PUTTING CHINA'S ECONOMIC EXPANSION IN PERSPECTIVE

China's economic expansion over the past quarter of a century has been one of the strongest in world history. Following years of rapid expansion, the country has become the world's third largest exporter and a key trading partner of the euro area. Together with net domestic and global benefits, this rapid expansion has brought about a number of policy challenges, and structural imbalances have emerged both internally and externally. Currently, these imbalances relate to the risks of abundant liquidity, overcapacity in some industries and external surpluses, and appear linked to the tightly managed exchange rate regime and ample domestic savings, among other factors. While there is broad consensus that China's near-term prospects are benign, the authorities have acknowledged the need for policy adjustment to ensure that the outlook also remains favourable in the long run. Promoting more balanced domestic demand and supply conditions would be consistent with a gradual and orderly resolution of global imbalances in the medium term.

1 INTRODUCTION

The emergence of China in the global economy is one of the most profound economic transformations that the world has witnessed in recent decades. Since the early 1990s, when market-oriented reforms and measures to open up to foreign competition began to be intensified, China's GDP has recorded annual growth rates that are remarkable for an economy of its size. The country's share of global output increased from 1.7% in 1990 to 5% in 2005 and it has rapidly climbed from being the eleventh largest economy in the world in 1990, as measured in US dollars at current exchange rates, to the fourth largest in 2005 – the second largest if adjustments are made for differences in purchasing power.[1] In only 15 years, real GDP per capita has increased from being roughly comparable to that of India – another economy to have experienced above-average growth over the period – to more than double that figure in 2005.

The most important achievements of China's economic expansion are briefly reviewed in Section 2. This expansion brings with it many benefits and opportunities both domestically, for example rising living standards and welfare, and for the global economy, for instance higher potential growth, trade and competition, and lower prices of manufactured imports. But it also creates new challenges, especially in the long run, as the country becomes an increasingly strong competitor on global markets and quickly climbs the technology ladder. Moreover, this rapid development also confronts Chinese policy-makers with the problem of how best to control domestic policy conditions.

This article focuses on the macroeconomic challenges arising in China that have a direct bearing on the euro area external environment, given China's weight in global trade. These challenges, which are discussed in Section 3, mainly relate to the unbalanced growth pattern of domestic demand and the high and growing external surpluses. Section 4 argues – in line with certain arguments produced in the recent policy debate, both in China and in the international community – that the challenges are at least partly related to the de facto pegged exchange rate regime. Section 5 concludes.

2 ECONOMIC ACHIEVEMENTS

China's rapid expansion is the result of a combination of structural factors and policy choices. In structural terms, China has benefited from an exceptionally high rate of capital accumulation. Real gross fixed capital formation

1 Taking into account recent data revisions, China's nominal GDP at market exchange rates was USD 2.2 trillion in 2005, compared with USD 12.5 trillion in the United States, USD 10 trillion in the euro area, and USD 4.6 trillion in Japan, according to data from the IMF World Economic Outlook. In nominal terms, China accounted for 5% of 2005 world GDP, compared with 28% for the United States and 22.4% for the euro area. In purchasing power parity terms, the United States accounted for 20.1% of world GDP in 2005, ahead of China (15.4%) and the euro area (14.8%).

has risen by more than 13% per year since 1990, consistently outpacing real GDP growth, and the investment share of nominal GDP increased from around 25% in 1990 to almost 41% in 2005. In turn, these high rates of capital accumulation have been supported by high savings, currently equivalent to almost half of nominal GDP. A remarkable increase in labour productivity, as measured by GDP per worker, in particular in the manufacturing sector, has been another important driver of growth. China has benefited from a cheap, abundant and relatively well-qualified labour force. The increasing trade specialisation in Asia – which has been labelled "the Asian production chain" – has also resulted in competitiveness gains, cheaper products and ultimately higher trade volumes and faster growth.[2]

Domestic reforms implemented during the 1990s have progressively reduced the weight of the public sector in the economy and have transformed the structure of the industrial sector. In 1994, 82% of industrial value added was generated by the public sector through state and collectively owned enterprises. In 2005 this share had shrunk to around 41%, whereas the share generated by privately and foreign-owned enterprises increased.[3] Productivity improvements have also been brought about by the increased exposure of Chinese enterprises to foreign competition through trade and technology transfers, taking place via FDI and joint ventures with foreign capital. Trade openness, as measured by the share of exports plus imports in GDP, increased from 27% in 1990 to 69% in 2005, with a particularly steep acceleration following the country's accession to the WTO in 2001. Chinese openness today is significantly higher than in many advanced economies and emerging markets.[4] Although processing trade[5] accounts for a large portion of Chinese trade – up to 44% according to official data – it is also the area where technology transfers are most important.

