

Global Imbalances: China's Perspective¹

Yu Yongding

Director and Senior Fellow
Institute of World Economics and Politics
Chinese Academy of Social Sciences

Paper prepared for international conference on
Global Imbalances, Organized by IIE
Washington 8 February 2007

Introduction

This paper discusses global imbalances from China's perspective. The first section is a review of American opinions on global imbalances. The aim of the section is to provide some insight on how the different opinions of American economists on global imbalances are perceived by Chinese economists. This section also gives a brief account of Chinese economists' own views on the issue so that comparison of the differences can be made by economists outside China. The second section discusses the question of why Asian economies are running current account surpluses and how long they will continue to do so. The aim of the section is to answer the question of the sustainability of the US current account deficit. The third section provides a backdrop of the development of China's international balance of payments, so as to bring the discussions in the following sections into context. The fourth section discusses why running current account surplus persistently is undesirable for China. It argues that correction of China's imbalances is in the interest of China, and should be made, no matter what America does or does not. In the fifth section, the sustainability of China's twin surpluses is discussed. In the sixth section, the causes of China's imbalances, which are characterized by the "twin surpluses" rather than by a single surplus— current account surplus, are discussed in details. This section is the core of the paper which will serve as basis for the discussion of policies responses by the Chinese government in the next section. In the seventh section, policies that have already been adopted and may be adopted by the Chinese government are introduced. The section is aimed at shedding some light on China's possible role in the future path of global imbalances. The last section is a short summary. The section also raises the possibility of the worsening of China's imbalances with very grave consequences for China's financial stability in the future.

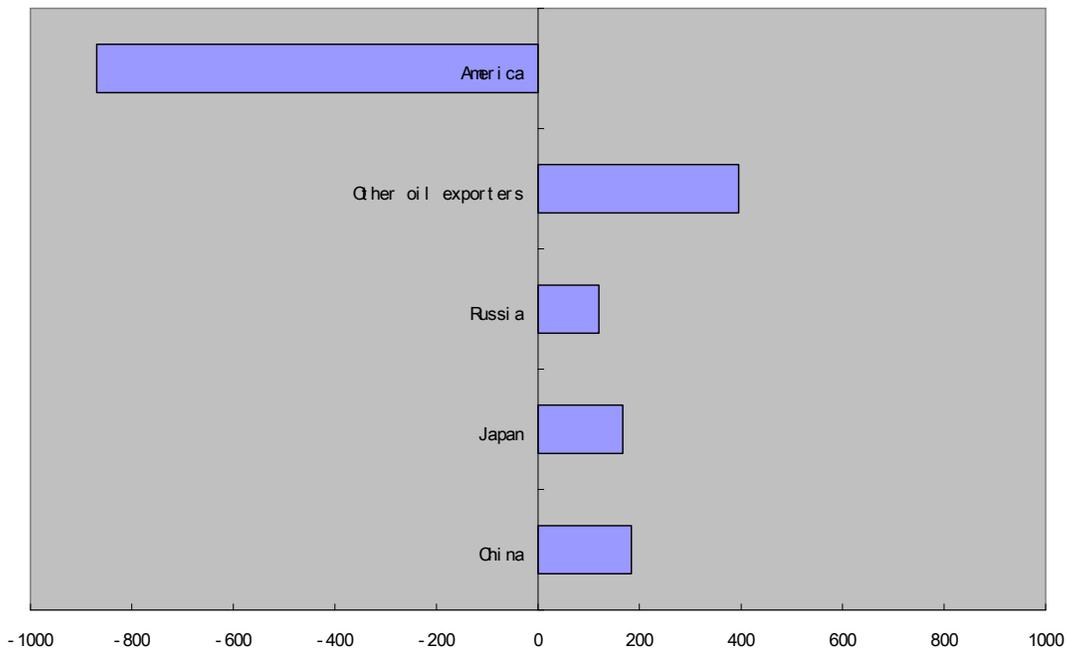
¹ This paper is prepared for the conference organized by IIE in Washington, Feb.8 2007.

I. China's Perception of the Development of the US Current Account

Deficits

Global imbalances have been worsening continuously, since the Institute for International Economics rang the alarm-bell many years ago. According to a recent forecast by the World Bank², by the end of 2006, the U.S. current deficit would reach \$869 billion, a 10% increase over 2005. At the same time, the current account surpluses of China, Japan, Russia, oil exporting countries excluding Russia, and the rest of the world would be \$184 billion³, \$167 billion, \$120 billion and \$395 billion, respectively (Figure 1).

Figure 1. Global Imbalances



Source: World Bank.

The US has run current account deficit for 25 years, except for 1990. The steady increase in the US current account deficit failed to cause serious concern in capital markets until February 2002, when the US dollar began its “strategic devaluation”.

Since then the U.S. dollar has fallen by 23 percent on JPMorgan’s trade-weighted real exchange rate. However, the depreciation failed to improve the US current account.

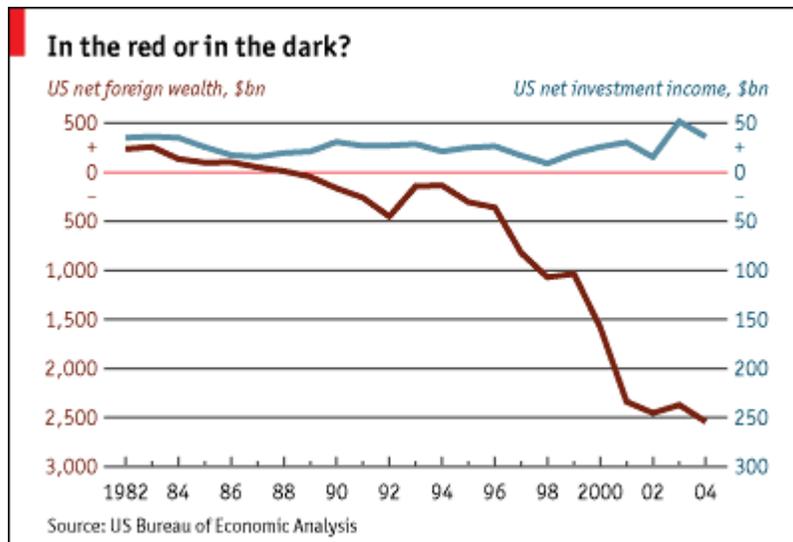
² The World Bank: World Economic Outlook, September, 2006, Washington DC.

³ China’s Official estimation was \$140 billion (given by Fu Yingzi, Assistant Minister, Ministry of Commerce of the People’s Republic of China, on November 5 2006). Based on the data available in December, I guess the figure should be \$170 billion.

For Chinese economists, the first question is whether the US government is really serious about the correction of the US current account deficit. The richest country in the world, while enjoying very high living standards, is able maintain a high growth rate of investment through borrowing, which in turn enables its productivity to rise strongly and hence guarantees its residents to enjoy even higher living standards in the future. What more can a country possibly want?

After having run current account deficit for more than two decades, with its international investment position (NIIP) surpassing \$2.5 trillion, America still enjoys a positive, though small, net income on its NIIP (Figure 2). Dark matter or not, this fact implies that America will not face payment problem for its foreign debts in foreseeable future. Then why bother? Why the US should have to correct its current account deficit rather than prolong this enviable position?

Figure 2 American Foreign Debt and Investment Income

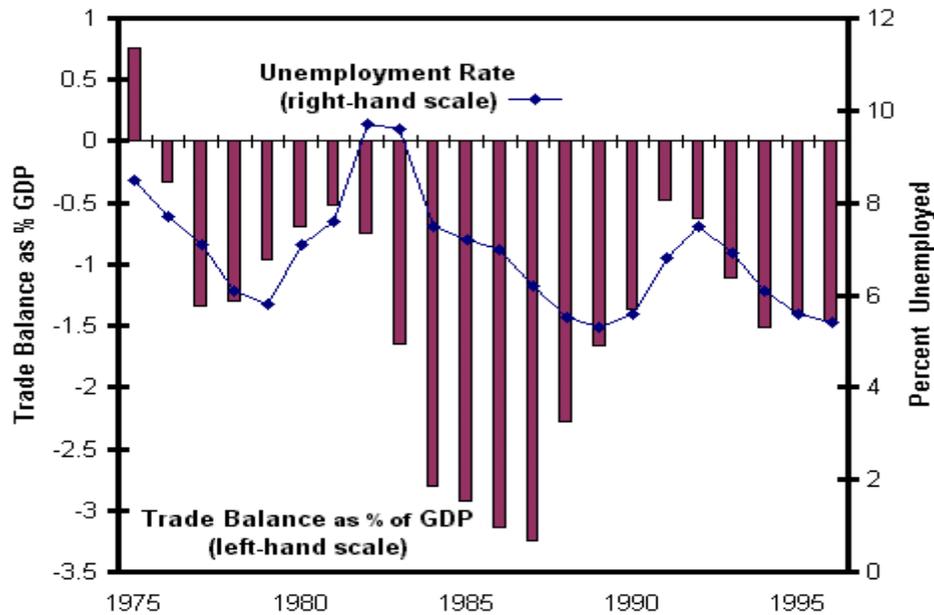


Source: America's dark materials, Jan 19th 2006.

