Keynote Address
China's Exchange Rate Policy and Economic Restructuring

WU XIAOLING

I am very glad that the Peterson Institute has offered to me this opportunity to share my views on two issues of interest to you: China's foreign exchange and monetary policies. I believe the reason we have difficulties and controversies is because of lack of communication. If we can enhance communication between people, we can solve these problems.

I will first discuss the relationship between China's foreign exchange policy and the balancing of the Chinese economy. In recent years, with the increasing openness of China's economy and its rapid economic growth, China's trade surplus has been growing as well. Figure 1 shows the evolution of China's trade balance with the United States, Western Europe, East and Southeast Asian countries, and the resource-exporting economies of Saudi Arabia (oil) and Brazil (iron ore and soybeans). The figure shows that some of the surpluses are transferred from other countries. Because of multilateral companies' allocation of resources, the manufacturing industry is moving to emerging markets. Thus China has a growing surplus with the advanced economies of Europe and North America but runs increasing deficits with the East and Southeast Asian economies and

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the resource- and energy-rich emerging-market countries such as Brazil and Saudi Arabia.

Figure 2 shows the sources of the trade deficit of the United States. In 1998 China accounted for 27 percent of the US trade deficit. By 2005 China's share had risen to 42 percent. Meanwhile, the US trade deficit with Japan and East and Southeast Asian countries in 1998 was much larger than it is with those countries today. This corroborates my conclusion that some of China's surplus has been transferred from other countries, especially those in East and Southeast Asia.

China's international trade imbalance actually reflects an imbalance in China's internal economic structure. The major symptoms are high saving and investment rates coupled with low consumption. China's national saving rate in 2002 was close to 50 percent of GDP. Its investment rate was around 42 percent of GDP. The difference between savings and investment, of course, is made up in trade surplus.

Furthermore, within total savings, household savings is actually declining. Figure 3 shows that in 1992 household savings accounted for 52.4 percent of national savings. In 2005 it accounted for 38.9 percent. Meanwhile, the shares in total savings of corporate (or enterprise) and government savings increased relatively quickly. Because China's investment rate is already very high, further investment is constrained by resource and environmental concerns. Thus, a lack of sufficient consumption results in a large surplus for China.

In the current international monetary system, the US dollar is the world's reserve currency, and many emerging markets have increased their dollar holdings. It is only natural for the United States to run a trade deficit with other countries. However, this deficit cannot be unsustainably large. I have to admit that China's large trade surplus and its increasing foreign exchange reserves do not benefit China, because the return on the investment in the foreign exchange reserves, specifically US treasuries, is far lower than the return on capital investment in China.

We believe that the exchange rate plays only a limited role in balancing international trade and reducing the trade surplus. Exchange rate changes will play only some role in restraining China's exports and controlling inflation. However, the exchange rates of the deutsche mark (1971–2006) and Japanese yen (1977–2006) against the US dollar show that currency appreciations do not necessarily result in reduced trade surpluses.

Figure 4 shows the exchange rate of the deutsche mark and Germany's trade balance. There is no apparent correlation between the two. Similarly, the yen has appreciated over the years, but this appreciation does not change Japan's trade surplus (figure 5).

For these reasons, we say that China's trade surplus is the result of three factors: China's economic structure, adjustments in the location of international production, and the international monetary system. To reduce China's trade surplus, we have to restructure the Chinese economy.

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Now I'd like to discuss the restructuring of macroeconomic policies. Actually, in recent years, we have implemented a number of measures to increase exchange rate flexibility, reform the foreign exchange regime, and relax some capital control measures. To be more specific, these measures include reviewing policies originally designed to encourage exports and restrain imports; improving the pricing mechanism of resources; reinforcing environmental regulations; boosting household consumption; improving government income-transfer policies; encouraging enterprises to invest overseas; and relaxing foreign exchange controls. We have already seen the preliminary effects of these restructuring policies. In September 2007, exports grew by 22.8 percent. This was the second consecutive month that export growth ran lower than the average of 28.6 percent in the first seven months of the year.

