult to have sustained economic growth in the global economy with the current Chinese exchange rate regime. At the same time, the much-needed switch to a flexible exchange rate is unlikely to occur anytime soon.

Dr. Lindsey noted that Chinese prosperity is good for global peace and for U.S. and Japanese consumers. The Chinese economy, characterized by low labor costs and an overhang of previously mismanaged capital, has since 1994 seen productivity growth on average 5 percent greater than that in America. China currently represents an impressive 10 percent of global economic growth. But China also contributes to deflationary pressures abroad through the price differential of its goods with Japanese and American manufactures, Dr. Lindsey said. Over the long run, according to Dr. Lindsey, the fixed exchange rate is untenable. A flexible exchange rate that values relative prices more accurately is necessary.

A second problem with the current exchange rate regime is that managed rate adjustments lead to currency speculation. Dr. Lindsey reminded his audience that high productivity growth in rebuilding economies in Japan and Europe created the pressures for revaluation that caused the collapse of the Bretton-Woods managed exchange rate regime.

Finally, Dr. Lindsey said that with its economy pegged to the U.S. dollar China effectively allows the U.S. Federal Reserve Bank to manage its monetary policy. Although Dr. Lindsey noted that the Fed does a very good job, he went on to say that if China is a nation that aspires to great power status, it should manage its own monetary policy.

There are three reasons – all linked to fundamental weaknesses in the Chinese economy – why a flexible exchange rate policy is unlikely anytime soon, according to Dr. Lindsey.

1) China is dependent on strict capital controls. With flexible exchange rates there must be capital mobility to allow capital flows to balance out a deficit or surplus in the current accounts. Rather than call for flexible exchange rates, Dr. Lindsey thinks investors should simply attach a higher risk premium to their business in China, where they do not have complete control of the capital they put in.

2) China lacks the statistical infrastructure necessary to conduct an independent, discretionary monetary policy. Growth over the last 3 years has been remarkably stable at 8 percent. Rather than being a statistical anomaly, Dr. Lindsey believes this may be a legacy of the command economy, in which producers regularly adjusted numbers to hit their growth targets.

3) Chinese economic policy is a mercantilist state policy. The objective of the economy is the wealth of the state and not the wealth of the Chinese people. The pegged exchange rate fits well into the agenda of a regime that is attempting to accumulate massive quantities of foreign exchange.

Dr. Lindsey concluded by repeating his main theme: the current situation is untenable over the long term but change in the near future is unlikely. Tariffs are not a good solution because they penalize the American consumer. The better solution, according to Dr. Lindsey, is for investors to look more closely at the risks associated with dealing in China.

Mr. Taizo Nishimuro
Director and Chairman of the Board, Toshiba Corporation

Mr. Nishimuro began by giving a brief overview of the Chinese economy in the past decade. Maintaining strong growth throughout the 1990s and early part of this decade, China has continued to expand its economy, especially after its entrance into the WTO in 2002. China's exports and imports have increased dramatically, Nishimuro said, as has foreign direct investment (FDI) flowing in.

Although China's growth may appear to be completely positive, however, numerous problems remain. According to Mr. Nishimuro, some of these are:

- Increasing disparities in wealth distribution
- Rising unemployment
- Drastic regional differences resulting in population drift to cities
- State ownership of enterprises
- Bad bank debt and high government debt
- Massive population growth

Other issues yet to be sufficiently addressed are whether China can maintain its high level of FDI inflows ($50 billion in 2002), how sustained export expansion will affect long-term stability, rising deflation, nascent agricultural demands, and the need for a social security system.

Mr. Nishimuro then posed the question: "Why is China's performance so outstanding?" The answer, he said, is threefold. First, domestic demand is up, with consumption in the cities very high. Second, crucial infrastructure to facilitate new manufacturing has been established. Finally, China has been successful in incorporating technological know-how from abroad, Taiwan being one notable example.

To conclude, Mr. Nishimuro addressed what the rest of the world should do to assure that China's growth will have a positive effect on the global economy. The WTO should not pursue overly strict monitoring of China's reforms but should make sure that changes happening in China should be sustainable. In addition, China should be allowed by Japan and ASEAN nations to determine its own economic policy. Finally, as China will only become more important to the world economy, its impact must be carefully tracked and measured.