Some US economists argue that the current account deficit costs U.S. jobs and it means that the US economy is losing competitiveness. However, as argued by other American economists, “employment statistics do not bear out the relationship between a rising current account deficit and lower employment.”⁴ Figure 3 clearly supports for the argument.

⁴ Matthew Higgins and Thomas Kliggard: Viewing Current Account Deficit as Capital Inflow, Current Issues, Federal Reserve Bank of New York, December 1998.

Figure 3 Civilian Unemployment Rate (1948-1996)⁵



Source: Unemployment data from Economic Report of the President 1997, Table B-40: Civilian Unemployment rate 1948-96, page 346. Trade Balance data from Table B-101: U.S. International Transactions, page 414.

In a more recent report, the US-China Business Council made a very good case study of the relationship between current account deficit and unemployment. The report found that the projected loss of 500,000 manufacturing jobs over the next four years caused by China's imports will be made up by the gain of 500,000 service sector jobs. "While this structural shift displaces some workers in manufacturing sectors..., the economy as a whole will benefit from permanent output and price effects of increased trade with China," ⁶What's at issue is not whether current account deficit leads to unemployment but how a trade-off between temporary or sector specific costs and permanent whole-economy benefits should be made. In other words, the current account deficit-unemployment trade-off is a political issue rather than an economic one. The same logic applies to the competitiveness argument. Current account deficit means capital inflows, which in turn means more domestic investment than otherwise would have. A country's competitiveness perhaps will improve rather than deteriorate, due to running current account deficit in the past. This is equivalent to say that capital inflows are more likely to improve rather than harm a country's competitiveness..

For Chinese economists, the second question is on the sustainability of the US current account deficit. Richard Cooper argued that Americas save quite enough for future

⁵ Daniel T. Griswold America's Maligned and Misunderstood Trade, Trade Policy Analysis No. 2 April 20, 1998.

⁶ Richard McComark: China Trade Will Considerably Boost U.S. Wealth, Argues U.S.-China Business Council, Manufacturing and Technology News, March 17, 2006 Volume 13, No. 6. richard@manufacturingnews.com.

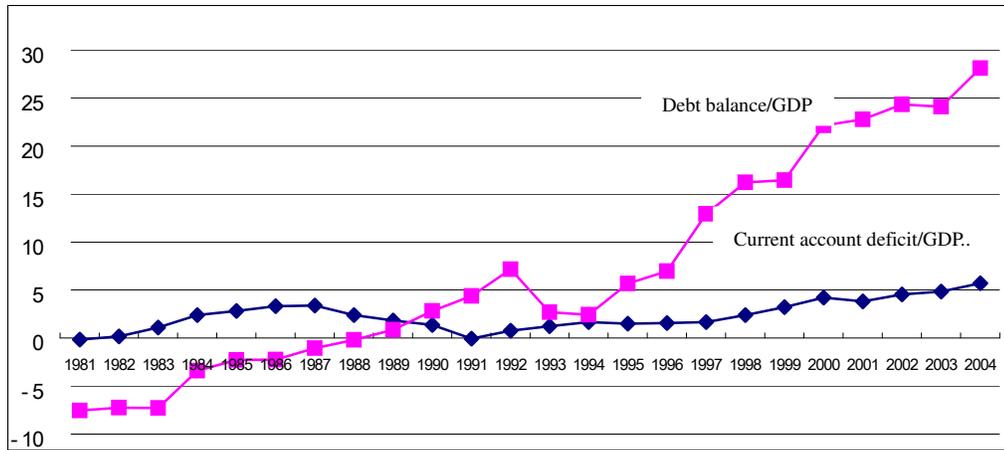
generations. Properly measured, they save a third of US GDP.⁷ His argument is persuasive. However, the argument does not answer the question of the sustainability of the US current account deficit. As pointed out by Feldstein, “expenditures on education and household durables (cars and refrigerators and so on) should be considered as investment rather than consumption; so should be research and development by the government. Reclassification will raise both savings and investment simultaneously by the same amount, but that the difference won’t change at all.”⁸ Most Chinese economists would agree with the opinion advanced at the Federal Reserve Bank (Ferguson, 2005) that the sustainability of the US current account deficit mainly depends on the market perception of America’s repayment ability for its debts. Beneficial or not for America to run the deficit current account deficit, the key is whether surplus countries are still willing to finance the deficit. Historical experience fails to provide clue to the answer to the question on the basis of the current account deficit/GDP ratio. Canada’s current account deficit averaged 2.5 percent of GDP between 1975 and 1998; the UK current account deficit averaged 4.1 percent of GDP between 1984 and 2003; and Australia’s current account deficit averaged 4.1 of GDP between 1974 and 2003.⁹ Between 1995 and 1999 the US current account deficit/GDP ratio was between 1.48% and 3.2%. Since 2000 the ratio has been increasing rather quickly. From 2000 to 2004, the ratio was 4.21%, 3.81%, 4.52%, 4.82% and 5.68%, respectively. In 2005, it has reached 7 %, which is very worrying indeed. For an ordinary developing country the figure is high enough to trigger a currency crisis. But the United State is not an ordinary country and the ratio may fall back again. Perhaps, a more useful concept for the consideration of the sustainability of the US current account deficit is the NIIP-GDP ratio. The persistent current account deficit leads to the increase in a negative NIIP. An indefinitely large negative NIIP as a percentage of GDP is inconsistent with long-run equilibrium, which implies that the accumulation of debts eventually will overwhelm the debtor’s repayment ability, as long as the positive interest rate is positive. Therefore, the question here becomes whether the US NIIP-GDP ratio has a limit (Figure 4).

⁷ Richard Cooper: Living with Global Imbalances: A Contrarian View, Policy Briefs, Institute for International Economics, November 2005.

⁸ An interview given by Martin Feldstein to “Caijing”, a Chinese magazine, on November 21, 2006.

⁹The Royal Bank of Scotland Group, 2004, “Global imbalances and the dollar: where next?”, lucy.o’carroll@rbs.co.uk, 2 December 2004.

Figure 4. America's current account deficit/GDP ratio and external debt balance/GDP ratio



Sources: Financial Statistic Year Book, IMF, 2001 and 2004.

Note: Drawn by Sheng Hongqing.

To answer the question, we need to study the trajectory of the NIIP-GDP ratio.¹⁰ By definition, the relationship between NIIP and the current account deficit can be defined as :

$$\frac{dZ}{dt} = CA \quad (1)$$

Where $Z=NIIP$, $CA=$ current account deficit. The proportional changes in NIIP as a percentage of GDP is

$$\frac{dz/dt}{z} = \frac{d(Z/GDP)/dt}{Z/GDP} = \frac{dZ/dt}{Z} - \frac{dGDP/dt}{GDP} \quad (2)$$

Combining the above two relations, we obtain :

$$\frac{d(Z/GDP)/dt}{Z/GDP} = \frac{dZ/dt}{Z} - \frac{dGDP/dt}{GDP} = \frac{CA/GDP}{Z/GDP} - \frac{dGDP/dt}{GDP} = \frac{ca}{z} - n \quad (3)$$

Namely,

$$\frac{dz/dt}{z} = \frac{ca}{z} - n \quad (4)$$

¹⁰ Here we will not dwell on the difference between NIIP and net foreign debt.

Where ca is the CA/GDP ratio , n is growth rate of GDP. The solution for the differential equation (4) is :

$$z = \frac{ca}{n} + C_1 e^{-nt} \quad (5)$$

It can be seen from (5) that as long as ca is a constant (and n is positive), the net foreign debt/GDP ratio will enter a steady state. But how can we guarantee a constant ca ? Here I have to settle for a descriptive and qualitative approach. According to Ferguson, there are five factors to explain the large U.S. current account deficit. “The first three explanations focus primarily on domestic developments: the fiscal deficit, an autonomous drop-off in private saving rates, and the surge in productivity growth. The remaining explanations encompass developments abroad as well: the slowdown in foreign demand and the apparent rise in global financial intermediation.”¹¹ The results derived by the Fed research team found “the greatest roles to increased productivity growth, which has made the United States a magnet for foreign saving, and to the slump in foreign domestic demand, which has led to an excess of saving in those economies. The narrowing of the risk premium on dollar assets appears to explain a bit less of the widening of the trade deficit, with the loosening of fiscal policy and reduction of private saving making still-smaller contributions.”¹² It seems that among the above-mentioned factors, some contribute to the increase in ca , and others the decrease in ca . For example, if the current account deficit is caused by the fiscal deficit, the current account deficit/GDP ratio will increase; if it is caused by the surge in productivity growth, faster growth of GDP will lead to a fall of ca . Aside from the factors listed by Ferguson, the low interest rates world-wide will play an important role in containing the endogenous increase in ca . In short, it seems that there are no firm evidences indicating that the US current account deficit/GDP ratio is trended to increase. If we can assume that ca is more or less a constant without a clear trend to increase in a foreseeable future, we should be able to assume that there is a limit for the US NIIP/GDP ratio.