Moving the exchange rate in the absence of economic restructuring policies will hurt China's economy and thus the global economy, as China is one of its driving forces. For this reason, we decided to reform our foreign exchange regime in a controlled manner, on our own initiative, and in a gradual fashion. This is not a manipulation of the exchange rate but rather shows China fulfilling its responsibility as a large emerging-market country.

Now I would like to discuss China's monetary policy. The growing trade surplus, admittedly, results in increased foreign exchange reserves for China. In recent years, using open-market operations and increases in the required reserve ratio, the People's Bank of China (PBC) has been effectively controlling the growth of base money as well as the liquidity of the banking sector (see figure 6).

Figure 7 shows the excessive reserves of China's banking sector, representing its liquidity. At the moment, excess reserves stand at around 2.5 percent of deposits. China's money supply has been also under control. However, within the money supply, M1 has grown faster than M2 (see figure 8) due to the rapid development of the equity market. Because of the booming equity market, a large number of households turned their savings into investments in the equity market, resulting in a surge of M1.

In recent years, China has maintained GDP growth of 10 to 11 percent, and in May 2007, the consumer price index (CPI) stood at under 3 percent: a high growth and low inflation situation. However, starting in June 2007 China experienced increasing inflationary pressure. With China's current CPI, such pressure is still controllable. In August the CPI grew by 6.5 percent and in September by 6.2 percent. Since 2004, housing prices in China have been rising very quickly, and since 2007, the equity market also has been expanding rapidly (figure 9). The PBC will work to monitor very closely the financial risk related to a potential asset-market correction.

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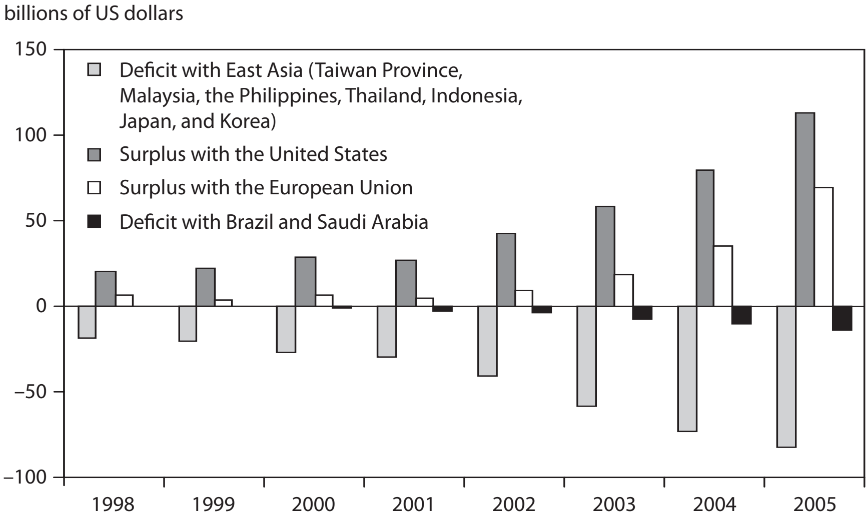
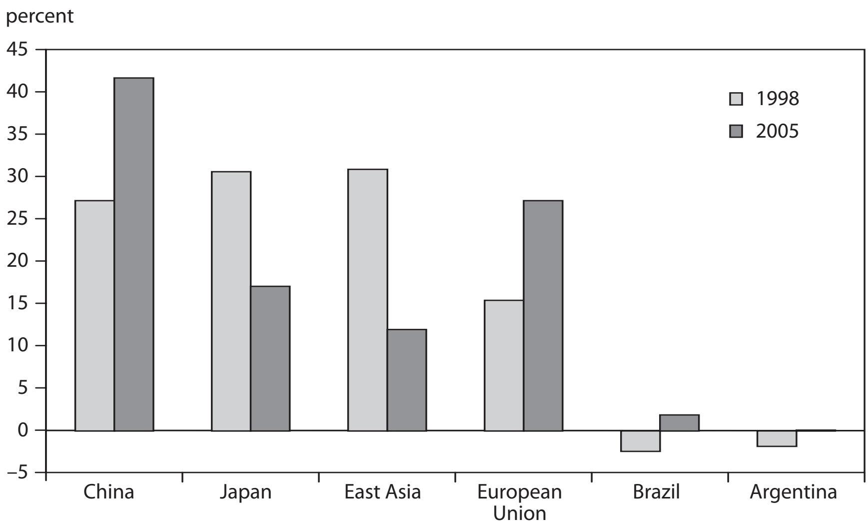
Figure 1 China's trade balance with East Asia, the United States, and the European Union, 1998–2005



Sources: CEIC data; International Monetary Fund, *Direction of Trade Statistics;* Chinese Ministry of Commerce website, http://english.mofcom.gov.cn.

