China in the World Economy

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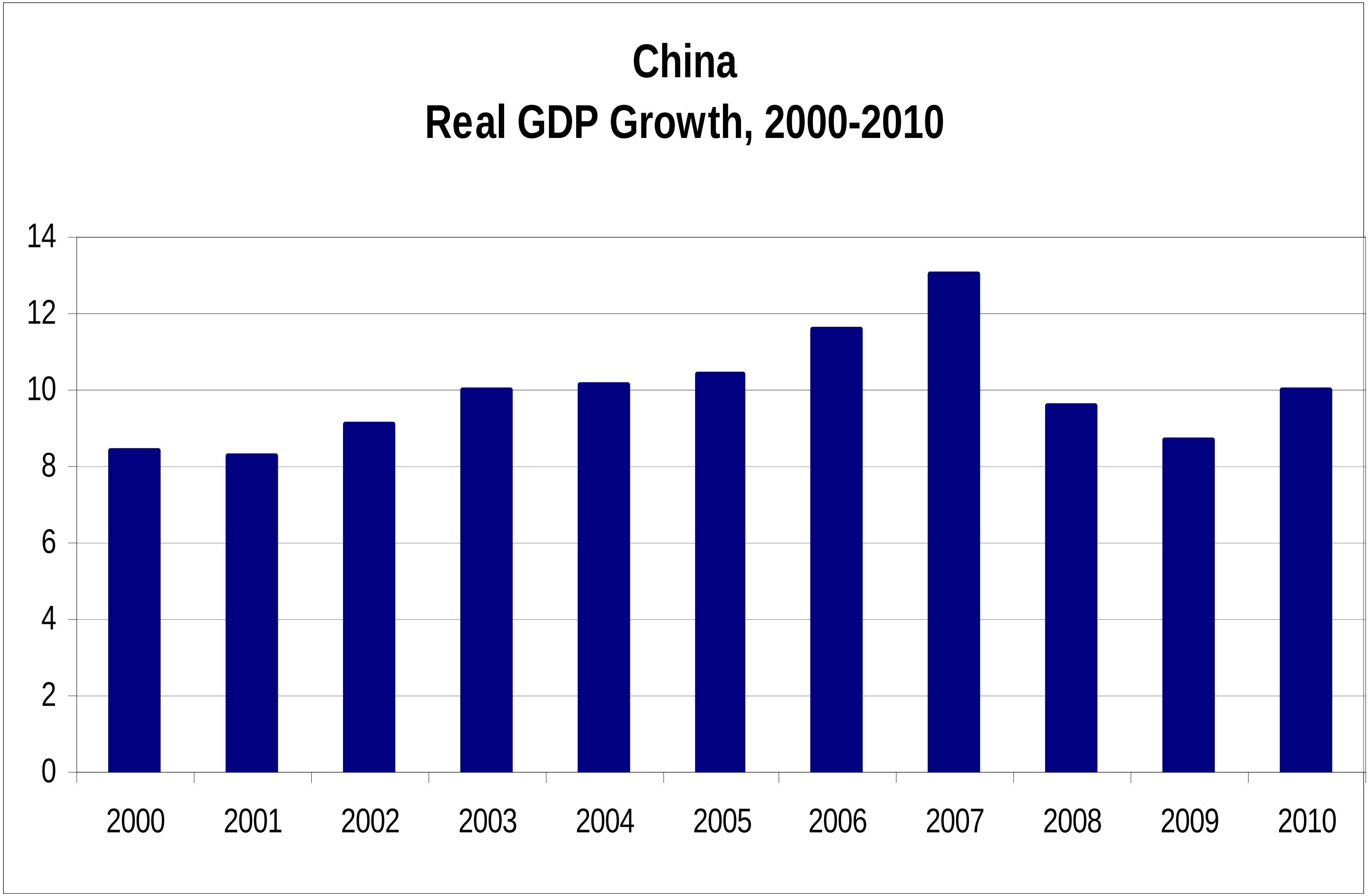
Economic Outlook

- Global economic crisis has been good for China
  - Not part of global financial crisis
  - Negative growth shock operated only through trade channel
  - Highly effective economic stimulus program
  - Modest economic slowdown in 2009 (8.7% GDP)
- Global crisis made Chinese officials more aware of excessive reliance on global economy
  - Accelerated shift back toward a more balanced growth path
  - Emphasis on development of domestic economy