Edwin Truman pointed out that, using a simple equilibrium condition that in order to stabilize the ratio of the US NIIP to GDP, the ratio of the current account deficit to GDP must equal the growth rate of nominal GDP times the NIIP ratio,¹³ and assuming a normal growth rate of US nominal GDP of 6 percent, a range of possible pairs of US current account deficits and NIIPs can be identified as follows

1. NIIP status quo: Maintaining the US NIIP ratio at about 25 percent of GDP implies a reduction in the US current account deficit to 1.5 percent of GDP.
2. Current account status quo: Maintaining the current account deficit at about 5 percent of GDP implies that the NIIP would stabilize at 83 percent of GDP.

¹¹ Ditto.

¹² Ditto.

¹³ This is the condition defining the steady state of the NIIP/GDP trajectory depicted by equation (4).

3. Productivity view: a continuation of the recent elevated growth of US productivity combined with the increased flexibility of financial markets identified suggests that the US current account deficit in the near term need only narrow to 4 percent of GDP, which would imply a NIIP of 67 percent.
4. Global wealth view: to stabilize the share of net claims on the United States as a share of global wealth, the current account deficit should narrow to about 3 percent of GDP and an NIIP at about 50 percent of GDP.
5. Issing view: the US current account deficit has to shrink to 2 percent of GDP, implying a NIIP of 33 percent.
6. Zero trade deficit: The United States will eventually have to reduce its deficit on goods and services to zero. Net lending to the United States would be limited to the amount sufficient to cover net income payments and net transfer payments.. With a current account deficit 0.5 percent of GDP, the implied NIIP would shrink to 8 percent of GDP. ¹⁴

Assuming starting from 2003, $t = 0$, NIIP/GDP $z(0) = 24.09$ percent , $ca =$ constant $= 4.82$ percent , the nominal growth rate of GDP $=$ constant $= 4.9$ percent. The specific solution for the differential equation (5) is :

$$f = 0.98 - 0.74e^{-0.049t}$$

My student did a simulation as follows.

Table 1 : A Simulation of the US NIIP/GDP ratio, 2003—2010

year	2003	2004	2005	2006	2007	2008	2009	2010
Years passed	0	1	2	3	4	5	6	7
NIIP/GDP ratio (%)	24.09	27.54	30.91	34.12	37.17	40.08	42.85	45.49

Sources: Sheng Hong¹⁵

On the one hand, the simulation shows that the US NIIP/GDP ratio will stabilize at 98%, which is very high and will be significantly higher, if we assume a higher

¹⁴ Truman, Edwin, "The US Current Account Deficit and the Euro Area", Speech prepared for "The ECB and Its Watchers VI" Conference, Frankfurt, Germany, July 2, 2004.

¹⁵ Sheng Hongqing; American Current Account Deficit, Dissertation, Post Graduate School of Chinese Academy of Social Sciences, 2005.

current account/GDP ratio. On the other hand, it also shows that there is still a long way to go for the ratio to reach such a steady state.

Even we believe that there is a limit of 98% for the US NIIP/GDP ratio, we still cannot say whether the US current account deficit is sustainable. On the one hand, “Australia’s negative net investment position reached 60 percent of GDP in the mid-1990s, Ireland’s exceeded 70 percent in the 1980s, and New Zealand accumulated a position amounting to nearly 90 percent of GDP in the late 1990s. Notably, these economies have recently been among the most successful—in terms of economic growth—in the industrialized world”.¹⁶ On the other hand, it is entirely possible that while the ratio is approaching the steady state, the rest of the world loses its confidence or panic, and stop financing the US current account deficit. As a result, a dramatic correction would happen.

II. The Possible Trajectories of Major Current Account Surplus Countries

As showed in the figure 1, the major counterparts of the US current account deficit are the surpluses of China, Japan, Russia, oil exporting countries excluding Russia. The oil exporters, notably in the Middle East but also in countries such as Russia, Nigeria, and Venezuela constituted by far the largest of important capital exporting countries, which are followed by China and Japan. Will the saving glut (Bernanke, 2005) in these three groups of countries continue? Will the excess savings of these three groups of countries continue to flow into the US? The answers to these questions hold the key for the sustainability of the US current account deficit. Oil exporting countries’ current account surpluses are more likely to be temporary. When oil price drops, the current account surpluses will drop. Over the past three decades, we have seen many such ups and downs. Furthermore, for some countries, such as Arabic countries, the US may no longer be a safe heaven for their oil money and they may find other destinations to invest their oil revenues.

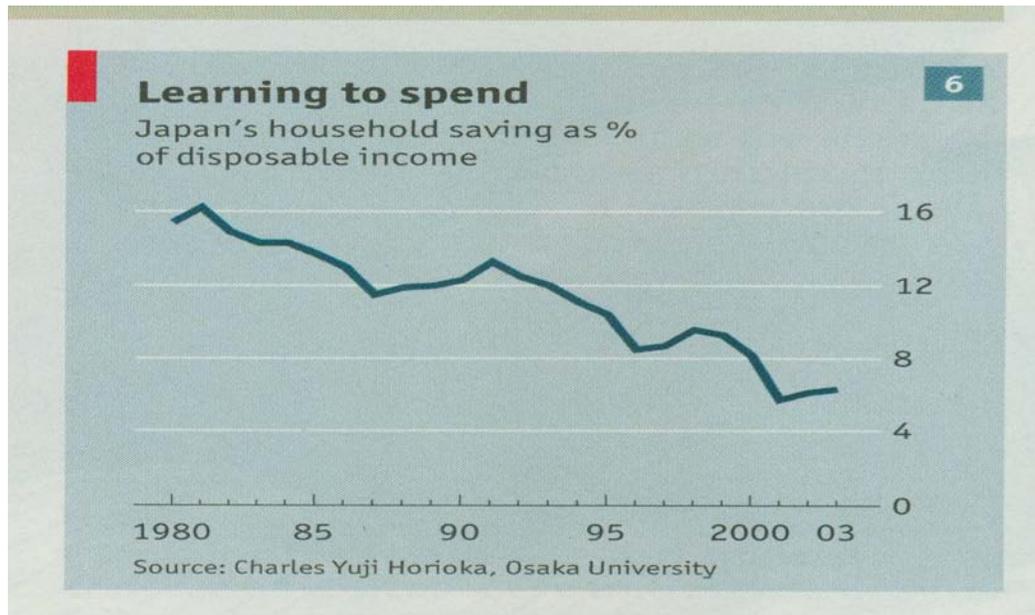
Japan’s household saving rate has been falling steadily for decades. Following the further aging of the Japanese society, the saving rate is likely to fall further. Japan’s current high saving-investment gap is due to low investment rate as a aftermath of Japan’s decade long deflation. The Japanese economy is in the process of slow recovery. Japan’s corporate profitability is high, which has surpassed the Heisei Boom and is expected to surpass the Izanagi Boom that lasted for 57 months.¹⁷ As a result, Japan’s investment has grown for five years. According to a Tankan survey, in FY 2006, the growth rate of capital investment will be 8.3%. It is entirely possible

¹⁶ Poole. William, “How dangerous is the US current account deficit? ”, Economic Policy Lecture Series, Lindenwood University, St. Charles, Mo., Nov.9 2005.

¹⁷ The Japanese Economy: Outlook and Pending Issues, Mizuho Research Institute, Nov. 16, 2006

that Japan's current account deficit/GDP ratio will fall steadily in coming years, owing to the narrowing of the saving-investment gap.¹⁸

Figure 5. Japan's Household Saving (%)



Source: Economist

China aside, East Asian emerging economies' saving glut and current account surpluses are related to the aftermath of the Asian Financial Crisis. It can be expected that following their economies' returning to the norm, most East Asian economies will probably resume their old pattern of international balance of payments. Thailand, which has returned to run current account deficit in recent years, is a case in point. In the following section, I will discuss China's international balance of payments in details. What I can say here is that it is not in China's interest to maintain a large current account surplus against the US. Policy changes aimed at reducing the surplus has been under way. Although it will take some time for China to obtain a basically balance current account, but it will take place sooner or later.

Therefore, in my view, whether the US current account deficit is sustainable depends on whether the current account surplus countries are able or wish to maintain their current account surpluses against the United States. It is very likely that Asian countries may decide that it is time to narrow the saving-investment gaps of their own countries, or to reduce the dependence on the external market, or to reorganize their trade in a way so that the intra-regional trade will increase vis-à-vis interregional trade. Asian central banks may decide to diversify their foreign exchange reserves away from the US T bills orderly or disorderly. All these changes will lead to the reduction of Asian current account surplus vis-à-vis the US and hence reduce the demand for

¹⁸ Ditto.

the US dollar-denominated financial assets. As a result, Asian countries may force a drastic correction upon the US economy, even if everything is fine from the US perspective. In the following section, I will discuss the evolution of China's international balance of payment over the past 26 years and pave the way for the discussions in the following sections.