Rapid growth has deeply transformed China's economic structure, as shown for example by the dramatic change in the sectoral composition of Chinese output. With productivity in agriculture (as measured by GDP per worker) only around one-fifth of the level in the whole economy, China is one of the countries with the highest productivity differential between agriculture and the rest of the economy. Insofar as this differential is reflected in wages, it has triggered a mass relocation of labour from the rural and state-owned sectors of the economy to more productive sectors, such as manufacturing, services and privately owned enterprises.

Although around 40% of China's labour force is still employed in the agricultural sector, this share has fallen dramatically from almost 71% in 1978. The primary sector's share of nominal GDP has also declined, from 28% in 1978 to 13% in 2005. However, value added per worker in agriculture still remains lower than in many comparable economies, suggesting that China has ample opportunity to increase agricultural output and productivity.

Alongside the obvious domestic benefits, China's rapid growth has had a tremendous impact on the rest of the world. China is one of the main engines of world growth, contributing around a third of global real GDP growth since 2000. It is a major global exporter, making up around 6.6% of total world exports in 2005. It is also one of the world's largest recipients of foreign investment, absorbing around 25% of total FDI flows to emerging market economies in 2005. China's export share has increased steadily over time, especially in advanced

2 Many recent papers attempt to measure whether growth in China is driven mainly by improvements in total factor productivity or increases in factor utilisation (Box 1 of the IMF's Staff Report for the 2005 Article IV Consultation on China provides an estimate. A survey of the available studies can be found in O. Blanchard and F. Giavazzi (2006), "Rebalancing Growth in China: A Three-Handed Approach", CEPR Discussion Paper No 5403). Most of these papers conclude that total factor productivity continues to be an important driver of GDP growth, although its growth rate has declined recently.

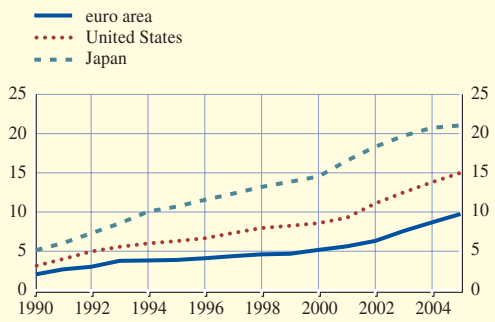
3 See also OECD (2005), Economic Survey of China, Chapter 2.

4 China's trade openness in 2005 was higher than the average for Latin American countries (45%), and was significantly higher than in the euro area (39%), Japan (28%) and the United States (26%).

5 Defined as the processing of imported intermediate goods that become inputs for the production of re-exported goods.

Chart 1 Share of imports from China

(as a percentage of each economy's total imports)



Source: IMF Direction of Trade Statistics.

economies. Between 1990 and 2005, it gained market shares in each of the world's three largest economies: from 2% to 9.8% in the euro area, from 3.1% to 15% in the United States and from 5.1% to 21% in Japan (Chart 1).[6] Over the same period, China also gained importance as a destination market for advanced economies' exports. It now accounts for 3.5% of extra-euro area exports and 4.6% of US exports (against slightly more than 1% for both countries in 1990), whereas China's share of Japanese exports rose to 13.5% in 2005, from around 2% in 1990. As a result, China now runs substantial trade surpluses with the euro area and especially the United States.

In the United States and the euro area, China's market share gains have been largely offset by losses by other Asian economies, such as Japan. For example, in the euro area, imports from Japan fell from around 9% of the total in 1990 to 4.7% in 2005. On balance, over the past ten years, the market share of Asia as a whole in the euro area has changed little.

Although imports from China represent a challenge for a number of producers, in particular those in advanced economies operating in the more traditional, labour-intensive manufacturing sectors where China has a competitive advantage, in net terms China's rapid rise has been mutually beneficial both to China and to the global economy. The euro area, in particular, has a significant interest in China's steady transition to a stronger, more balanced and more open economy.