China
Real GDP Growth, 2000-2010
14
12
10
8
6
4
2
0
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010

Strong Economic Growth in 2010

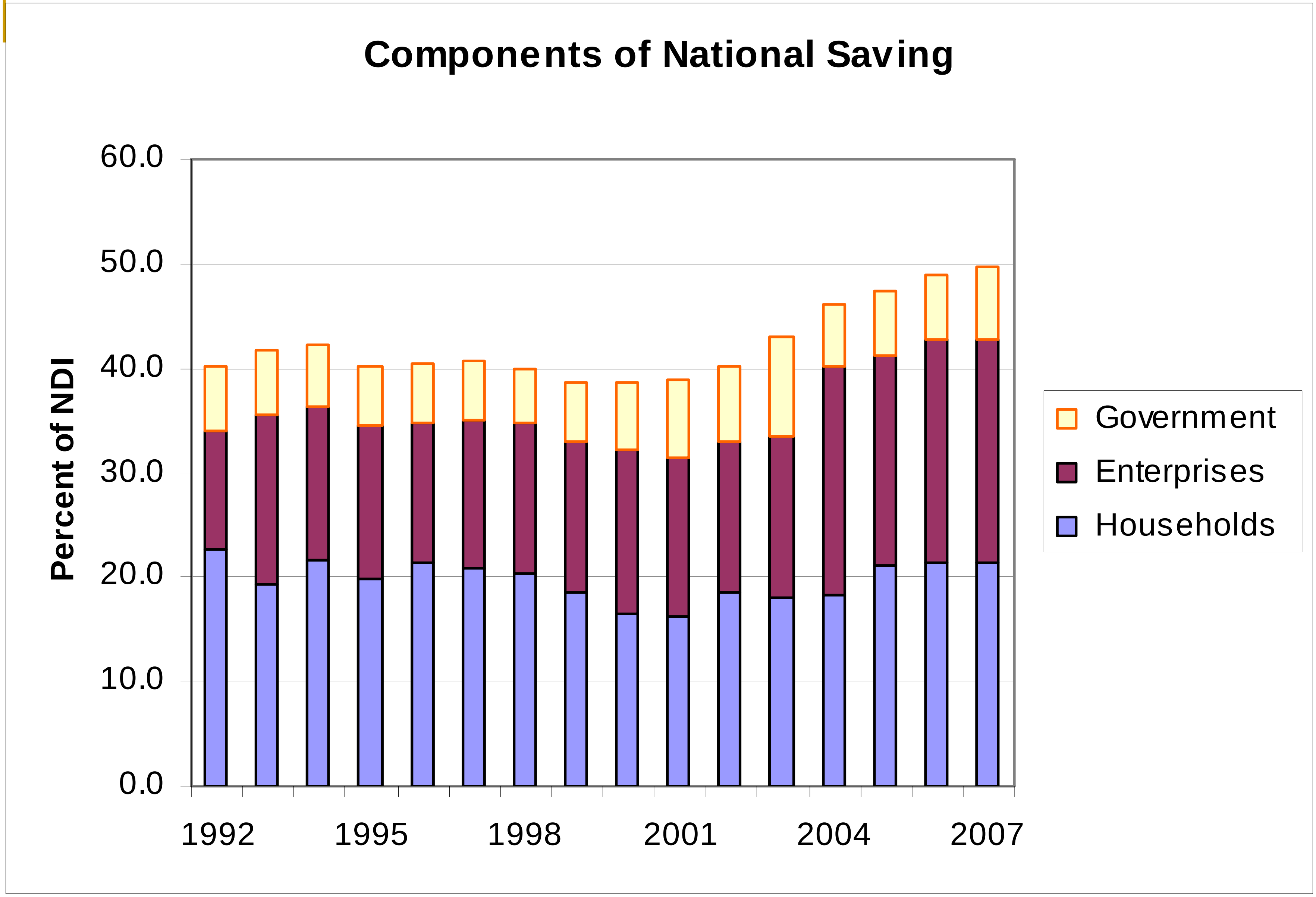
- GDP growth projected near 10 percent
- Inflation of 2-3 percent
- Shift of monetary policy toward modest restraint
- Some concerns about real estate bubble
- No fiscal problems
- Emphasis on growth of domestic economy
  - Particularly, western provinces, and
  - Urbanization
  - Problem of channeling income to households