III. The Evolution of China's International Balance of Payments

Before answering the question of what has led China's current account surplus to become so large, we should make facts correct in the first place. First, China has become an important current account surplus country only very recently. Until 2000, China's current account surplus was just \$20.5 billion. In contrast, Japan had been running current account surplus between ¥ 8 trillion and ¥ 18 trillion variously from 1991 to 2005, which dwarfed China's current account surplus greatly.¹⁹ China's current account surplus surged since 2004, reaching \$55.5 billion. But the figure was still only a third of Japan's current account surplus of 171.8 \$billion.²⁰ In 2005 China's current account surplus reached 160.8 billion, with a trade surplus of \$124.8 billion.²¹

It is worth noting that the surge of China's current account surplus and trade surplus to a significant degree is attributable to disguised capital inflows due to RMB revaluation expectations. Unfortunately, no firm data are available to determine to what extent it is the case.

China's current account surplus accounted only a small proportion of the US current account, something like a sixth. As Cooper rightly pointed out, "Even if China revalued the renminbi enough to eliminate its current account surplus altogether, and if all that change (implausibly) accrued to the United States, it would reduce the US current account deficit by only 10 percent."²² The importance of China's current account surplus has been blown out of proportion because of politics. Economists should reject mingling serious economic facts and logic with populist politics.

Second, China has run investment income deficit for decades, which is likely to increase in the future and offset China's trade surplus eventually. China's current account structure may cause serious problems for it in the future. In contrast, Japan has consistently run investment income account surplus as well as trade surplus. In 2005 its investment income reached ¥ 11.4 trillion, surpassing its trade surplus of

¹⁹ Source: B Bernanke (2005).

²⁰ Source: B Bernanke (2005)

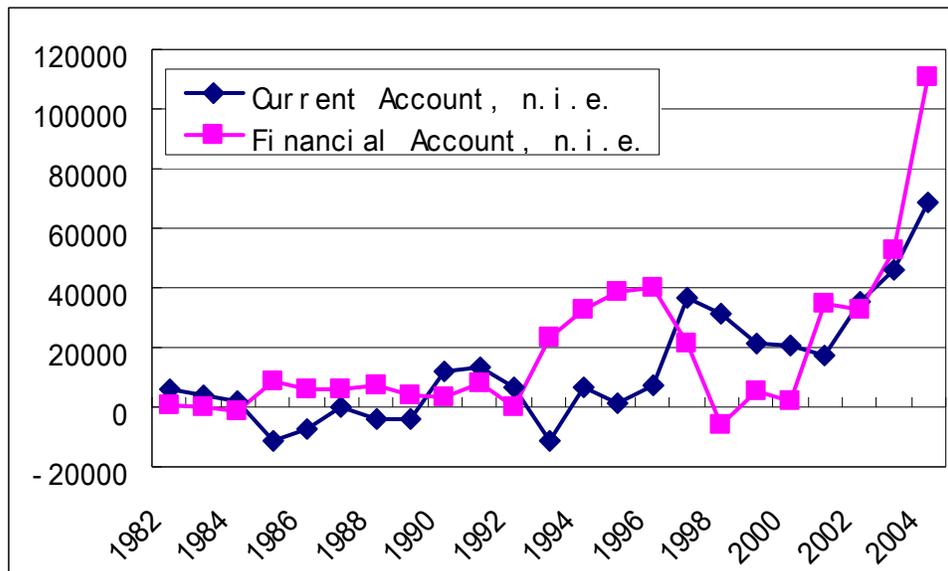
²¹ China Monetary Policy Report, Quarter 2, 2006, People's Bank of China, p125.

²² Richard Cooper: Living with Global Imbalances: A Contrarian View, Policy Briefs, Institute for International Economics, November 2005. p7.

¥ 10.4 trillion.²³ This is a very rational current account structure for an ageing Japan. The same is hardly true of China.

Third, China's structure of international balance of payment is characterized by the so-called twin surpluses (figure 6). China is neither a typical debt repayment country because of its current account surplus, nor a creditor country because of its investment income account deficit and capital account surplus. The discussion of China's current account surplus should not separate with discussion of its capital account surplus, which most western economists do. Otherwise, we will fail to understand the nature and causes of either account. Fourth, In the past, the main contributor to China's accumulation of foreign exchange reserves was the capital account surplus, more precisely, FDI inflows. Only since 2005, the current account surplus has superseded FDI to become the more important contributor to the increase in the foreign exchange reserves. Fifth, the Chinese government has realized that running a large current account surplus is undesirable for China. In fact, according to the 11th five year program formulated by National Reform and Development Commission (NRDC), formerly State Planning Commission, China has set a goal of achieving a basically balanced current account in the next five years.

Figure 6. China's current and capital accounts (unit: million US dollar)



Sources: IMF

Here, let me give a brief account of the evolution of China's international balance of payments since reform and opening up. Before the late 1970s, China was an autarky economy with negligible foreign trade and zero capital inflow (except for Japanese government aids).

²³ Kojima Akira : Balance Adjusted , The Japan Journal July 2006 , 10-12.

Due to the lack of foreign exchanges,²⁴ at the beginning of opening up, it is very natural that trade was aimed at earning foreign exchanges. At the same time, the Chinese government was keenly aware of the need for foreign technology in its drive for modernization. There were two options for acquiring foreign technology at the time: to borrow to pay for foreign capital goods and technology and to attract FDI. Chinese economists compared the pro and con of the two options and the government's final decision was that FDI should be the preferable form of capital inflows. Therefore, the key elements of China's open policy were FDI attraction for technology and export promotion for foreign exchanges.²⁵

It is assumed in economics of development that developing countries should run current account deficits and capital account surpluses, so as to utilize foreign saving to obtain an investment rate higher than what their domestic saving rate can support. In China, despite its low level of per capita income, the saving rate had been high and hence FDI attraction was not aimed at using foreign resource to supplement the shortfall of domestic saving. The Latin American debt crisis also influenced significantly the Chinese government's thinking in the early 1980s. The government deliberately prevented capital inflows from being translated into current account deficit by requesting foreign funded enterprises to balance their foreign exchange expenditures by their own foreign exchange revenues. At the same time, on top of FDI inflows, the Chinese government encouraged Chinese enterprises to utilize their comparative advantages to run trade surpluses so as to earn foreign exchange reserves as much as possible. Unlike the rest of the East Asian emerging economies, China did not experience a period of trade deficit as a result of utilizing capital inflows to supplement domestic resources. The variation of FDI inflows were basically devoided from the changes in the need for foreign resources, but mainly subject to changes in political atmosphere. On the other hand, the changes in China's trade account balance were mainly related to the growth momentum of the domestic economy, which was cyclical in nature. In the second half of the 1980s, the economy was suffering from overheating and high inflation. During this period, the Chinese economy ran trade deficit for most of time. From 1990 to 1992, the Chinese economy was in recession and hence it ran trade surplus. In 1993 the Chinese economy was overheating again, with the growth rate of fixed assets investment being more than 60%. Naturally, China ran trade deficit in the year. Since 1992-1993, FDI inflows began to surge due to the improved political environment and preferential policy. The pattern of the twin surpluses began to emerge. 1995 devaluation of RMB was a watershed. China's export momentum was built up since then. In 1996 and 1997 some Chinese economists raised the issue of twin surpluses. Basically, they argued that (1) a poor

²⁴ According to an anecdotal report, when the Chinese delegation led by Mr. Deng Xiaoping was preparing for its first participation in the UN conference after the restoration of China's seat in the UN, all the US dollars the government could find for the delegation from China's banks were \$38,000. As result, when they checked in a luxury hotel in New York, they had no money to pay tips. Wenshi Cankao, internally circulated by People's daily, January 4, 2007. p.25.

²⁵ There was a big debate on whether China should develop foreign trade with capitalist counties in later 1970s and early 1980s. Fortunately, the supporters of export promotion found support from Marx's writing, which showed that Marx was sympathetic with David Ricardo's concept of comparative advantage. But the overwhelming motivation for the government was earning foreign exchanges.

country could better use its resources for domestic investment and consumption; (2) China should translate its capital inflows into current account deficit.²⁶ The old mercantilist tendency of foreign exchange reserve accumulation was also questioned in the debate. Unfortunately, discussion was muzzled before it was really started. The Asian financial crisis that happened later seemed to vindicate the opinion of “the more foreign exchange reserves the better”. China’s success in avoiding being hit by speculative capital was attributed to its relatively large foreign exchange reserves (about \$200 billion). Until very recently, most of officials and economists in China would still think that the more FDI and trade surplus the better, and it is still difficult to convince many Chinese economists that \$1trillion foreign exchange reserves are too much.