SESSION ONE

The Impact of China's Rapid Economic Development

Ms. Naoko Munakata's presentation compared the view of China as a threat to the view of China as an opportunity and emphasized its aspect as an opportunity. While China has rapidly expanded its exports and attracted foreign direct investment (FDI), it has also increased imports. The starkest example is that China replaced the U.S. as the largest destination for Korean exports. At least for the moment, China's rise does not seem to be crowding out ASEAN's manufacturing sectors as had been previously feared, because of intra-industry trade (IIT) particularly in general and electrical components. While IIT boosted intra-regional trade, this does not imply a regional self-sufficiency. East Asia is still largely dependent on developed markets outside the region. Ms. Munakata also noted the development of a Chinese middle class, the potential to create markets for high-end Japanese consumer products, and the increase in Chinese FDI in other regional economies.

Due to these positive aspects of China's growth, Ms Munakata noted, the argument that China is an economic threat had passed its peak in Japan as elsewhere in Asia. At the same time, competitive pressure from China is expected to stay and problems such as continued disrespect for intellectual property rights have to be dealt with. Asian economies view China more realistically than before.

Ms. Munakata also discussed the impact of China's rise on regional economic frameworks. While China's new activism in FTAs with ASEAN and positive attitudes on regional cooperation in general stimulated developments of regional frameworks, how far and fast East Asian governments can implement agreements on the ground remains to be seen. Ms. Munakata warned that Asian leaders needed to awake to the reality that their perennial big announcements would not bear fruit and could damage their credibility among business people unless faithfully implemented on the ground.

Dr. Tarrin Nimmanahaeminda looked at the impact of Chinese growth from a Southeast Asian perspective. He emphasized China's sustainable, export-led growth, the FDI influx into China, and the increase in government infrastructure spending. He noted, however, that Chinese consumption spending is still disproportionately weak because China is simply accumulating reserves.

As far as the exchange rate is concerned, Dr. Nimmanahaeminda sees it as a matter of timing. China is asking for more time and may very well need it. ASEAN does not see a flexible exchange rate coming quickly.

From ASEAN's perspective, the more important issue is the diversion of FDI flows from Southeast Asia into China. In 1997, shortly before the financial crisis, ASEAN began to lose export market share to China; thereafter, FDI flows also diverted to China. ASEAN's response is to work at liberalizing and strengthening AFTA and ASEAN to make Southeast Asia a more competitive and attractive investment market.

One idea was to invite Australia and New Zealand to join ASEAN, but internal politics within the group made it impossible. Similar politics within ASEAN +3 made an expansion difficult. Dr. Nimmanahaeminda's other ideas included an Asian IMF and a broader currency index to which China could peg. This index would probably result in a more reasonable valuation of the renminbi, Dr. Nimmanahaeminda said.

Dr. Robert Kapp viewed Chinese growth quite optimistically. Noting that 80 percent of council members viewed business in China as much better in 2003, he said that China even provided a bright spot on a bleak landscape for telecom firms. According to Dr. Kapp, the perception is that China is a tough place to do business, but it is increasingly manageable.

Dr. Kapp's response to the theory that China is exporting deflation is simply that China is doing what we have told them to do. They can't be blamed for the competitive advantage that stems from low labor costs. A bigger potential concern is that a crisis in the Taiwan Straits could easily derail all of the growth coming from the Chinese economy. Taiwan is the most threatening security issue on the horizon, in Dr. Kapp's view.

In order to illustrate the absurdity of the accusation that China is exporting deflation, Dr. Kapp facetiously proposed to consider all countries with a GDP per capita below $10,000 unfair traders." China has an inexhaustible supply of cheap labor, but there is nothing we can do about it. Nor is there anything that China could do that would address this issue. Dr. Kapp noted that many U.S. companies have legitimate concerns stemming from China's cost advantages, but the nostalgia for days when China was irrelevant is not helpful, he said. China matters now and we need to find ways to address the difficulties and take advantage of the opportunities.