U.S. China Conflicts

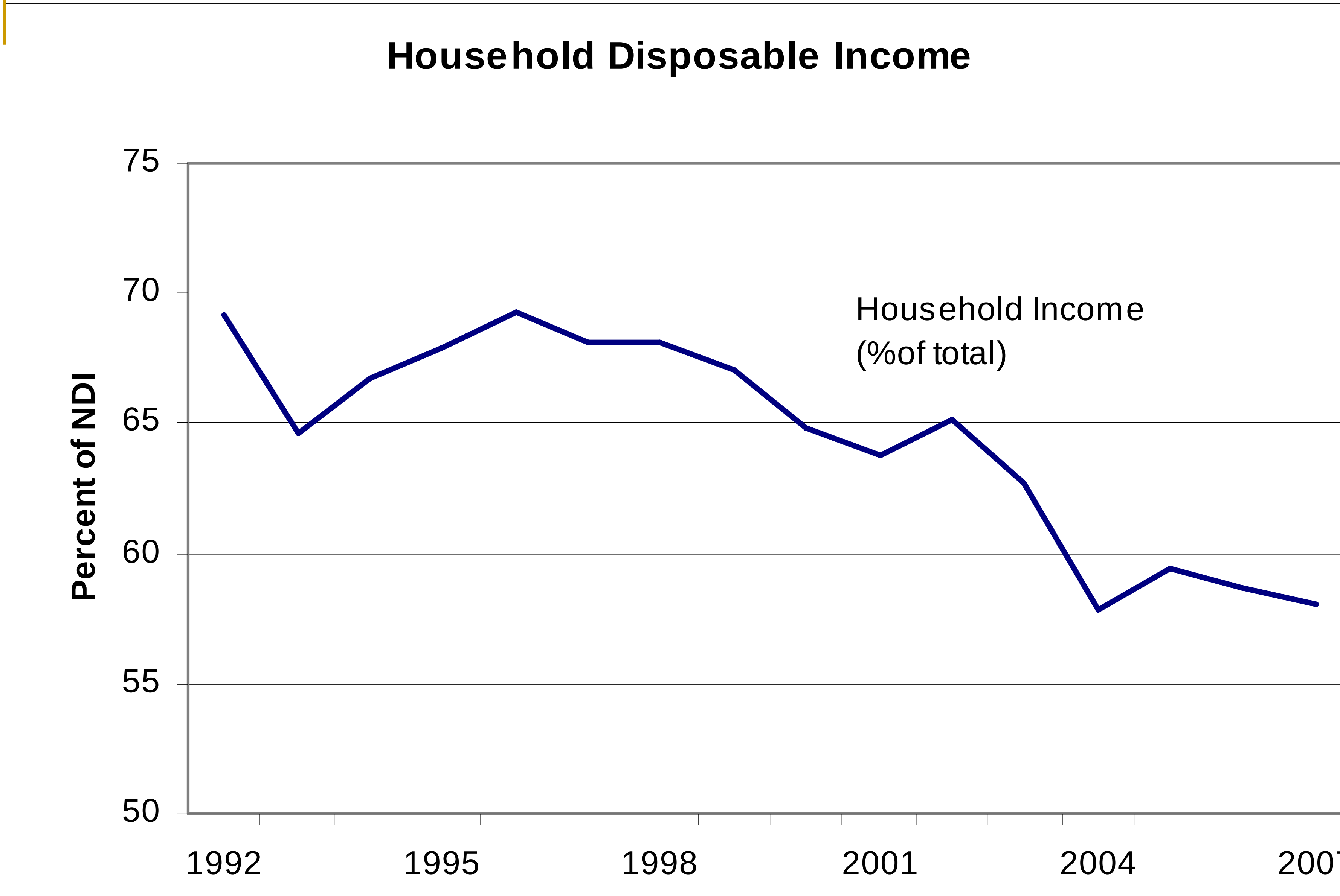
- Growing problem in 2010
- Replay of U.S. Japan trade frictions – deja vu
- Both countries need to rebalance their economies
  - China toward greater emphasis on domestic demand, particularly consumption
  - United States toward increased saving and greater efforts to export
  - Neither was interested prior to crisis, but their policies were not sustainable.