China is the third largest country of origin of euro area imports, and its share of 9.8% of total euro area imports is rapidly catching up with the shares of the United Kingdom (12%) and the United States (10.3%). The euro area has become a key market for Chinese products, absorbing almost 15% of its exports, the largest share after the United States and ahead of Japan. Euro area exports to China increased almost threefold between 2000 and 2005, rising much faster than euro area exports to the rest of the world. Investment in China has allowed European firms to remain competitive by gaining access to competitively priced inputs and to penetrate the rapidly growing Chinese market. Symmetrically, the openness of European markets to Chinese exports has been a key factor in China's development. Moreover, investment from European firms has brought capital goods, knowledge and technology that has helped China develop its productive capacity.

China's industrial expansion has also created a seemingly insatiable demand for imports of raw materials, intermediate and capital goods, which is having a sizeable impact on the global economy. China is currently the second largest energy consumer globally, in addition to being a major consumer of a number of other commodities and base metals, and in the past three years has accounted for over 50% of the growth in the global demand for these commodities. Commodity exporters, such as Chile, Brazil, Australia and Canada, have seen their exports surge as a result. Neighbouring economies such as Japan, Korea and Taiwan have also benefited from China's demand for intermediate and capital goods. Finally, China has had a significant impact on global prices. The country's demand for commodities contributes to an upward pressure on prices. At

6 These shares are calculated using the IMF Direction of Trade Database, and refer to external trade in goods only.

the same time, competitively priced Chinese exports help to restrain inflationary pressures in advanced economies. It is not always easy to gauge the net effect of these opposite trends.[7]

Wage growth globally may have also moderated as a result of competition from China and the increase in the global labour supply that stemmed from the country's integration in the global economy. The emergence of China's economy has changed the global balance between labour, which is abundant in the country, and physical capital, which is scarce. Economic theory suggests that the relative price of labour should fall and that of capital should rise as a result. Although China may not have been the only force behind this development, it is interesting to note that the fall in the wage shares in GDP and the rise in the profit shares observed globally in recent years are consistent with the prediction made by the theory.

3 MACROECONOMIC CHALLENGES

China's recent growth experience has been marked by deep structural changes in the composition of domestic demand. These changes, which have been partly the result of deliberate policy choices, have also created a number of macroeconomic challenges for Chinese policy-makers. In particular, external imbalances have widened significantly, especially since 2004, at least in part owing to a falling consumption ratio and rising domestic savings. Additionally, the marginal product of capital has decreased and risks of overcapacity have emerged in some sectors. Moreover, the economy has become increasingly dependent on investment and exports as engines for domestic growth. The Chinese authorities have recognised these challenges, in particular the need to rebalance the composition of domestic demand between consumption and investment. The international community has also stressed that rebalancing domestic demand in China would offer an important contribution towards an orderly resolution of global imbalances.

CONSUMPTION, SAVINGS AND EXTERNAL IMBALANCES

Although domestic consumption has grown at robust rates in China, it has lagged behind the overall growth rate of the economy for many years. As a result, its share of GDP has fallen steadily over time (see Chart 2); its current share of 46% is significantly lower than, for example, 86% in the United States, 78% in the euro area, 71% in India and 67% in Korea. Correspondingly, a falling consumption share of GDP has been matched by a rapid increase in savings. Overall domestic savings account for around a half of Chinese GDP, one of the highest shares among economies of comparable size and level of development.[8]

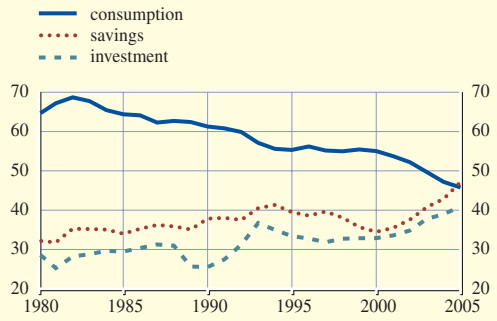
An increase in gross savings and a fall in consumption are not uncommon across catching-up economies, and it has been argued that a similar pattern was to be expected in China. However, China's saving ratio is high by any standard, and it has been more than sufficient to finance the high and growing level of capital formation that has characterised the country's growth pattern over the past decades. As the domestic savings-investment gap has widened, China's external imbalances have increased, as reflected in the high and growing trade and current account surpluses and rising foreign exchange reserves. The trade balance rose to a record surplus of USD 134 billion in 2005 (6% of GDP). Net foreign assets have also increased and the country has turned into a net supplier of capital to the rest of the world – an unusual position for an emerging economy (see Chart 3). Moreover, as a high proportion of the country's stock of external assets are foreign