Two suggestions Dr. Kapp made are that China must modernize its savings and its banking system. Under the current exchange rate regime, China is accumulating foreign exchange that could be better deployed. He suggested that China should consider investing money back into the U.S., not in the form of treasuries, but in actual FDI (perhaps in depressed areas like West Virginia). Despite the furor this would cause initially, it is important for the relationship between the U.S. and China to be more dynamic, with goods and capital flowing both ways.

Questions and Answers

The first question from the audience asked what the ASEAN view of renminbi revaluation is. Dr. Nimmanahaeminda responded that ASEAN is unlikely to support the U.S. on this issue. For ASEAN, trade with China is increasingly important and as important as trade with the West so it is unlikely to do anything to jeopardize that relationship.

Dr. Kapp responded to a second question on how the Chinese military can come into the economic picture in Asia. He believes that many smaller countries will make their peace with China but that the U.S. still might be invited to play a role in some of these countries through naval basing arrangements to counter Chinese power. In general though, China's economic power is more important than its military posture. Dr. Bush added that Chinese capabilities do not necessarily imply intentions. The Chinese military could also make a positive contribution in the war on terror.

A final question noted the increase in business tension in U.S.-China relations and asked if this was simply a function of U.S. domestic politics. Dr. Kapp answered that business is schizophrenic and that there were in fact many serious problems with China's WTO compliance at the end of the second year since China's entrance to the WTO. The American business community at first was understanding of the difficulties but is now expressing more doubt and suspicion.

SESSION TWO

Political, Economic, and Social Challenges Facing China: Implications for China's Mid-term Development

Dr. Bates Gill opened the session by praising the timing of the conference. Though many think that China is moving ever upward, he said, China's rapid modernization has brought about many serious problems: unemployment, income disparities, crime, drug-use, health problems like HIV/AIDS and SARS, and environmental issues. Session two, he said, would try to address some of these problems and determine whether or not they should worry the United States. The three panelists were increasingly optimistic about the future of China's economy.

Dr. Chi Hung Kwan spoke about China as a primitive capitalist nation. As such, China's leaders have many issues to address. By projecting three features of China's future – the end of one-party dictatorship, unification with Taiwan, and China's GDP surpassing that of the United States – Dr. Kwan examined some areas where China still needs improvement:

- Uneven income distribution
- Lack of democratic features in government
- Weak private property rights
- Lack of social security system

Of his three projections, Dr. Kwan predicted that the first – transition to democracy – will be the most difficult. Like many people, he is worried about a loss of stability resulting from this change. Unification with Taiwan will not take place until income levels on the mainland and in Taiwan converge. Finally, China's GDP might pass that of Japan by 2020 and the U.S. by 2050, according to Dr. Kwan. Two factors will be important, he said, the relative growth rates between the economies and potential appreciation of the renminbi.

Dr. Nicholas Lardy was slightly more optimistic about China's future, though he also admitted it is facing serious challenges. China's growth, he said, is very fast, particularly on the trade side. A reason for this is the great extent to which China's economy is open to the rest of the world: It is twice as open as the U.S. economy and three times more open than Japan's.

A second reason for optimism, according to Dr. Lardy, is China's high rate of savings and investment, which has reached 40 percent of GDP. Even if this rate declines, he said, China should continue to grow.

Like Dr. Kwan, Dr. Lardy also outlined some of the challenges facing China:

- Too many non-performing loans
- Lending has exploded to unsustainable levels

- The rate of return banks are getting is too low
- More jobs need to be created

If credit growth is not slowed down, Dr. Lardy concluded, the future of China's economy could be bleak.

Dr. Dong Tao was much more upbeat about China, speaking on China's immense future influence on the rest of the world. In three years, he said, 70-80 percent of the world's electronic products will be made in China – because of the high quality and low cost of its products, it is already taking market share from other countries.

China's low wage rate, an important factor now, will continue to be influential in the future, said Dr. Tao. Because only 30 percent of China's working population is now mobilized, wages will not rise anytime soon. This will continue to be an obstacle other countries must overcome. In addition, although China's slow-growing rural sector could be a problem, the urban sector is booming, with purchasing power equal to that of South Korea in 1988. The world, he said, has to find a way to tap into this market.