Figure 2 Breakdown of US trade balance (US statistics), 1998 and 2005



Note: East Asia includes Malaysia, the Philippines, Indonesia, Korea, and Singapore.

Source: People's Bank of China.

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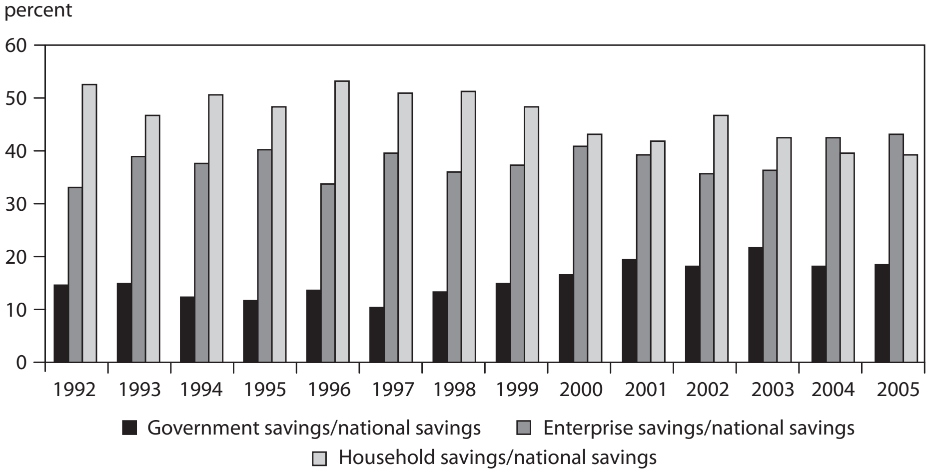
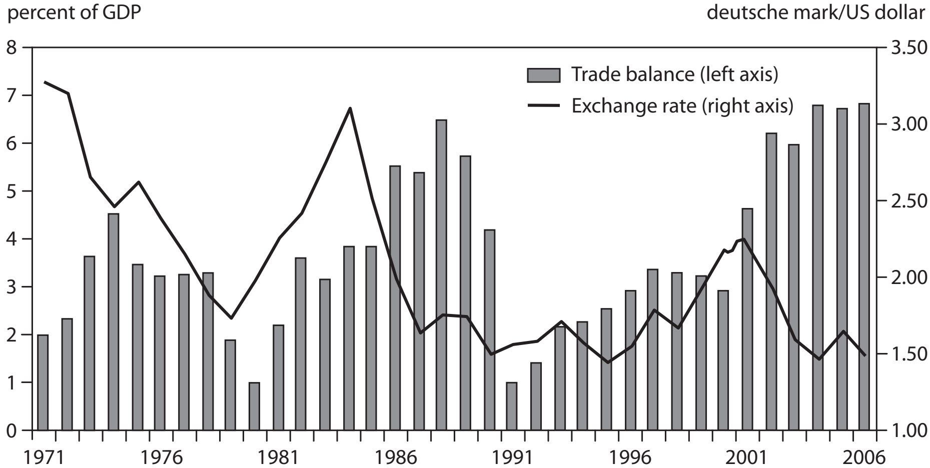
Figure 3 Share of savings of all sectors in national savings, 1992–2005



Source: People's Bank of China.

Figure 4 Deutsche mark exchange rate and Germany's trade surplus, 1971–2006



Source: People's Bank of China.