In retrospect, China’s current structure of international balance of payments characterized by the twin surpluses is a product of specific circumstances and accidental policy responses, meaning that the chain of events that has happened is not inevitable and that there could be other options to be taken. There is nothing inherent in China’s current pattern of international balance of payment. However, any new policy is path- dependent. We still have options. However, options are constrained by specific conditions created by options that we had chosen in the past.

IV The Undesirability of the Twin Surpluses

Before analyzing the causes that have led the twin surpluses to become so large, I will first try to show that the twin surpluses are undesirable for China. To analyze the desirability of the twin surpluses more carefully, we can use the following identity:²⁷
Household savings of residents + government savings + reinvested profit + investment income
 = *investment by domestic enterprises + government investment + reinvested profit + new FDI + trade surplus*

Based on the above accounting identity, we have²⁸

$$(I_e - S_p) + (I_g - S_g) + (I_f - CA) = 0 \quad (5)$$

where I_e, I_g, I_f, S_p, S_g and CA represent investments by domestic private (non-governmental) investment, government investment, foreign investment (FDI), domestic private savings, government savings, and current account deficit. In the following discussions, we assume away the government sector. Hence, for a typical developing country, under ideal condition, there should be

²⁶ John Williamson’s paper (1994) was quoted in the debate.

²⁷ In this identity, we ignore other forms of capital inflow, which is not that important in China.

²⁸ Yu Yongding and Qin Donghai : China’s Twin Surpluses: Nature, Causes and Policy Responses, *Shijie Jingji*, No.3, 2006

$$I_f - CA = 0$$

The above equation implies that FDI is financed by foreign savings. The utilization of foreign savings is reflected by existence of current account *deficit*.

After rearrangement, we have

$$(S_e - I_e) = I_f - CA \quad (6)$$

Where I_f not only represents FDI but also the amount of the increase in foreign exchange reserves in the form of the US treasury bills; $-CA$ is current account surplus, representing another portion of increase in foreign exchange reserves created by the surplus. The above identity (6) implies that while foreign investors obtain equity assets I_f , the hosting country obtains an equal amount of foreign debt assets (TBs).

It can be seen that if $I_f - CA > 0$, the hosting country is accumulating foreign exchange reserves. In contrast, if $I_f - CA < 0$, the hosting country is depleting foreign exchange reserves. In China, $I_f > 0$, $-CA > 0$ and hence $I_f - CA > 0$. This is what we called the “twin surplus”.

The question of whether the twin surpluses are beneficial for China can be discussed within the framework of dynamic optimization. We rewrite equation (6) as follows

$$I_e + I_f = S + CA \quad (7)$$

Where S is domestic saving and here the government sector is assumed away,

Based on the above equation, there are several cases with regard to China’s internal and external balances that are worth discussing. The first case: current account deficit is zero and domestic savings are equal to planned domestic investment, which implies that macroeconomic situation is tight. In this case, the increase in FDI means domestic investment is crowded out. Because current account deficit is zero, at final analysis, FDI is financed by domestic savings and the foreign exchanges brought in by foreign investors end up as the increase in foreign exchange reserves. The second case: current account deficit is zero and domestic savings are greater than investment by domestic firm, which implies that macroeconomic situation is loose and there is no crowding-out. But in this case FDI is also actually financed by domestic savings.

²⁹The third case: current account is in surplus. In this case, not only FDI is fully financed by domestic savings, but also US treasury bills are bought through outflows of excess domestic savings. In any of the above three cases, FDI has been failed to be translated into current account deficit

In developing countries, it is assumed, the profitability of investment is much higher than the yield of treasury bills. As pointed out by the late Professor Rudi Dornbusch (1988), it is certainly not reasonable for residents of poor countries to buy US treasury bills in preference to investing resources in their own countries so as to raise their productivity and standard of living. Williamson further pointed out that (1995), “[t]he strategic decision is whether to allow the capital inflow to be translated into a current account deficit so as to finance increased domestic investment and/or consumption.”³⁰ Therefore, running current account surplus by a developing country is misallocation of resources in the first place. Running current account surplus as well as large capital account surplus is misallocation of resources a second round. It is obvious that twin surpluses mean double misallocation of resources.

In an efficient capital market, there should be an equilibrium state where there is no difference in costs between buying and acquiring via FDI. In other words, there should be an optimum amount of FDI that China should attract, no more and no less. The question can be analyzed on the basis of the following simple relationship:

$$I = S + \frac{dF}{dt} \quad (8)$$

Where $I = I_e + I_f$, namely, total domestic investment is equal to investment by domestic investors plus investment by foreign funded enterprises (FFEs). where $\frac{dF}{dt} = M - X = CA$

To sharp the focus, we assume that China attracts FDI while maintaining a balanced current account and hence $CA=0$,³¹ which implies that FDI in aggregate terms is financed by domestic saving, and the inflow of funds in the form of FDI will translate to the increase in foreign exchange reserves. Here FDI inflows involve a sort of “debt-equity swap”. Taking into consideration the fact that hosting country has to yield profits on the foreign capital while obtaining payment from the foreign exchange reserves in US treasury bills, the total consumption of the hosting country, which is assume to be the objective of dynamic optimization of the economy, can be expressed as:

$$C = Q(K_d + K_f) - (\rho - i)K_f - I_d - I_f$$

²⁹ In this case, there is no “crowding out” and again FDI essentially is financed by domestic savings and the end result is also the increase in foreign exchange reserves. In this case, due to the lack of demand, macroeconomic policy will be taken to stimulate demand and current account surplus will be encouraged.

³⁰ p8.

³¹ This situation is more and less in line with China’s reality until recent years.

Where $Q(K_d + K_f)$ is the production function; $I_d = \frac{dK_d}{dt}$; $I_f = \frac{dK_f}{dt}$;

The objective functional of households can be defined as follows:

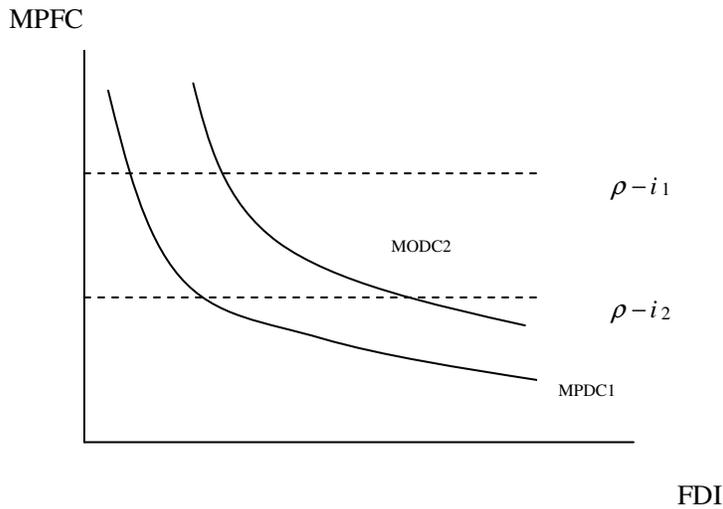
$$U = \int_0^T U \left[Q(K_d + K_f) - (\rho - i)K_f - \frac{dK_d}{dt} - \frac{dK_f}{dt} \right] dt$$

Solving the first order conditions for the maximization of the objective functional, we have

$$\frac{\partial Q(K_f)}{\partial K_f} + \frac{\partial Q(K_d)}{\partial K_d} = (\rho - i) \quad (9)$$

Given the marginal productivity of domestic capital MPDC, we can have the following relationship between the marginal productivity of foreign capital (MPFC) and the net foreign investment income $(\rho - i)$.

Figure 9. The optimum amount of FDI attraction



The graph shows that, on one hand, other things being equal, the higher the net foreign investment income, the less the FDI should be attracted. On the other hand, given the net foreign investment income, the higher the MPFC, the more FDI should be introduced. If FDI has strong spill-over effect, MPDC will be raised in certain ways, which implies that MPFC curve should shift to the right, which in turn implies that more FDI can be attracted to improve the utility of the nation. If we re-introduce current account surplus into the analysis, it can be shown that the basic conclusion will be the same. The conclusion implied by the above analysis is that there is an optimum amount of FDI attraction, which is determined by factors such as profitability of FDI stock, yield of treasury bills, marginal productivities of domestic

capital stock vis-à-vis FFE's capital stock. Any further attraction of FDI will lead to the decrease in national welfare.