Economic Rebalancing In China

- China became overly dependent on export surplus to sustain growth after admission to WTO due to weak growth of domestic consumption
- Increasing rates of domestic saving
  - Concentrated in enterprises, not households
  - Household saving comparable to other high-growth economies
- Falling share of income flowing to households.
- Consumption only 35 percent of GDP



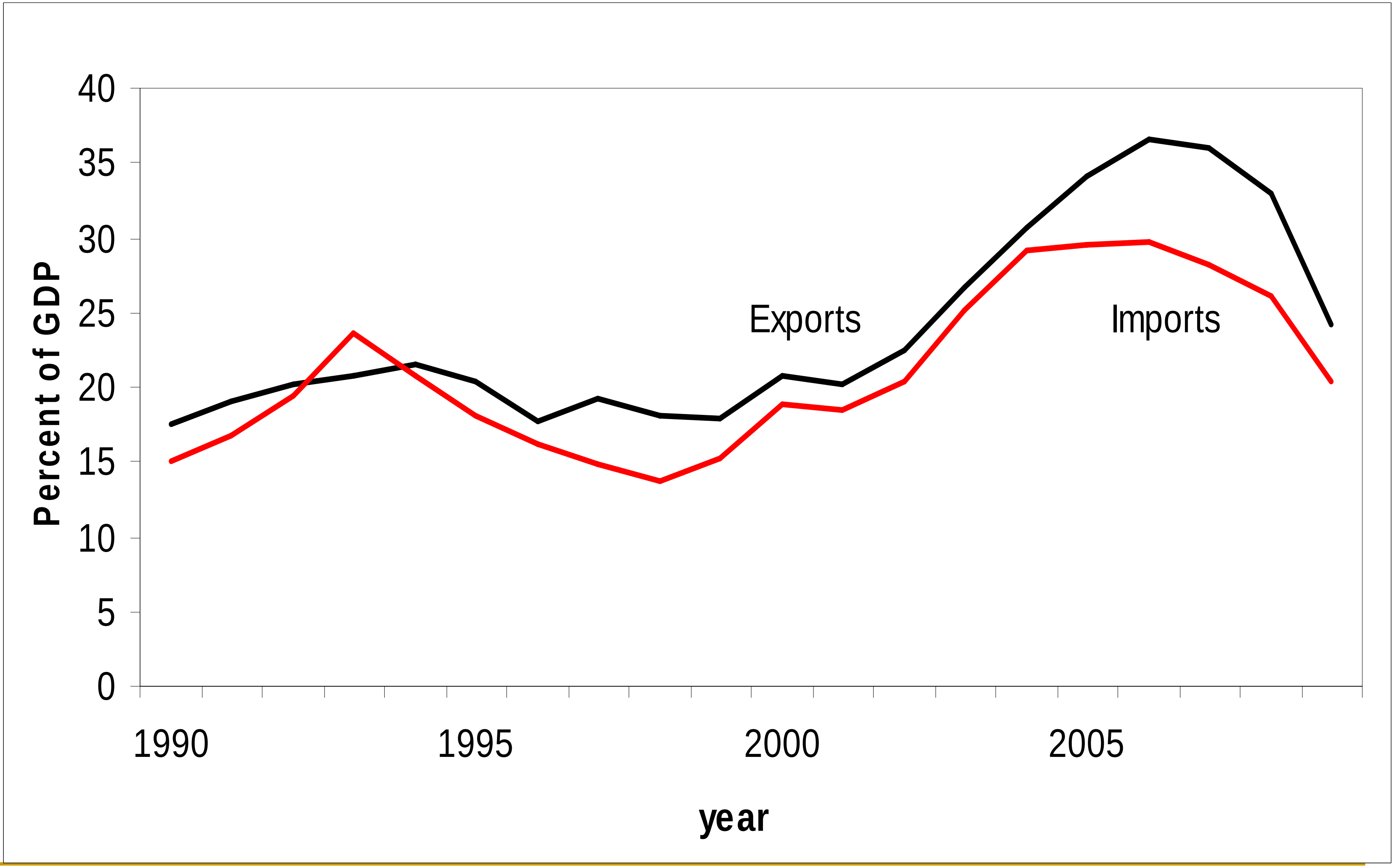
Components of National Saving
Percent of NDI
60.0
50.0
40.0
30.0
20.0
10.0
0.0
1992
1995
1998
2001
2004
2007
Government
Enterprises
Households