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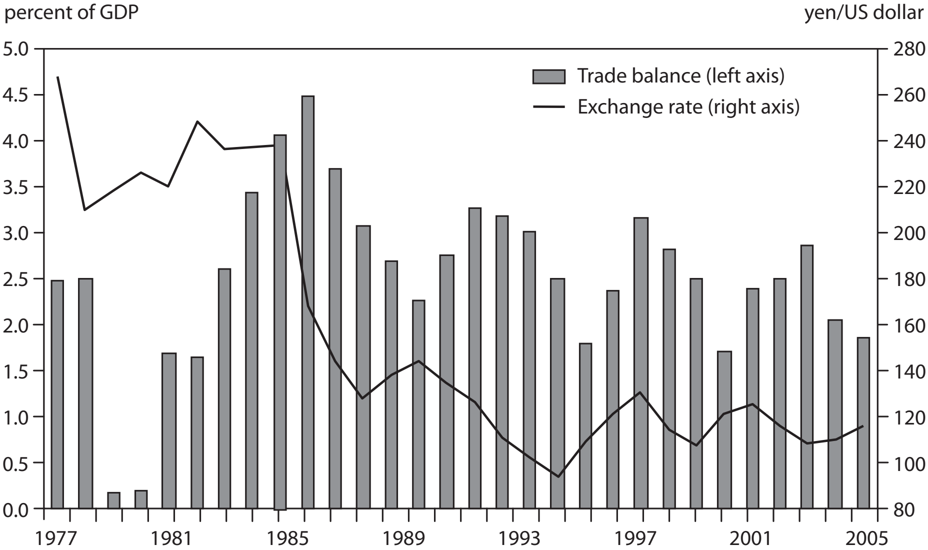
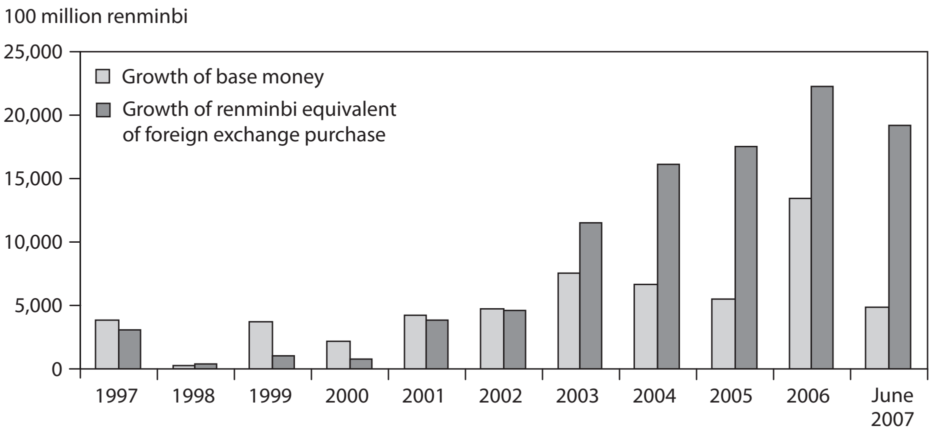
Figure 5 Yen exchange rate and Japan's trade surplus, 1977–2005



Source: People's Bank of China.

Figure 6 Comparison of the growth of renminbi equivalent of foreign exchange purchase and growth of base money, 1997 to June 2007



Source: People's Bank of China.

