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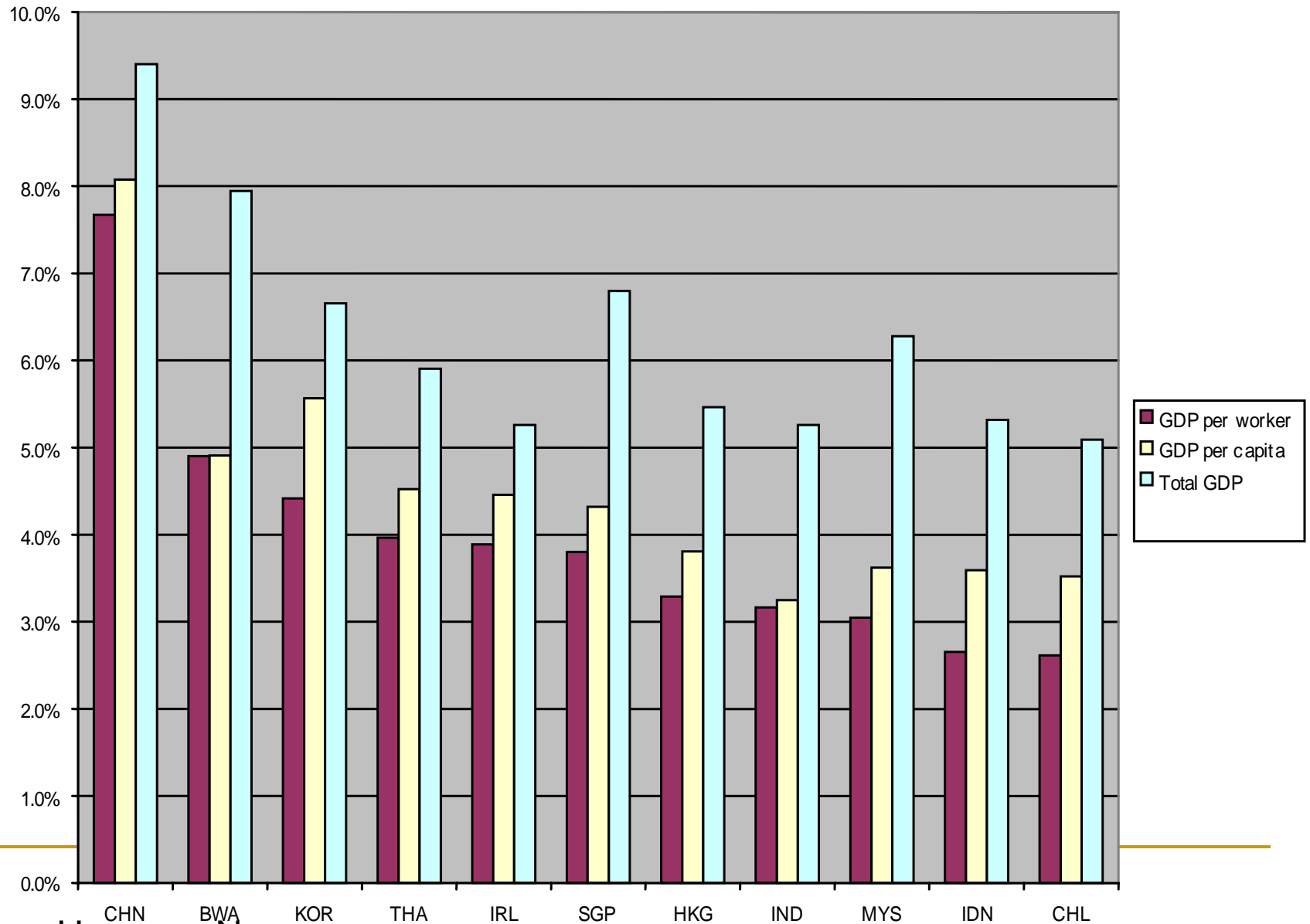
# **China's macroeconomic management: issues and solutions**

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Yu Yongding  
Institute of World Economics and Politics  
Chinese Academy of Social Science