It can be shown that without market distortion in the form of preferential policy toward FDI, the inflows should be translated into current account deficit. The failure in translation implies that there are market distortions, which in turn implies that the allocation of resources is less than optimum. Market mechanisms that translate capital account surplus into current account deficit can be summarized as follows. *Ceteris Paribus*, with perfect financial markets, a surge of capital inflows will lower the interest rates of the hosting country. The lowering of the interest rates will create an investment-saving gap, which in turn will lead to current account deficit. Changes in the interest rate will equilibrate the demand for and supply of hosting country's assets. Eventually, the hosting country's international balance of payments will be balanced, with equal amount of increases in both capital inflows and current account deficit.³²

In short, international economic activities are aimed at improving welfare of a nation by engaging in cross-border and cross-generation resource allocations world wide. However, price distortion of various forms will lead to misallocation of resources. If exchange rate of a country is set too low, goods and services that do not enjoy natural comparative advantage will be exported and those that do enjoy natural comparative advantage (from the point of view of foreign exporters) will fail to be imported. Hence trade surplus may represent misallocation of resources resulted from over-export. The same is true of cross-generation resource allocation. Due to price distortion, domestic assets with high future income streams may be exchanged for foreign assets with low future income streams, leading to the reduction in the inter-temporal utility of the country. China's twin surpluses are result of misallocation, though under certain circumstances the misallocation is necessary, and should be corrected. After have decided that the twin surpluses are not in the interest of China, the question of how the problem can be solved should be discussed. However, in order to find the policy combinations for the correction of imbalances, the causes of China's twin surpluses must be identified in the first place.

V. Unsustainability of China's Twin surpluses

If a persistent current account deficit is unsustainable, how about a persistent current account surplus? In a two- country world, unsustainability of current account deficit automatically implies unsustainability of current account surplus. In a multi-country world, for a country at a given level of development, sustainability is more complicated, because of the existence of the echelon of countries in different development stages with different structure of international balance of payments. According to Growth (1957), a nation's balance of payments evolves in tandem with its stage of development. There are six stages:(1)Young debtor nation;(2)Mature debtor nation;(3)Debt repayment nation;(4)Young creditor nation;(5)Mature creditor

³² Yu Yongding: Global Imbalances and China, Australia Economic Review, March 2007.

nation;(6)Credit disposition nation.³³ However, China, with its twin surpluses is difficult to fit into any of the six stages. China is not a mature debt nation, because it runs current account surplus and its trade surplus dominates its current account. Neither China is a debt repayment nation, because it runs capital account surplus and its income investment deficit is expect to increase. China's situation is unique. There is no historical precedent that can be based on to predict the sustainability of China's current pattern of international balance of payments. Without major policy changes, China may be able to run trade surplus for some time to come. However, it is worth noting that China has run capital account surplus for more than two decades almost without interruption (except for 1998). Over the decades, China has attracted \$600 billion cumulated FDI. The government so far is unable to provide any reliable statistics about the total value of FDI stock. Japan is expected to run investment income surplus of 11.94 trillion yen, equivalent to \$100 billion (assuming a very weak exchange rate of 119 yen for 1 dollar), in 2006-7 fiscal year. In contrast, after running trade surplus for decades, China's investment income deficit is expected to increase. China's 11th five-year program called for attracting \$50 billion FDI annually for the next five years. If the program is materialized, by the end of 2010, after having taken into consideration depreciation, bankruptcy and withdrawals, China's FDI stock should reach at least \$800 billion (this could be a vast underestimation). According to a recent survey done by the WB, foreign funded enterprises' average profitability is 22%. With FDI stock surpassing \$800 billion, China's investment income deficit may reach \$176 billion, assuming a profitability of 20% for FDI. If foreign investors decide to remit their income back home, and if we assume that by the end of 2010, China's foreign exchange reserves reach \$ 2 trillion and return on US treasury bills is 5%, , China has to run \$76 billion trade surplus to maintain the balance of the current account. China's international balance of payments is quite messy at this moment. We need to study the trajectories of all major items in the balance sheet carefully. Otherwise, China will be in big trouble in near future. The stupidest thing that China has done in the past is the equity-debt swap. This not only has led to huge welfare losses but also created huge burden for the maintenance of international balance of payments in the future.

In the short-term, the unsustainability of China's twin surplus is also very clear, if not clearer. Due to the enormous scale of increase in foreign exchange reserves, in a short period of three years, the total balance of central bank bill issued has surpassed 3 trillion Yuan RMB. In contrast, the total balance of government bonds was just 3 trillion Yuan RMB after 10 years' issuance. Most of the central bank bills are short term bills of three month. One important question is whether sterilization can be implemented unlimitedly. Theoretically speaking, as long as the interest rates paid by the central bank on its bills is lower than corresponding interest rates of American assets, say, the yields of treasury bills, the central bank should be able to carry on with full sterilization infinitively, and hence to maintain an effective control of the monetary base. However, there are several obstacles to the continuation of full

³³ Kojima Akira: Balance Adjusted, The Japan Journal July 2006. p. 12.

sterilization. One of the obstacles is that the continuous purchase of low yield central bank bills and the increase in share of low yield assets in the total assets will worsen commercial banks' profitability, which in turn will create long-term negative impact on the fragile banking system. Therefore, faced with continuous increase in foreign exchange reserves, the Central bank has to make choice among three contradicting objectives: a tight monetary policy, a health financial system and exchange rate stability. Faced with a high growth rate of fixed assets investment and steady increase in the investment rate, there is no choice for the PBOC but to tighten monetary policy significantly. However, while the Federal funds rate is on hold, the narrowing the interest spread between China's bench mark interest and the Federal funds rate, it has become even more difficult to discourage capital inflow into China. Now China is flooded by excessive liquidity. Wages, CPI and assets prices all are in rising. Some rises are dramatic and other are more modest. But there is no doubt whatsoever that China is heading for trouble. The immediate cause for the trouble is the excessive liquidity and the fundamental cause is the twin surpluses. But how can the twin surpluses be reduced?

VI. The Causes of China's Twin Surpluses

The most important reason that economists both within and outside China disagree about what are needed for China to bring about current account adjustment is that they disagree about what has led China to become such an important player in global imbalances in the first place.

Recently, Dooley, Folkerts-Landau, and Garber (hereafter DFG) put forward a theory arguing that in the next decade or two, Asian countries will continue to finance the US current account deficit happily, because Asian countries need to run trade surplus against the US so as to solve their employment problem. DFG hypothesis is a simplistic generalization of Asian, especially China's experience. Actually, within China, many economists hold a similar view and to a certain extent the consideration of employment is indeed one of the most important motivations behind the government's export drive. However, I do not think DFG hypothesis is a correct explanation of China's export drive in the past and projections on China's future growth strategy based on this hypothesis can be misleading.

Then why does China as a developing country run a large current account surplus and why does China with excess savings attract so much FDI? In the following we will answer these questions.

The first explanation for current account surplus that comes to one's mind is the saving-investment gap. If the saving-investment gap is indeed the cause of the current account surplus and if the high saving-investment gap is structural, China's current account surplus will not disappear any time soon. However, we cannot rule out the

possibility that, to a certain extent, policies promoting current account surplus has led to the occurrence of the saving-investment gap. In recent months, debate on whether China's investment rate is very high was heat. However, the measurement of investment and saving is not that important for the identification of the causes of current account surplus, because what really matter is the difference, the gap. The real important thing is the reliability of China's statistic of current account surplus. It is likely that a significant proportion of the increase in China's current account surplus was due to over-invoice of exports and under-invoice of imports. As far as I am concerned, It is difficult to say how big China's saving-investment gap is. Perhaps the gap is big but that it is less than people think. There is something structural and inherent in household's high saving propensity but that the investment rate is more variable. I tend to think the saving-investment gap is not the ultimate cause of current account surplus. It probably cannot explain a large part of current account surplus.

The second explanation is economic cycles, global as well as domestic. China tends to run current account surplus (or bigger surplus) when the economy is weak, and deficit when overheating. China's current account deficit in 1993, the only one sine 1990, obviously was a result of overheating. In 1993, the growth rate of GDP was 14 percent and that of fixed assets investment was 61.8 percent. In 2005, with China's economy being hit by overcapacity and growth momentum of the world economy being very strong, China's running large current account surplus was quite natural. The cyclical factor can be used to explain the cyclical part of the saving-investment gap. Hence the saving-investment gap can be regarded as consisting of two parts: trend and cyclical element. Superimposing the two will give a better explanation of China's current account surplus.

The third factor contributing to China's current account surplus is government's export promotion policy, which includes exchange rate policy and tax rebate. To prevent FDI from being translated into current account deficit, the government demanded foreign investors guarantee the self-balancing of foreign exchanges for important foreign investment projects. In other words, FDI must be export-oriented. As a result, while FDI was introduced, corresponding trade deficits were minimized.³⁴ It is also undeniable that China's exchange rate policy is conducive to China's trade surplus. Before the Asian financial crisis, China's exchange rate policy was characterized by the "real targeting approach".³⁵ Exchange rate was set at a level based on the production cost of exports and aimed at maintain the competitiveness of the exports. During the Asian financial crisis, RMB was pegged to the US dollar. The peg was dropped last July. However, the exchange rate's influence on current account should not be exaggerated. In 1997, in support of Chinese government's policy of no-devaluation, I pointed out that "Chinese exports' foreign content was as high as 57 percent, the competitive edge achieved by devaluation would be offset immediately to

³⁴ This policy was abolished as part of China's commitments for WTO entry in 2001.