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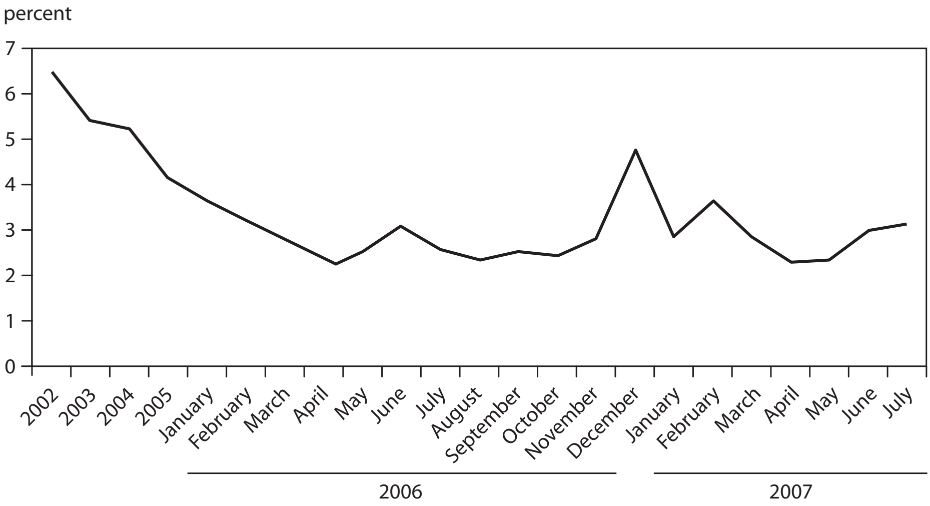
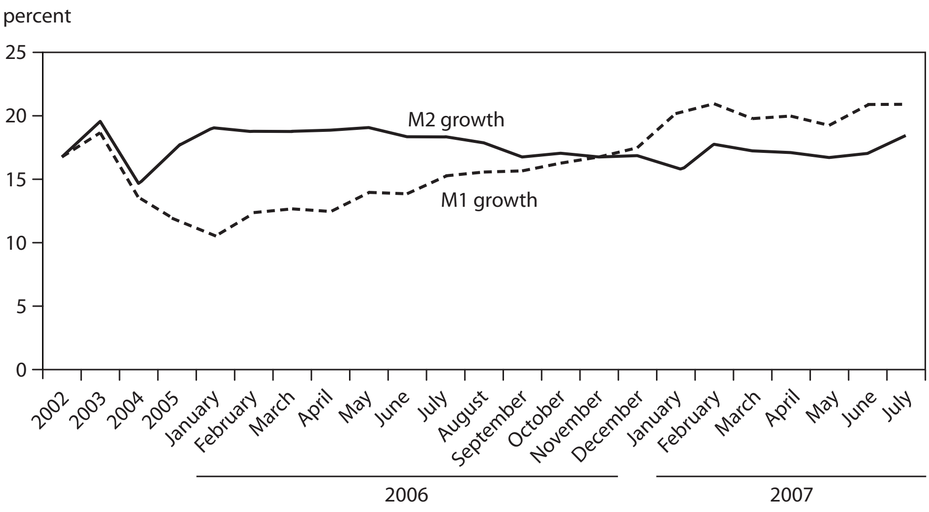
Figure 7 Excess reserve ratio, 2002 to July 2007



Source: People's Bank of China.

Figure 8 Growth of money supply, 2002 to July 2007



Source: People's Bank of China.

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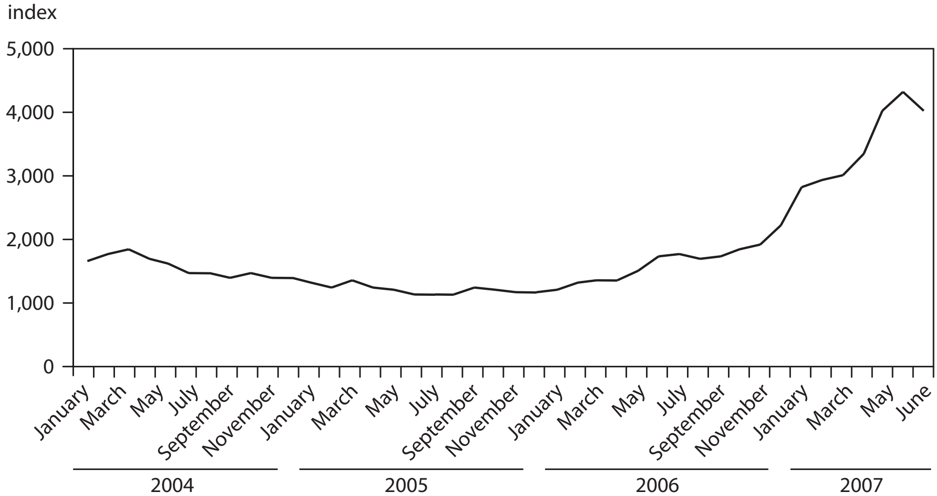
Figure 9 Movement in Shanghai Stock Exchange A Share Index, 2004 to June 2007



Source: People's Bank of China.

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