Dr. Tao finished his remarks by predicting a future "supply shock" caused by massive Chinese production. Though demand is meeting supply now, he said, China's steel production will double in three years, as will its cell phone production. Other industries will also drastically increase production, leading to a shock in the near future.

Questions and Answers

Dr. Tao responded to a question on whether China's boom will stop by saying that he thinks the boom will continue, mostly because of China's immense labor pool and the high quality of its goods. Some problems that could stop it, however, are non-performing loans and a possible decline in FDI. Dr. Lardy agreed that long-term prospects for growth look good. Dr. Kwan thought that the banking sector is problematic. He also said that rural China is a drag on the economy. In his view, a banking crisis is possible.

Dr. Tao responded to a second question: if China keeps increasing production and domestic demand is absorbing that supply, how is purchasing power rising? He answered that China's urban and rural sectors must be considered separately. While rural wages are stagnant, he said, urban wages are on the rise and are fueling purchasing power. Dr. Lardy agreed that a rising gap in income between skilled and unskilled workers allows purchasing power to rise in the cities.

In response to a question on whether there are any income re-distributing efforts going on in China? Dr. Lardy answered that though the regime is aware of the problem, nothing significant is being done. Dr. Tao said that the "Go West" campaign is a good start to setting public spending infrastructure in the rural west.

SESSION THREE

Influence of Chinese and Other Asian Foreign Exchange Systems on Industrial Competitiveness and the Macro Economy

After introductions by Mr. Sherman Katz, the four panelists made their remarks. All the speakers addressed the issue of China's currency but a general agreement on what China should do was not reached. The first three speakers urged caution, saying a floating renminbi could raise many problems. Mr. Frank Vargo, however, disagreed by saying that that was a commonly held misconception.

Dr. Fred Hu was adamant in his belief that revaluation of the renminbi will not improve the U.S. trade deficit. The data to support the assertion that floating the renminbi will help the U.S. manufacturing sector, he said, is not there. The U.S. and China simply compete directly in very few markets, according to Dr. Hu. And even if wages were to rise in China, manufacturing would move to India.

The true size of the United States' trade deficit with China is smaller than most think, Dr. Hu said. In order to reduce this deficit, rather than pushing China to float the renminbi the U.S. should relax restrictions on high-tech exports to China. Dr. Hu asserted that U.S. companies are being punished by this export regime rather than a cheap Chinese currency. Especially since China is now a member of the WTO, the United States should open its economy more to this emerging market.

Rather than addressing implications of China's currency on the United States as Dr. Hu did, Mr. Haruhiko Kuroda made four points about the renminbi and its impact on the world economy.

First, the renminbi is possibly undervalued by 30-40 percent. The current value does not accurately reflect China's rapid growth and is putting strains on the world economy. Second, after the 1997 Asian currency crisis, the renminbi was one of the few currencies to remain pegged to the dollar. Third, China's dollar-peg system is unsustainable. Because China's economy continues to grow, intervention may become increasingly necessary, which will bring about risks to China's foreign exchange reserves and monetary control.

Mr. Kuroda's final point was that while the renminbi must be allowed to adjust, this change must be gradual. China could adopt a "crawling-peg" system – one based on a basket of currencies – with the intention of floating the renminbi several years down the road. After that happens, Mr. Kuroda concluded, China should be allowed into the Group of Seven (G7).

Dr. Laurence Meyer's conclusion was also that now is not the time for China to float its currency. As a young economy, China does not have many effective macroeconomic tools. According to Dr. Meyer, it is therefore correctly using its exchange rate as its number one weapon. Dr. Meyer also said that the U.S. is paying too much attention to the renminbi problem. Not only is China not the only country that pegs its currency to the dollar, but also Latin America is much harder hit by a weak renminbi than is the United States.

China's export policy in Asia is "micro-pain for macro-gain," according to Dr. Meyer. Rather than focusing on an undervalued renminbi as a scapegoat for high unemployment and a massive current account deficit, the U.S. and other countries should be examining all the opportunities offered by China.