7 In the literature, it is generally found that the emergence of low-cost producers has led to a fall of imported inflation in developed economies, although estimates of the exact impact vary widely across studies. For example, the IMF finds that globalisation has reduced inflation in advanced economies by an average of a quarter of a percentage point a year over the past decade. See Chapter III of the IMF's World Economic Outlook of April 2006. See also N. Pain, I. Koske and M. Sollie (2006), "Globalisation and Inflation in the OECD Economies", OECD Economics Department Working Papers, No 524.

8 This share has increased sharply from 32% in 1980, on account of growing private and public savings.

Chart 2 Consumption, savings and investment

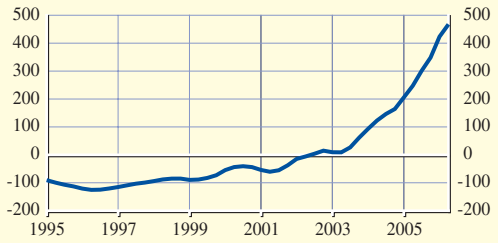
(as a percentage of nominal GDP)



Source: IMF World Economic Outlook database.

Chart 3 Net foreign assets[1)]

(USD billions; quarterly data)



Source: NiGEM database.
1) Data after end-2004 are based on estimates by the National Institute of Economic and Social Research.

exchange reserves held in US dollars, China has also become an important source of financing of the US current account deficit.

External imbalances in China have attracted much attention recently, not least because of their role in the build-up of global imbalances. However, these imbalances are symptoms of domestic structural weaknesses that relate to the country's saving and consumption behaviour. Many studies have tried to explain the structural drivers of Chinese savings. The broad consensus is that the rise in savings has been caused by a combination of factors, in particular: (i) a decline in the share of disposable income in GDP, which has closely matched the fall in the consumption share;[9] (ii) an increase in precautionary savings due to the need to provide for healthcare, basic education and retirement given the lack of sufficient public provision of these services as a result of the restructuring of public enterprises; (iii) financial system weaknesses, which impose borrowing constraints and limit households' access to consumer finance; and (iv) demographic trends, in particular the fall in the dependency ratio.[10] A sustainable reduction of external imbalances ultimately requires an adjustment of the underlying forces driving these structural trends.

INVESTMENT AND THE RISK OF OVERCAPACITY

Aggregate investment has risen rapidly in recent years, both in level and as a share of GDP, to become the single most important driver of overall growth, accounting for around 50% of real GDP growth over the past five years. The investment share of nominal GDP has also increased substantially in the past decade, to 41% in 2005 – a record high by regional standards and a level comparable to that in several other South-East Asian economies prior to the 1997-98 crisis (see Chart 4).

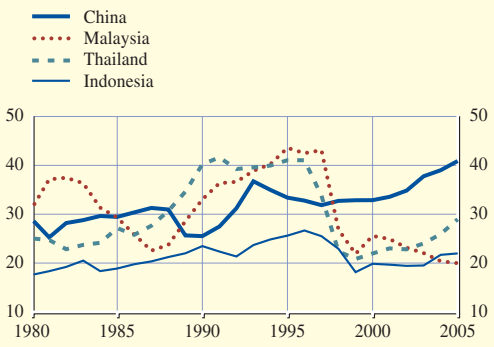
Sustained investment growth and increasing investment shares of GDP are not necessarily indicative of a risk of overcapacity. In principle,

9 In turn, the fall in the share of disposable income in GDP reflects both weak wage growth and a decline in investment income as a share of GDP. The former is related to the availability of substantial under-utilised labour resources in the economy. The latter is related to the low interest rates on bank deposits, which have been the dominant vehicle of household savings. The low-dividend policy and the narrow shareholding base have also prevented households from benefiting from the increase in corporate wealth. See IMF Regional Economic Outlook, May 2006.