Household Disposable Income
Percent of NDI
75
70
65
60
55
50
Household Income
(%of total)
1992
1995
1998
2001
2004
2007

China' Trade Performance

- Trade did not emerge as a major issue until 2005
  - Prior to joining WTO, trade was a relatively constant share of GDP with a small surplus.
  - Both exports and import grew rapidly after WTO membership.
  - Import share leveled out after 2004.
- Reflects domestic S-I imbalance and productivity growth in export sector.
  - All this occurred against the backdrop of a constant nominal exchange rate from 1993.

China’s Trade, 1990-2009



Processing Trade

- China has become a major hub for Asian production network
  - Example of U.S. and Taiwan electronics
  - Apple Computer - Ipod
- Represents about half of China’s exports
- Very low domestic value added
- Dominated by foreign-owned companies
  - Tax and tariff-favored exports

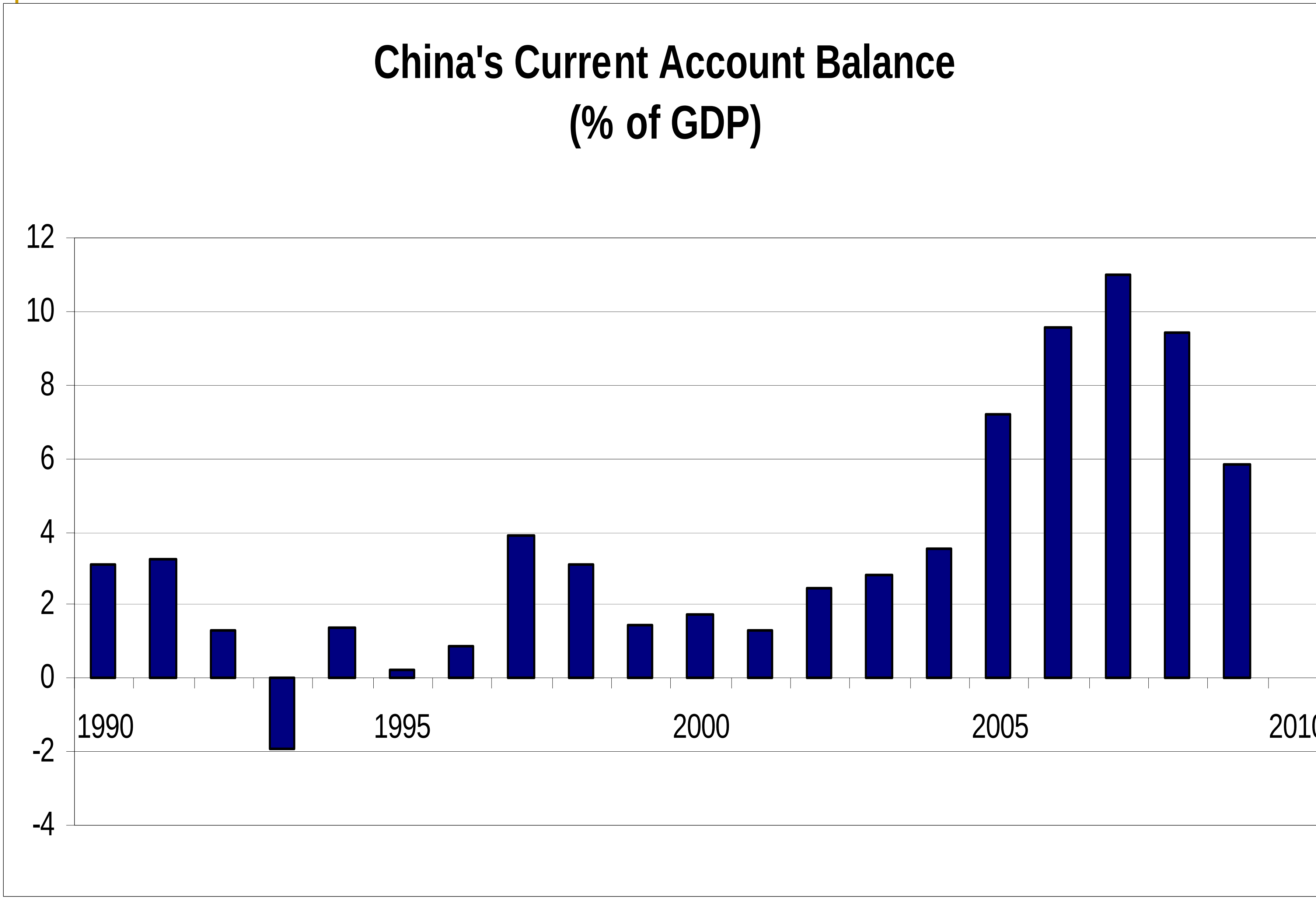
Domestic Value Added: Processing vs. Normal Exports