May 31 2007, ADBI, Tokyo

# China : the fastest growing country in the world since 1978



see: Hausmann

# Factors contributing to China's growth

authors	period	Growth rate	Capital	Labor	TFP	Total
Maddison (1998)	1978-1995	7.5	49	21	<b>30</b>	100
Chow and Li(2000)	1978-1998	9.3	55	13	<b>32</b>	100
Wu (2002)	1980-2004	9.5	52	11	<b>37</b>	100
Hu and Khan(1997)	1979-1994	9.3	46	13	<b>41</b>	100
Swamy(2003)	1980-1997	10.0	39	16	<b>45</b>	100
World Bank(1997)	1978-1995	9.4	37	17	<b>46</b>	100
Bosworth and Collins(2003)	1980-1990	9.2	23	31	<b>46</b>	100
Bosworth and Collins(2003)	1990-2000	10.1	32	18	<b>50</b>	100
Rawski	1978-2004				<b>29</b>	
Cai (2006)	Since reform		28	24	<b>48</b>	100

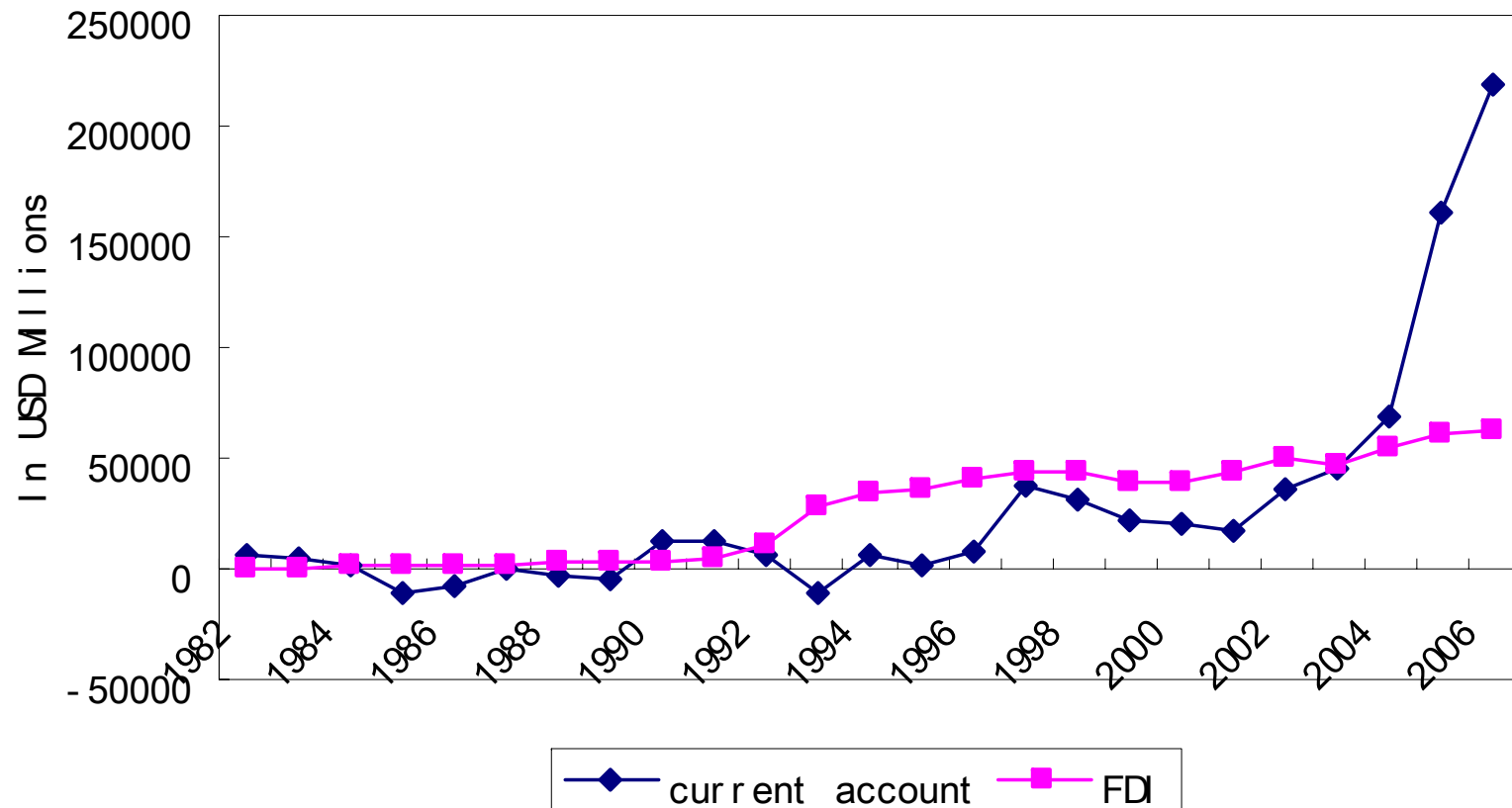
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# Long run problems