10 According to World Bank data, China's dependency ratio was 45% in 2003, down from 67% in 1980. As a comparison, the dependency ratio in India and Mexico was 60% in 2003 (source: World Development Indicators). However, China's dependency ratio is projected to start rising again after 2010 to reach around 65% in 2050, mainly as a result of the birth control programme implemented since 1979 (the "one-child policy"; see United Nations, World Population Prospects: The 2004 Revision Population Database).

Chart 4 Investment ratios in selected emerging Asian economies

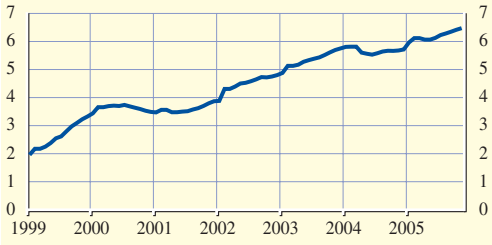
(as a percentage of GDP)



Source: IMF World Economic Outlook database.

Chart 5 Corporate profitability

(net profits as a percentage of corporate assets; monthly data)



Source: CEIC database.

rapid investment growth may result from a rational response of the corporate sector to current and expected demand conditions. High investment shares of GDP are also common for catching-up economies. Ceteris paribus, fast growing economies need comparatively faster capital accumulation to keep the capital stock constant as a share of GDP.

Indices of corporate profitability have remained broadly sound in China, whereas excessive investment should have led to overproduction, falling prices and a profit squeeze (see Chart 5). However, other indices of capital efficiency, such as the marginal product of capital, have fallen recently, suggesting that the productivity of additional investment has fallen (see Chart 6). It has been argued that such falls can be expected following a protracted period of investment growth. Moreover, although the different classification of investment across countries renders international comparisons not entirely appropriate, the marginal product of capital in China in 2005 was still comparable to the level in Korea and Indonesia.

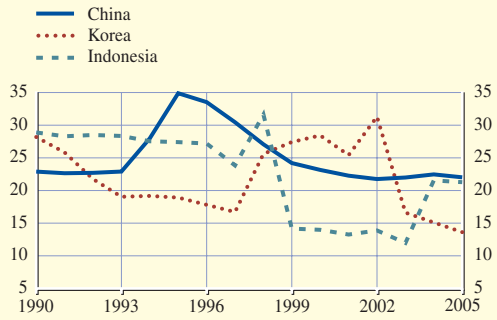
In a country with a low capital-to-labour ratio, a falling marginal product of capital may also signal an inefficient allocation of capital. A significant share of Chinese investment is financed through retained profits. In addition, Chinese financial markets are still in their infancy: the vast majority of financial assets are intermediated by the banking system. The equity market is relatively thin. Traded securities, such as corporate bonds, are negligible. Other financial services, including insurance, are also relatively little developed. This suggests that the efficiency gains in capital allocation from promoting more sophisticated financial intermediaries and products could potentially be very high.

Data at industry level suggest that the risk of overcapacity may be more material in some sectors of the Chinese economy. For example, the automobile and steel industries – which combined account for over 15% of total industrial output – have experienced rapid production and inventory growth, a shift to net exports and, at the same time, a significant fall in prices, profits and capacity utilisation rates, which taken together may be seen as evidence of excessive investment. This issue may not be detected by aggregate indicators of capital efficiency (such as the marginal product of capital, or indicators of corporate profitability) because the build-up of overcapacity in those sectors is partly offset by the lack of investment in other sectors of the Chinese economy, such as public and rural infrastructures, transportation and agriculture.

This problem is acknowledged by the Chinese authorities, who earlier in 2005 identified a

Chart 6 Marginal product of capital[1)]

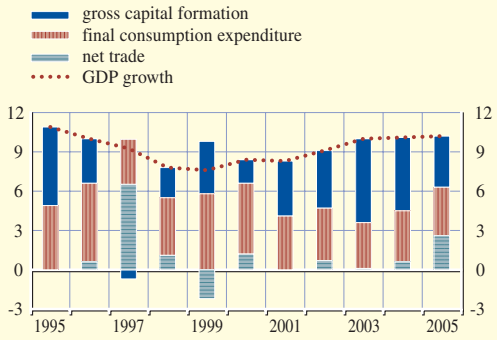
(percentages)



Source: IMF World Economic Outlook database.
1) Calculated as 100*(GFCF/ΔGDP), where GFCF is gross fixed capital formation.