	Normal Exports		Processing Exports	
	2002	**2006**	**2002**	**2006**
All Merchandise				
Foreign Value-added	10.8	11.3	74.3	81.9
Domestic Value-added	89.2	88.7	25.7	18.1
Manufactured Goods				
Foreign Value-added	11.6	11.7	74.9	82.3
Domestic Value-added	88.4	88.3	25.1	17.7

Source: Koopman, Wang, and Wei (2008)

Economic Rebalancing

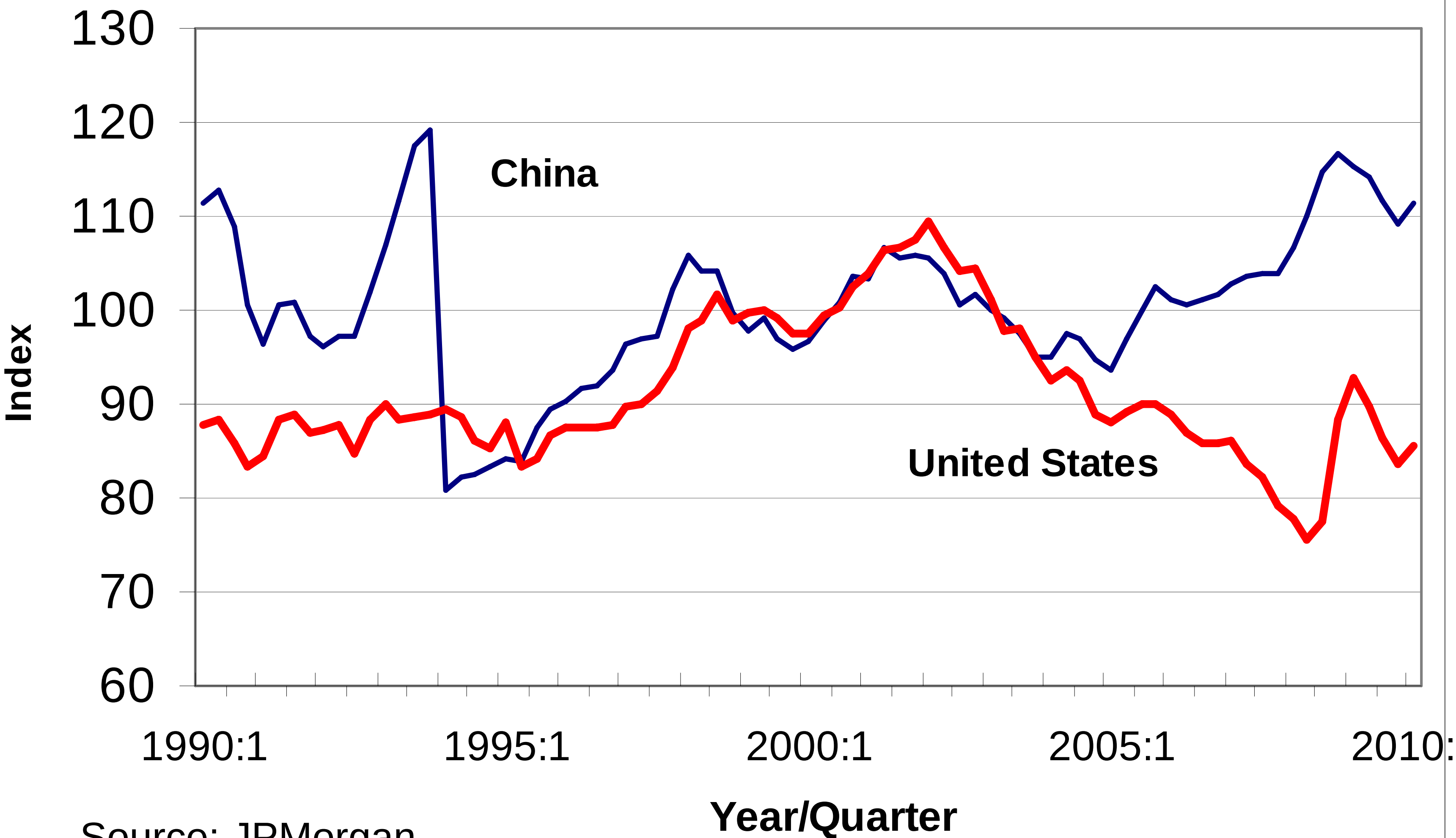
- Some adjustment has occurred
  - Current account surplus peaked in 2006, and declined sharply in 2009
  - U.S. and China's effective exchange rates have diverged
  - Nominal bilateral rate appreciated by 22 percent between 2005 and 2008.
  - China's other trading partners have had large depreciations in recent period– Korea, Taiwan, Malaysia
- Concern that surplus will grow rapidly in future due to economic recovery in advanced-country markets.