Mr. Frank Vargo disagreed strongly with the other panelists on the issue of renminbi revaluation. Although he agreed that China offers huge opportunities for American manufacturers, an artificially weak renminbi is adversely affecting the U.S. trade deficit with China. The other factor contributing to this deficit, according to Mr. Vargo, is China's trade control regime, which has not changed since its entrance into the WTO.

Mr. Vargo went on to rebut some assertions about the effects of a revalued renminbi. Contrary to the beliefs of many, a stronger renminbi would *not* cause the United States to be unable to pay its debt. In addition, U.S. exports *would* grow if the renminbi were revalued.

Questions and Answers

To the first question on how much is the renminbi really undervalued and how you go about figuring that out, Dr. Meyer answered that it really depends on whom you ask. Many people say between 15-25 percent but it is very difficult to truly calculate. Dr. Hu said he believes it is undervalued only by 10-15 percent but that even 40 percent is not outrageously high. One has to think of it as a range.

To a question on how China will respond to foreign pressure to open its markets more for imports, Dr. Meyer said that China will not open its markets completely for some time. Mr. Vargo agreed that there will be much resistance to opening up in China.

Mr. Kuroda replied to a third question on whether concerns about China's currency are overstated and whether Japanese economy should be the focus by saying that a revaluation of the renminbi would not solve Japan's problems. The importance of the renminbi is not overstated, however.

$\boxed{\text{SESSION FOUR}}$

Summary and Conclusions

Mr. Noboru Hatakeyama analyzed the conference as separate discussions of three issues, development, future challenges and currency valuation. On development, Mr. Hatakeyama believes that most everyone expects China's economy will continue to grow at a fast pace.

To help think about the many challenges, Mr. Hatakeyama devised the following alphabet of challenges that China faces:

A: Appreciation of exchange rate
B: Bad loans
C: Corruption
D: Deflation/ Democratization
E: Environmental issues / Enterprises owned by state
F: Fiscal deficit
G: Gap between urban and rural areas
H: Household registration
I: Islam power in Western China
J: Justice system reform

On the currency issue, Mr. Hatakeyama noted that everyone more or less agreed on the necessity of abandoning the fixed rate system. What matters more is the timing of the switch and the consensus of "not now, not soon." The other option is a revaluation. Mr. Hatakeyama believes that if you can't change the system, revaluing might be a good option – especially if it helps to head off protectionist sentiment.

At the end, Mr. Hatakeyama added some of his thoughts on market opening. The question is whether China should open their markets more before floating their currency. But China is already doing almost all that they can to pursue market opening and comply with the WTO. To put increased demands on China for market opening is probably unrealistic.

Ambassador Carla Hills summarized each session of the conference as follows:

The consensus from session 1 was that the economic development of China is breathtaking and poised to continue. China is a power to be dealt with. In the past year it has accounted for 15 percent of global growth.

Summarizing session 2, Ambassador Hills agreed that there are many challenges, as listed by Mr. Hatakeyama. Ambassador Hills emphasized regional disparities, the lack of a safety net, profound banking weakness, and market reform issues. One key question is whether bad companies will be allowed to fail. In summary, session 2 made clear that there is not necessarily "clear sailing" ahead.

The third session focused on the foreign exchange issue and brought us back to Dr. Lindsey's keynote address, which concluded that investors need to pay more attention to the risks of doing business in China. The key issue on moving to a flexible exchange rate is timing. Ambassador Hills believes that if China is to move off the peg system it should do it when the economy is strong.

With the roadmap for a flexible exchange rate not very clear, Ambassador Hills proposed a compromise solution: widen the currency band and switch the peg from the U.S. dollar to a basket of currencies. She stressed that this was a hot issue. There is legislation on Capitol Hill that would impose a 27 percent tariff on China, which is the amount some think is required to make up for the extent to which the renminbi is undervalued.

Ambassador Hills reminded the audience that this only became an issue because of the happy bargain that existed with the U.S. buying Chinese exports and the Chinese buying U.S. treasuries. Ambassador Hills made other suggestions including bringing China into the G-7 and working at reform through insistence on WTO compliance to help integrate China into the global economy.