Chart 7 Contributions to GDP growth

(annual growth rate and percentage point contributions)



Source: National Bureau of Statistics of China.

number of sectors where problems of excess capacity were acute and targeted them with administrative measures to curb further capacity build-up.[11] The latest evidence points to a slowdown in investment growth in the second half of 2006, especially in the sectors most affected by overcapacity. However, investment is still the major driver of GDP growth.

REBALANCING GROWTH

As the share of consumption in GDP has fallen, Chinese growth has become increasingly dependent on investment and foreign demand (see Chart 7). It has been argued that excessive reliance on investment and exports as drivers of growth is undesirable from the point of view of the Chinese policy-maker. High investment can lead to overcapacity, falling prices and corporate profits, as well as rising non-performing loans, with implications for financial stability. Excessive reliance on exports exposes the economy to sudden changes in foreign demand conditions. Therefore, rebalancing the current drivers of growth away from investment and exports and towards consumption is seen as an important way of reducing these risks.

The Chinese authorities have acknowledged this challenge on several occasions. For example, the 11th Five-Year Programme, adopted in March 2006, explicitly calls for a rebalancing of the economy.[12] Moreover, the central bank has consistently motivated its recent policy action with the need to slow down investment and increase consumption. Looking ahead, it is possible that the policy measures introduced so far to curb liquidity and lending growth might contain investment and give a temporary boost to consumption. However, consumption, saving and investment decisions reflect structural and institutional factors. The IMF has recommended a number of structural reforms to stimulate a more permanent increase in consumption and make GDP growth more balanced over the medium term. These include fiscal reforms to reduce uncertainties surrounding the provision of basic social services such as pensions and health care, and financial sector reform to promote a more efficient allocation of resources, remove borrowing constraints and ensure long-term

11 The sectors targeted included the automotive, steel, ferrous metal and electricity sectors. The measures adopted were: instructions to banks to tighten lending to these sectors; measures to promote industrial consolidation; and controlled start-up licences. Similar measures were also introduced in the cement, coal, aluminium and coke industries.

12 A key goal of the plan, laying out the government's policy agenda for 2006-10, is "to maintain balanced and fairly rapid" growth (Chapter 1). The need to move to growth "that is less energy, resource and capital intensive" is also stressed by the Communiqué of the Fifth Plenary Session of the 16th Central Committee of the CCP on 11 October 2005.

growth prospects. These policy measures would reduce precautionary savings and boost consumption, thereby making Chinese domestic demand more self-sustained.

This mix of policy recommendations is widely supported by the international community. Indeed, structural domestic reforms to promote more balanced demand and supply conditions in the economy are also consistent with a gradual and orderly resolution of global imbalances in the medium term.

4 MONETARY AND EXCHANGE RATE POLICY

A fixed exchange rate vis-à-vis the US dollar has been part of the Chinese development model. Whether the renminbi peg to the dollar has also served the purpose of promoting external trade in the context of China's so-called export-led model of growth is debatable. According to one argument, the peg has not led to trade creation as it has not brought about exchange rate stability in effective terms. In fact, despite the peg, the real effective exchange rate (EER) has swung widely in recent years, mainly reflecting the volatility of the US dollar – and hence of the renminbi – against the currencies of some major trading partners, such as the euro and the Japanese yen (Chart 8). Thus, because China has substantial trade flows with Europe and Japan, in principle, the peg may have caused trade diversion away from Europe and Japan and towards the United States.[13] Consistent with this, the renminbi real EER has been only weakly correlated with China's current account balance.