China's Current Account Balance
(% of GDP)
12
10
8
6
4
2
0
-2
-4
1990
1995
2000
2005
2010

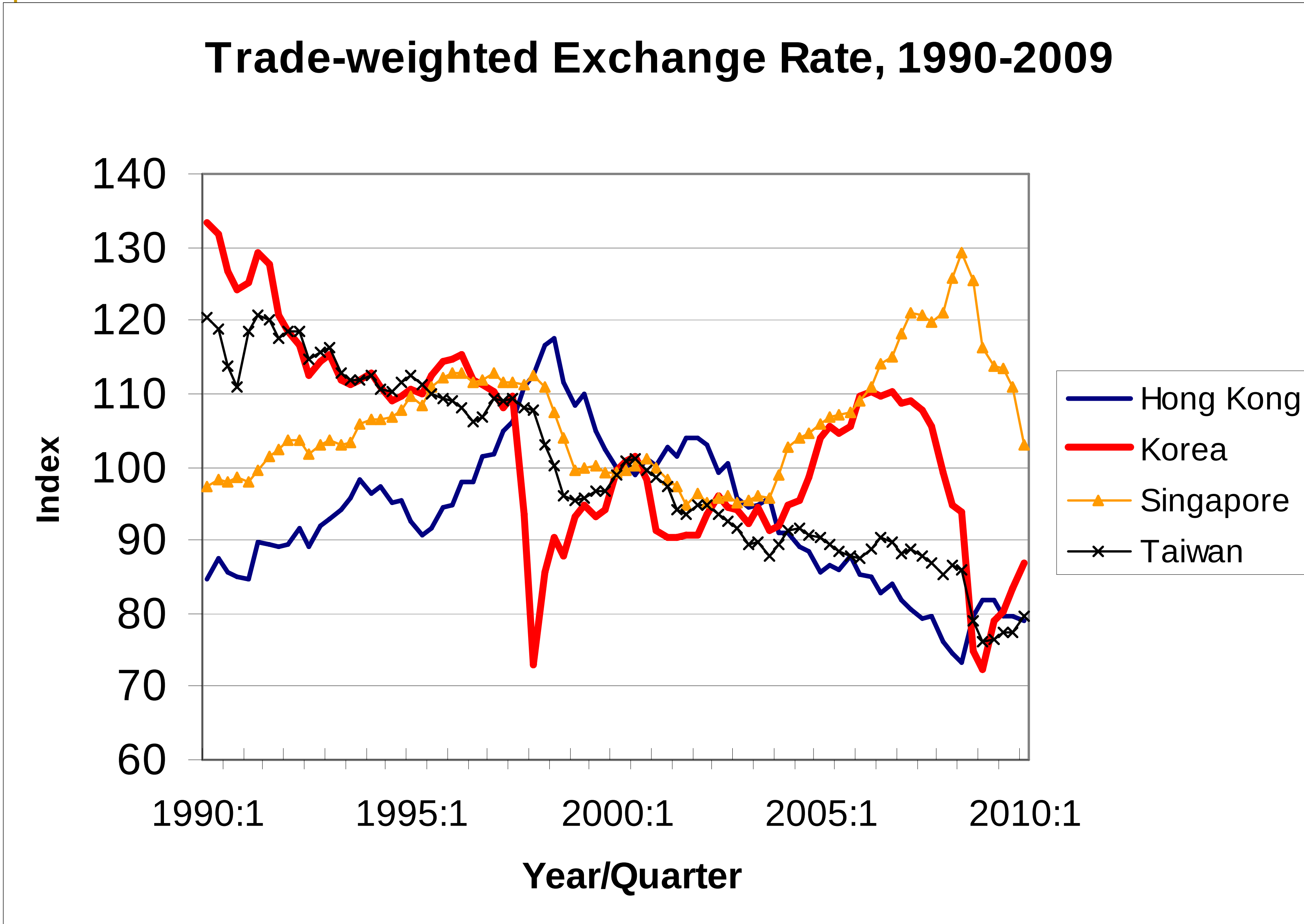
Exchange Rates

- What matters for trade is the *trade-weighted* real exchange rate, not nominal rates.
  - Adjustment can occur through differential rates of price inflation, if not nominal exchange rate changes.
  - Surplus countries with fixed exchange rate should have rapid growth in money supply and increase in domestic price level.
  - China has sought to short-circuit this mechanism through sterilization of reserves.
  - Still, Chinese and U.S. real exchange rates have departed substantially in recent years.

Trade-weighted Exchange Rate, 1990-2009



Source: JPMorgan



Trade-weighted Exchange Rate, 1990-2009
140
130
120
110
100
90
80
70
60
Index
1990:1
1995:1
2000:1
2005:1
2010:1
Year/Quarter
Hong Kong
Korea
Singapore
Taiwan

Economic Rebalancing

- Correction of global imbalances will require both changes in expenditure patterns and relative prices
  - The United States needs to increase national saving and shift to greater emphasis on exports
  - China needs to shift back to greater reliance on domestic demand growth -- reduced saving and increased consumption
- Exchange rate changes are an integral part of relative price adjustment
  - U.S. needs to reduce price of exports and raise cost of imports to be more competitive in world markets
  - China needs the reverse

Economic Rebalancing

- The United States and China are not direct competitors.
  - China is a center for production based on low-cost labor competing with Southeast Asia and countries like Mexico – large role as an assembler of parts produced elsewhere in Asia.