³⁵ Zhang, Zhichao:

a large extent by the price increases in foreign inputs of export goods.”³⁶ The same logic also applies to RMB appreciation. I tend to think that the policy factor is an important, if not the most important, contributing factor to China’s persistent current account surplus. The export promotion policy can lead to the widening in both current account surplus and saving-investment gap at the same time, or to increase in current account surplus via the widening of the saving-investment gap rather than other way around.

The fourth factor is China’s position in the global division of labor. Until quite recently, the economic relationship in East Asia was characterized by the so called *flock formation of flying wild geese pattern*. Based on the *vertical division of labor* , products and capital flow in and out across borders with the flying geese formation. Generally speaking, the flying geese formation would not necessarily lead some countries running current account surpluses and others deficits. In fact, most East Asian economies ran current account deficits in the 1960s, 1970s, 1980s, and most of 1990s until the Asian financial crisis. Since the later 1980s, as a result of the development of international production networks, processing trade became the dominant form of trade among less developed countries. China’s current account surplus coincided with the formation of international production networks, and its trade pattern was shaped to a large extent by FDI that flowed in as vehicles of the formation of international production networks. The pattern of FDI inflows was in turn shaped by Chinese government’s policy in favor of processing trade. As pointed out by Williamson, export promotion does not necessary means current account surplus. But export promotion based on processing trade does. In 2005, China’s total trade surpassed \$1 trillion, and accounted for more than 70 percent of GDP. In the same year, China’s total exports was \$762 billion, and processing trade accounted for 54.6 percent of the total exports, and FFEs in turn accounted for more than 80 percent of processing trade exports.³⁷ Among China’s \$102 billion trade surplus, \$140 billion was created by processing trade, and \$57 billion was created by FFEs.³⁸

In short, China’s current account deficit is attributable to four factors: the saving-investment gap, certain combination of domestic and global cyclical movement, government’s trade promotion policy, China’s specific position in the global division of labor, and especially its specific position in international production networks. The above four causes are interrelated. All factors that impact on current

³⁶ Yu Yongding, “Opinions on Structure Reform and Exchange Rate Regimes against the Backdrop of the Asian Financial Crisis”, prepared for the meeting organized by the Council on Foreign Exchange and Other Transactions, MoF, Japan, on March 6, 2000

³⁷ Business Watch Weekly (Shang Wu Zhou Kan), No. 7, Vol. 131, April 5 2006. p40.

³⁸ China costume office, 2006.

account balance should be fitted into the identity of the saving-investment gap vis-à-vis current account balance. However, identity says nothing about causality. Causality, if there is, can run from the right side of the identity to the left, and vice versa. It is wrong to say simply that China's current account surplus is caused by the saving-investment gap. In fact, as has been mentioned earlier, current account surplus may force upon the economy to create a saving-investment gap. Without having carefully checked the evolution of the events, it is impossible to determine what cause what. Without having conducted solid empirical tests, it is even more difficult to pin down the relative importance of each of the four factors in the determination of China's current account surplus. It seems to me that there is a trend factor in the saving-investment gap, which is related to the long-term elements such as the representative household saving propensity and demography. The domestic and external macroeconomic cycles superimpose a cyclical element on the trend. The export promotion policy is one of the elements influencing the trend factor in the saving-investment gap. However, this element may have a shorter life span than those more fundamental elements such as demography in deciding the saving-investment gap, and its importance will be tapering off gradually as a result of policy changes by the government. The current account surplus related with processing trade cannot be attributed to saving-investment gap. Assuming China's foreign trade is 100 percent of processing trade, and then no matter what the transmission mechanisms are, as long as there is trade, there will be saving-investment gap. Given processing trade, the enterprises and households will have to adjust their behavior so that the saving-investment gap can be equal to the current account surplus. Given the saving-investment gap the volume of trade will have to adjust so that the current account surplus can be equal to the saving-investment gap. The realized current account surplus and the saving-investment gap, which must be equal, are the result of mutual influence via a certain specific transmission mechanisms. The domination of processing trade in China's trade is the consequence of the policy in favor processing trade. Although the policy can be changed quite quickly, the established trade structure cannot be changed overnight, and impacts of processing trade on China's trade balance will continue to be felt in years to come.³⁹ The most worrying aspect of the domination of the processing trade is that, when somehow the saving-investment gap is narrowed, the processing trade surplus may fail to shrink. As a result, in order to equal the saving-investment gap, the general trade, which accounts more than 40% of China's total trade, will have to suffer large deficit and create serious negative impact of another kind on the economy as a whole.

In the following, we discuss how market distortion or imperfection has led to the excess capital inflows into China, while it has to "park" its excess domestic savings abroad to build up foreign exchange reserves.

³⁹ There are also problems with statistics of current account. Current account surplus may be overestimated in recent years.

First, due to the under-development of the financial markets, though there may be excess savings for the economy as a whole, it is very difficult for many potential importers of capital goods to raise funds domestically for imports. On the other hand, due to the preferential policy towards FDI, to attract FDI as a way to raise funds is much easier. Some times enterprises simply sold their foreign exchanges obtained via FDI to the PBOC, and use RMB to buy capital goods produced locally. As a result, on the one hand, there are increases in FDI and foreign exchange reserves. On the other hand, there are no changes in current account. Essentially, China's domestic savings have often to be intermediated by foreign capital markets for domestic investment.

Second, even if funds can be achieved domestically, due to capital control, it is difficult for potential importers to convert the RMB funds into foreign exchanges so that foreign goods can be brought and hence to attract FDI is still a better option.

Third, despite the fact that the returns required on FDI are much higher than the yields of US treasury bills. FDI is the cheapest form of foreign capital for myopic enterprises and local governments. In other words, under current institutional arrangements, from the point of view of local governments and individual state-owned enterprises, FDI is a "free lunch". Who cares the payments in the form of investment income, if the payments are due in 5 to 10 years' time, while my term in office is just four years? Faced with excessively lavish concessions: low tax rate, long tax holiday, lax regulations of environmental protection, free infrastructure, low or negative rents on land use, and guaranteed returns, what more foreign investors can hope for?

Fourth, China's fiscal system and institutional arrangements also give local governments great incentive to attract FDI. FDI is indispensable for increasing tax revenues at local levels.

Fifth, FDI attraction is one of the most important criteria, if not the most important criterion, for good government performance (*Zheng Ji*) for local governments. It is a common practice in China that all chief officials at all levels of governments are assigned targets for FDI attraction. Those who attract the largest amount of FDI are the most likely candidates for further promotion. To attract as much FDI as possible at any costs may not lead to the maximization of the long term welfare of the nation; it certainly will maximize local governments' utility function with a time horizon of four years.

Sixth, recently, in order to give new impetus to the reform of state-own enterprises and commercial banks, the merge and acquisition of Chinese firms by foreign investors and the acquirement of shares by "international strategic investors" in China's commercial banks are encouraged. Consequently, capital flows in and adds to the existing stock of foreign exchange reserves. In 2005 alone, \$ 32 billion capitals have been attracted as a result of selling bank shares of international strategic

investors, even though China has already piled up more than \$1trillion foreign exchange reserves, without knowing how to invest them with higher return.

Seventh, the single biggest FDI provider is Hong Kong and the second largest one is Virgin Islands. The latter alone accounted for more than 19 percent of China's total attraction of FDI in 2005. Though difficult to verify, anecdotal evidences show that a very large proportion of China's FDI is rent-seeking round-tripping FDI.

In summary, China's twin surpluses are both the result of its growth strategy featured by trade promotion and FDI attraction over the past 26 years as well as the increasing of the saving-investment gap. The saving-investment gap is a useful line of thinking, but it is wrong to exchange causality analysis based on history for reading an identity from left to right.

VII. China's Actions in Correcting Imbalances

To adjust China's abnormal pattern of international balance of payments, so as to reduce the twin surpluses, comprehensive measures should be taken, which include macroeconomic policy, trade and FDI policy, deepening of financial reform and capital account liberalization. The adjustment will be a long process and the adjustment should be implemented with great care.

To reduce current account surplus, the saving-investment gap should be reduced. To narrow the saving-investment gap either consumption or investment should be increased. Because of China's current investment rate being already too high, the focus should be on increasing consumption. In order to do so, the government expenditures on public goods must be increased. The major areas of expenditure increase should be on social security, medical care system and education system. The government's recent decision on increasing funds in supporting rural development will achieve the result of "killing two birds with one stone". Furthermore, government investment in infrastructure, such as railways, expressways, air-ports and harbors and government supported R & D should also be increased.

Preferential policies towards FDI should be cancelled so that domestic and FDI should be given equal treatment in term of credit access, tax treatment, and environmental requirement and so on. As a result, round-tripping FDI will be reduced and FDI that is not viable without all sorts of subsidies will stop flowing into the China. Export promotion policy should also be abolished gradually. Especially, policies in favor of processing trade should be adjusted.

Export promotion policy should be abolished gradually. More money should be spent on buying more foreign goods, especially those of strategically important goods and materials. Of course, while doing so, international markets should not be rocked.