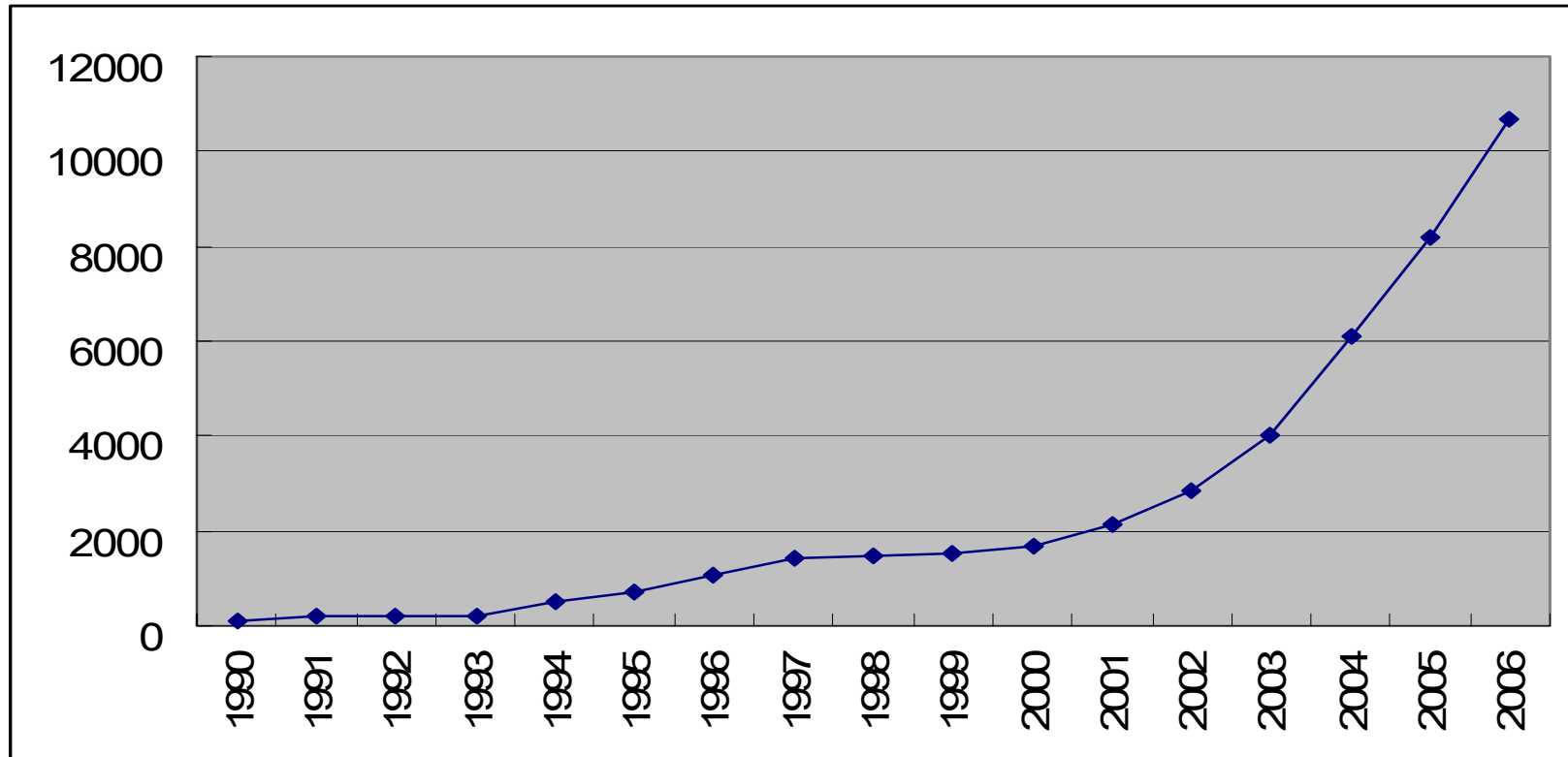
- Deterioration of Environment
  - Exhaustion of energy
  - Widening gap between the rich and poor and different regions
  - External imbalances
    - Characterized by persistent twin surpluses
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# China's twin surpluses