  - The United States is largely a producer of high-technology capital goods competing with the EU (Germany) and Japan.
- The United States should have a major interest in China as a fast-growing export market.

Economic Rebalancing

- The adjustments are much easier, however, when they are spread over many countries
  - Thus far, the EU and Japan have borne the bulk of the changed competitive balance with the United States
  - Countries that compete with China resist appreciation against dollar out of fears of losing competitiveness vis-a-vis China.

Economic Rebalancing

- China has maintained a fixed nominal exchange rate relative to the dollar since 1993 (some modest appreciation prior to the financial crisis).
  - In recent years, that has required massive intervention to offset large trade surpluses and capital inflows.
  - Investors earn very high returns in China and anticipate a future exchange rate appreciation
  - Large-scale sterilization to prevent excessive monetary growth and price inflation – issuance of domestic bonds to finance purchase of foreign exchange, and high bank reserve requirements.

Economic Rebalancing

- Global cost is China's trade surplus, not the exchange rate: distinguish means and ends.
  - China's policies are costly to other producers of low-wage products.
- Need to coordinate exchange rate and domestic restructuring
  - Sustain rapid growth, but change its composition.
  - Importance of internal relative price distortions: labor, capital, land, and energy.
- Large benefits to U.S. and China from coordinated actions to reduce their imbalances