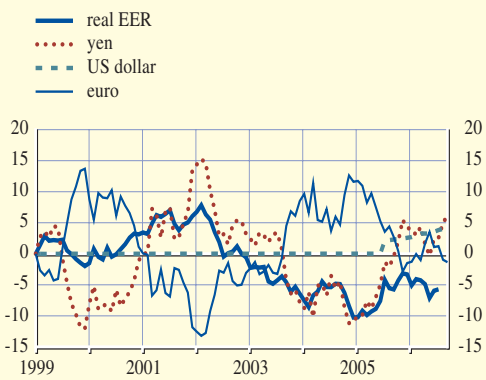
Historically, the peg has been an important element of the stabilisation policies pursued in the past decades. Together with other structural reforms that have opened up the Chinese economy to competition and liberalised price-setting mechanisms for most goods and services, the peg has helped to successfully stabilise inflation in recent years. Chinese CPI inflation has fallen significantly since the exchange rate reforms of 1994, and has remained relatively stable since then (see Chart 9).

However, recently there has been growing evidence that maintaining a hard peg to the US dollar is becoming increasingly challenging. The argument boils down to the "inconsistent trinity" hypothesis, which postulates that it is impossible for a country to simultaneously

13 M. Obstfeld (2006), "The Renminbi's Dollar Peg at the Crossroads", CEPR Discussion Paper No 5771.

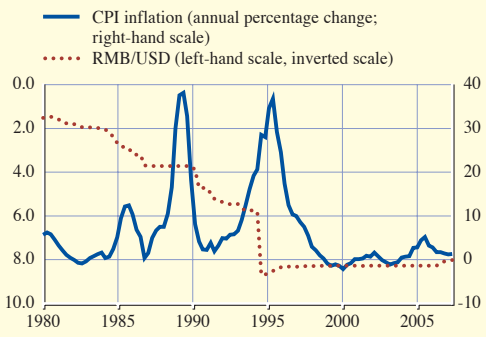
Chart 8 Renminbi exchange rate

(cumulative percentage change since January 1999)



Source: IMF International Financial Statistics.
Note: An upward movement represents an appreciation of the renminbi.

Chart 9 Renminbi exchange rate and CPI inflation



Source: NiGEM database.

achieve a fixed exchange rate and an independent monetary policy in the presence of free capital movements. So far in China, it has been possible to peg the exchange rate without overriding domestic monetary policy by controlling the capital account and by maintaining restrictions on cross-border capital movements. This has allowed a certain degree of monetary autonomy to be retained through the use of administrative measures, such as reserve requirements on deposits and the so-called "window guidance" policy, which aims at controlling the growth of domestic credit to certain sectors.

However, capital controls tend to lose effectiveness over time. Rising capital inflows, compounded by large current account surpluses, have exacerbated the trade-off between the fixed exchange rate and monetary autonomy. China recorded a current account surplus of USD 161 billion in 2005 (7.2% of GDP), on top of which net financial inflows helped to further increase the overall balance of payments surplus. Net FDI inflows averaged nearly 5% of GDP annually in the five years prior to the Asian crisis. They have fallen since then but were still USD 71 billion in 2005 (3.2% of GDP). Other capital flows – probably mostly speculative in nature – grew significantly in 2004 (to USD 91 billion) but have turned negative since then.

Overall, the twin surpluses of the Chinese balance of payments create appreciation pressures on the renminbi exchange rate, offset by repeated official intervention in foreign exchange markets. Official intervention, defined as the change in the stock of reserves, was USD 207 billion in 2005, or 9.3% of GDP, a trend which has continued in 2006. As a result, the stock of foreign exchange reserves has grown around sixfold since the beginning of 2000, to USD 1 trillion in October 2006, the highest stock in the world, equivalent to more than 600% of overall short-term debts.[14]

Over time, the People's Bank of China has conducted large-scale open market operations to partially sterilise the domestic monetary expansion caused by foreign exchange intervention. As a rough estimate, the central bank currently sterilises around two-thirds of the increase in reserves and in September 2006 the outstanding stock of sterilisation debt was around 40% of official reserves. The majority of this debt had a maturity of less than one year.

However, sterilisation entails some costs which are likely to increase more than proportionally with the rise in the stock of reserves. There may potentially be sizeable capital losses on the balance sheet of the monetary authority due to valuation effects on the reserves stock, if the exchange rate is allowed to appreciate – although the exact importance of this channel in practice is widely debated in the literature. There may also be implications for bank profitability and financial sector stability, as sterilisation bond yields have in some cases fallen below the yields paid by banks on deposits. More broadly, the subordination of monetary policy to foreign exchange policy hinders progress in interest rate liberalisation, which is a key condition for the development of an effective transmission mechanism for monetary policy. The development of strong domestic institutions for independent policy-making may also be delayed, and the economy may become increasingly exposed to external shocks. This vulnerability in particular will become increasingly relevant as China's integration in the global economy advances.