200 bil + 60 bil



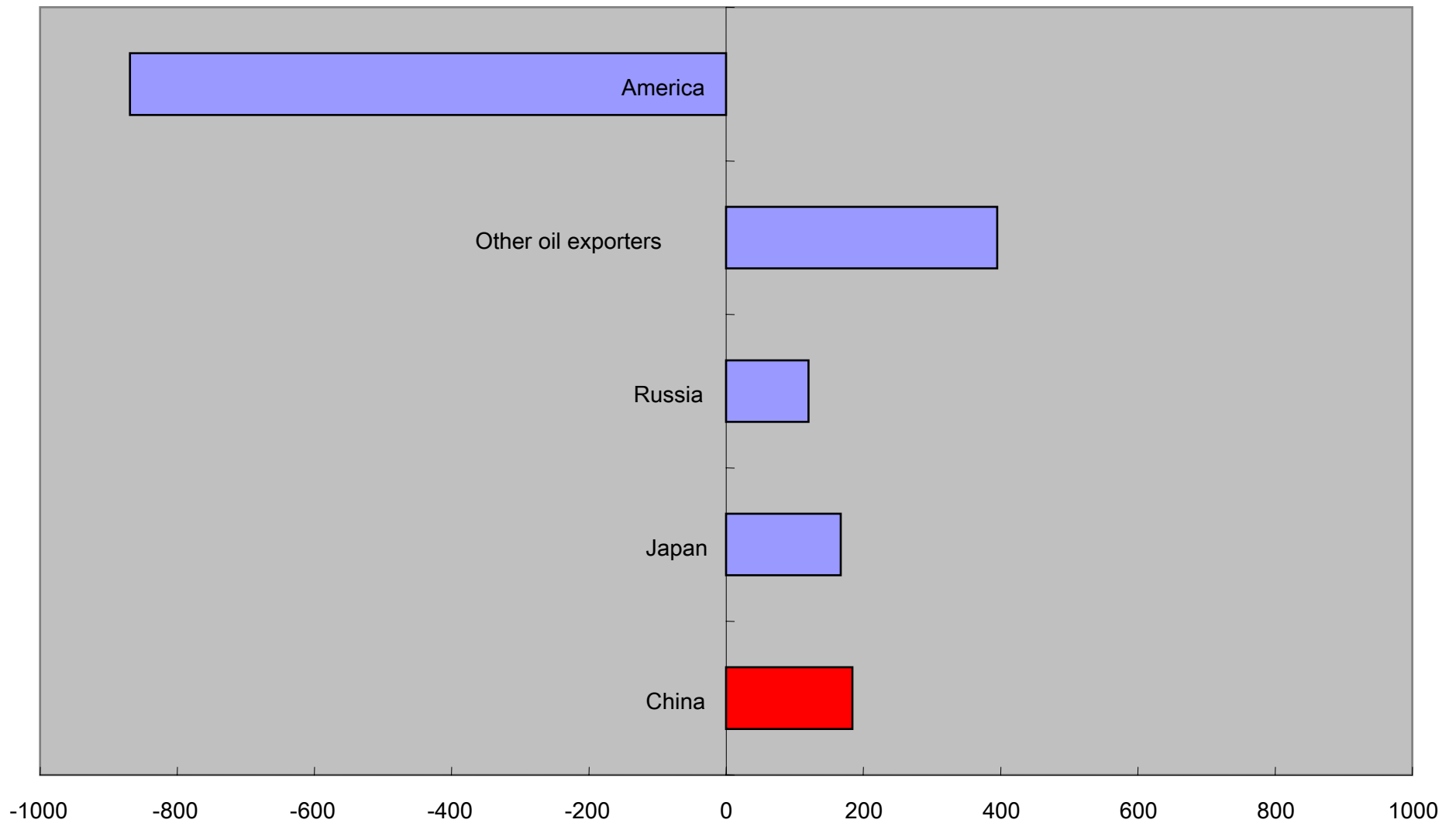
# The increase in foreign exchange reserves