Financial reforms should be speed up. SMEs should not be discriminated against. Corporate bond markets should be developed and stock markets should be made more effective and less speculative. The reform should be aimed at allowing domestic savings to be channeled effectively to enterprises so that they will have less incentive to attract FDI for the purpose of obtaining credit.

FFEs should be allowed to tap China's domestic capital market, so that there will be less need for new cross-border FDI. The government should provide the bulk of the funds necessary for the M&As aimed at enterprise reorganizations.

Chinese enterprises should be encourage to invest abroad both in the form of Greenfield investment and Merges and Acquisitions. However, the outflows should be strictly monitored by the government.

Capital account liberalization should be carried out smoothly and in an orderly manner. However, the completion of financial reform and the revitalize China's financial institution and banks in particular must be proceeds the final liberalization that is to make the RMB convertible.

RMB exchange rate should continue to appreciate gradually. This is a more efficient way of correcting China's imbalances. However, empirical evidence has shown that the so-called "expenditure-switching" effect of normal exchange rate changes is small in China as well as in the US. Due to the domination of processing trade in China, the effect of exchange rate changes should be even smaller. To use the exchange rate change as an instrument to achieve trade balance might lead to great exchange rate fluctuation. Abundant experience also shows that overemphasis of the importance of exchange rate policy in the correction of current account imbalances may not only fail to achieve the goal of correcting trade imbalance, but also cause tremendous hardship to countries concerned. After the Plaza Accord, despite the dramatic revaluation of the Japanese Yen and the slide of the US dollar, US trade deficit failed to improve in any significant way, but succeeded in causing tremendous hardship to the Japanese economy. However, while recognizing the limitation of exchange rate policy, personally, I am for more actions in the exchange rate front. Current development of China's domestic economy has made the adjustment of exchange rate policy even more urgent.

The Chinese leadership fully understands the need for RMB appreciation. The most important impediment for a firmer action is the worry for the impact on employment. For example, the textile industry is one of China's most important export industries which more than 19 million workers are employed and about 100 million workers are

involved directly or indirectly with the industry. The average profitability of the industry is just 3.5%. The government fears that if the pace of revaluation is too fast, the industry will be hit very badly and unemployment created will be tremendous. The possible negative impact on employment of a fast revaluation is the most important constraint on the government's exchange rate policy.

However, one can also argue that Chinese enterprises are much more resilient than people expect. In fact, after having appreciated by more than 5% since July 2005, China's trade surplus has been increasing continuously. In the 2005 and 2006, the growth rate of China's trade surplus was 220% and 50% (?), respectively. I believe that the possible negative impact of revaluation has been exaggerated. If China had taken action in 2003, and revalue RMB by 5% a year, China's exchange rate would have reached the equilibrium level and China would not have to face the problems now it is facing. Delay and indecision have and will continue to cost China a lot. The best timing for appreciation is when the economy is growing strongly. Revaluation will achieve the result of "kill two birds with one stone". When the economy slows down, which might happen in the near future, it will become more difficult to revalue. Of course, the negative impact of revaluation on employment should not be treated lightly. China may have to endure certain pain and governments at all levels should take the responsibility to alleviate the transitional pain of the workers.

One might ask that if appreciation of RMB will not help to reduce China's current account surplus in a significant way, why bother. The point is that China's immediate objective of revaluation should not be the reduction of current account surplus. It should be aimed at setting in motion a process of readjustment of China's growth strategy which was successful in the past but now is no longer appropriate. A more immediate objective of the appreciation is to allow China's exchange rate to reach the equilibrium level as quickly as possible. The criterion for equilibrium is not the disappearance of current account surplus, which is unlikely to happen until China's economic development has entered a new stage. Japan has continued running current account surplus since Plaza Accord in 1985, and Taiwan has done the same since 1986-1987 when the NTD appreciated by 30%. However, expectations of appreciation of the Japanese Yen and NTD disappeared after the appreciation, although adjustment of exchange rates in the two economies has been continued and the government interventions have not stopped entirely (This is especially true of the Japanese government).

Concluding Remarks

Over the past 26 years, China has achieved tremendous success in reform and opening up. Now China has become the fourth largest economy, the third largest trading nation and the largest foreign exchange reserve holding country. However, China is facing increasingly serious structural problems. Its investment rate is approaching 50 percent

of GDP and rising. Its dependence ratio is approaching 70 percent of GDP and rising. Its current account surplus surpassed \$102 billion in 2005, and probably will be higher in 2006. Now China's foreign exchange reserves have reached \$1trillion and a very large portion of the total value of the reserves may evaporate following the fall of the US dollar. China's environment is deteriorating continuously. Its energy shortage is acute.

To correct the imbalances, the Chinese government has adopted a comprehensive program aimed at achieving a more balance and sustainable growth pattern. Whether China's new strategy for a more balanced and sustainable growth will be successful is dependent on how well the Chinese government is able to balance the short run necessity for high growth and the long run necessity for structural adjustment. On the one hand, China's twin surpluses are a result of long-term imbalance and the events evolved in the past twenty five years. The pattern of twin surpluses cannot be changed over night. On the other hand, caution is not an excuse for inaction.

Global imbalances are not sustainable in the sense that imbalances are not in the long-term interests of Asian countries, and the imbalances should be and will be corrected, no matter of what the American government says and does. However, a drastic correction is neither inevitable nor desirable. The key task faced by governments in the world is to coordinate their policies to guarantee a smooth correction. Otherwise, something unexpected may trigger a dramatic meltdown of the world economy.

China should have sufficient sense of crisis. Otherwise, mistakes made by Mexico, Argentina, the East Asian four will be repeated. Many people around here cried wolf many time over the past twenty five years, and each time the wolf failed to come. Now situation may have really changed. China should be aware that something is approaching!

At this moment, the most serious threat to China's economic stability is excessive liquidity. China's stock prices have risen dramatically; China's housing prices have been rising stubbornly. Now Chinese banks' reserve requirements have reached 9.5%; banking system's holding of low yield central bank bills have reached 3.1 trillion. The new issues for the rolling over of old bills have been increasing rapidly and are likely to increase explosively in near future. China's capital control has become increasingly leaky. As a result, international capitals aiming at capital gain due to RMB revaluation are entering into China's stock markets, real estate markets, money markets, pushing up assets prices. It can be expected that after, say, five years' slow appreciation, markets will expect that the RMB will no longer appreciate. Shorting by speculative capital will start. Foreign investors will sell Chinese assets in drove. Taking consideration of China's extremely high M2/GDP ratio, China's weak financial system, and free movement of capital by then and so on, it is possible that all ingredients of a financial crisis will be well in place by then and anything can trigger a

big disaster. However, nothing is unavoidable as long as it is not too late. The hard choice facing the Chinese government is between a short term negative impact on export industries and a possible systematic crisis in the future. As previously quoted, according to the America-China Business Council report, what's at issue is not whether current account deficit leads to unemployment but how a trade-off between "temporary or sector specific costs and permanent whole-economy benefits should be made." In other words, the current account deficit-unemployment trade-off is a political issue rather than an economic one. Ironically, what's at issue in China is exactly the same. The choice is a political one and economists are not in a position to offer their suggestions. China may muddle through this time around just like what it has been done numerous times over the past 26 years. However, to raise and study all possible scenarios, no matter how unpleasant they are, is an unpleasant responsibility of economists.

References

- Dornbusch, R. and Helmers, F. Leslie C.H.. 1988. *The Open Economy*, Oxford: Oxford University Press.
- Eichengreen, Barry. 1996. *Globalizing Capital*. Princeton: Princeton University Press.
- Feldstein, M., 1983. "Domestic saving and international capital movements in the long run and the short run", *European Economic Review*. 21, 129-51
- Krugman, Paul. 1996. *Pop Internationalism*. Cambridge, Massachusetts: The MIT Press.
- Kojima Akira: Balance Adjusted, *The Japan Journal* July 2006.
- Mckinnon, R.I.. 1998 "Exchange Rate Coordination for Surmounting the East Asian Currency Crisis". *Asian Economic Journal*. Vol. 12, Number 4, December 1998.
- Radelet, S. and J.D. Sachs. 1998. "The East Asian Financial Crisis: Diagnoses, Remedies, Prospects," *Brookings Papers on Economic Activity* 1.
- Rodrik, D., 1998. "Who needs capital account convertibility?", *Princeton Essays in International Finance* 207, 1-10
- UNCTAD. 2001. *Trade and Development Report, 2001*. Geneva
- Williamson, J. 1995. "The Management of Capital Inflows" a working paper published in *Pensamiento Iberoamericano* January-June 1995.
- Yu, Yongding, "Some Problems with the Pattern of China's International Balance of Payments", *World Economy and Politics* (Chinese), No.10, 1997
- Yu, Yongding. 2005. "China's Rise , Twin Surplus and the Change of China's Development Strategy", a paper prepared for Namura Tokyo Club Conference, Kyoto, 21 November, 2005
- Wang J. 2006. "China's Macroeconomic Situation", EAI lecture note, unpublished.