Despite increasing rates of sterilisation, these interventions – which in terms of magnitude and duration are quite unique in the history of the current international monetary system – have fuelled liquidity growth in the economy. This growth is demonstrated by the strong rise in M2, which has consistently overshot the official target, and partly explains the strong investment growth witnessed in recent years. This makes the case for reforms, both to

14 For a comprehensive discussion of the main challenges stemming from China's twin surpluses of the balance of payments, see also the People's Bank of China, *Financial Stability Review,* September 2005, Part II, page 17.

structural policies in order to lower high savings, and to the monetary policy framework in order to allow for greater exchange rate flexibility, including the possibility for currency appreciation to rebalance the economy towards a path that is more sustainable internally as well as externally.

One concern is that exchange rate flexibility may lead to financial distress in a system which, because of the protection offered thus far by capital controls, is yet to develop tools to appropriately deal with exchange rate risk. Indeed, this has proven to be a problem in several countries where sudden currency changes have imposed a burden on firms and banks with large unhedged foreign currency positions. But this risk appears manageable in China, as the overall exposure of domestic firms to foreign exchange risk is relatively small by international standards.[15] With the existing capital controls in place, the banking system would also be sheltered from sudden reversals of foreign capital flows leading to large exchange rate changes. Indeed, greater exchange rate flexibility could, in fact, facilitate capital account liberalisation by preparing the economy to deal with the impact of larger cross-border capital flows in a gradual manner. The experience of economies such as Chile and Israel confirms the importance of rightly sequencing exchange rate reform and capital account convertibility.[16]

Greater exchange rate flexibility in China would improve investment decisions and boost consumers' purchasing power. Combined with fiscal reforms to reduce uncertainties surrounding the provision of basic public services, as well as financial reforms to remove borrowing constraints, these measures would reduce precautionary savings and boost consumption, thereby making Chinese domestic demand more self-sustained and less dependent on exports. It would promote a more efficient allocation of resources between tradable and non-tradable sectors, support more balanced domestic growth, and also be conducive to financial sector reform and capital account liberalisation, which are key policy objectives stated by the Chinese authorities.

China has made some progress on this front with the exchange rate reforms implemented since 21 July 2005. The authorities have allowed a small nominal appreciation and have emphasised their resolve to move towards a more market-determined exchange rate system. They have also taken measures to develop the foreign exchange market and, on several occasions in 2006, they made use of the flexibility allowed by the existing fluctuation bands to enable a greater appreciation of the renminbi. These steps have been welcome and have to be seen as part of an ongoing process. Lack of significant progress could result in a backlash of increased trade disputes and calls for protectionism across developed economies.

More exchange rate flexibility would be beneficial not only domestically but also for the rest of the world, where it would be conducive to a redistribution of global trade flows and would contribute to a gradual adjustment of global imbalances over the medium term. For this reason, the international community has encouraged China to build on the measures implemented since summer 2005 and to aim at a greater role of market forces in exchange rate determination.[17] In all likelihood this would entail a more significant orderly appreciation of the renminbi vis-à-vis the major floating currencies, which China's economy should be able to fully withstand. This would also help to promote more balanced demand conditions and more solid growth prospects domestically.

15 E. Prasad, T. Rumbaugh and Q. Wang (2005), "Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China", IMF Policy Discussion Paper 05/01.

16 See Obstfeld (2006), op. cit.

17 See, for example, the Statement by G-7 Finance Ministers and Central Bank Governors on 23 September 2005, available from http://www.ustreas.gov/press/releases/js2943.htm.

5 CONCLUSIONS

The emergence of China has had a tremendous impact on global growth and trade, but it has also created a number of challenges, both internally and externally. Although the near to medium-term prospects remain favourable, the Chinese authorities have acknowledged the need for some policy adjustment, in particular for a more balanced pattern of growth of domestic demand. Promoting more balanced demand and supply conditions, a greater role of financial markets in the determination of domestic asset prices and a further move towards a more significant orderly appreciation of the renminbi against other currencies, including major floating currencies, would also be consistent with a gradual and orderly resolution of global imbalances in the medium term.