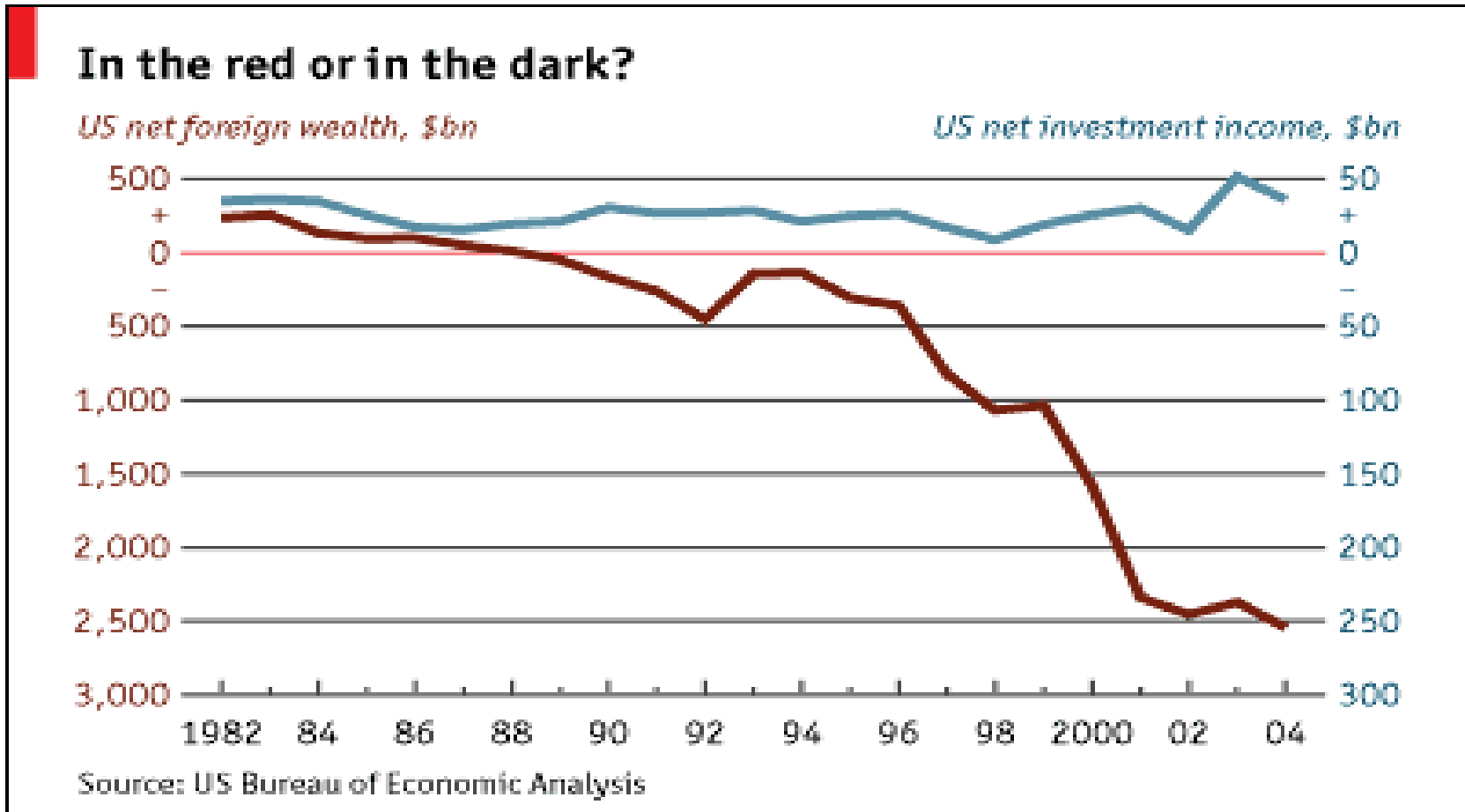
200 bil a year

# China is an important creditor of the US

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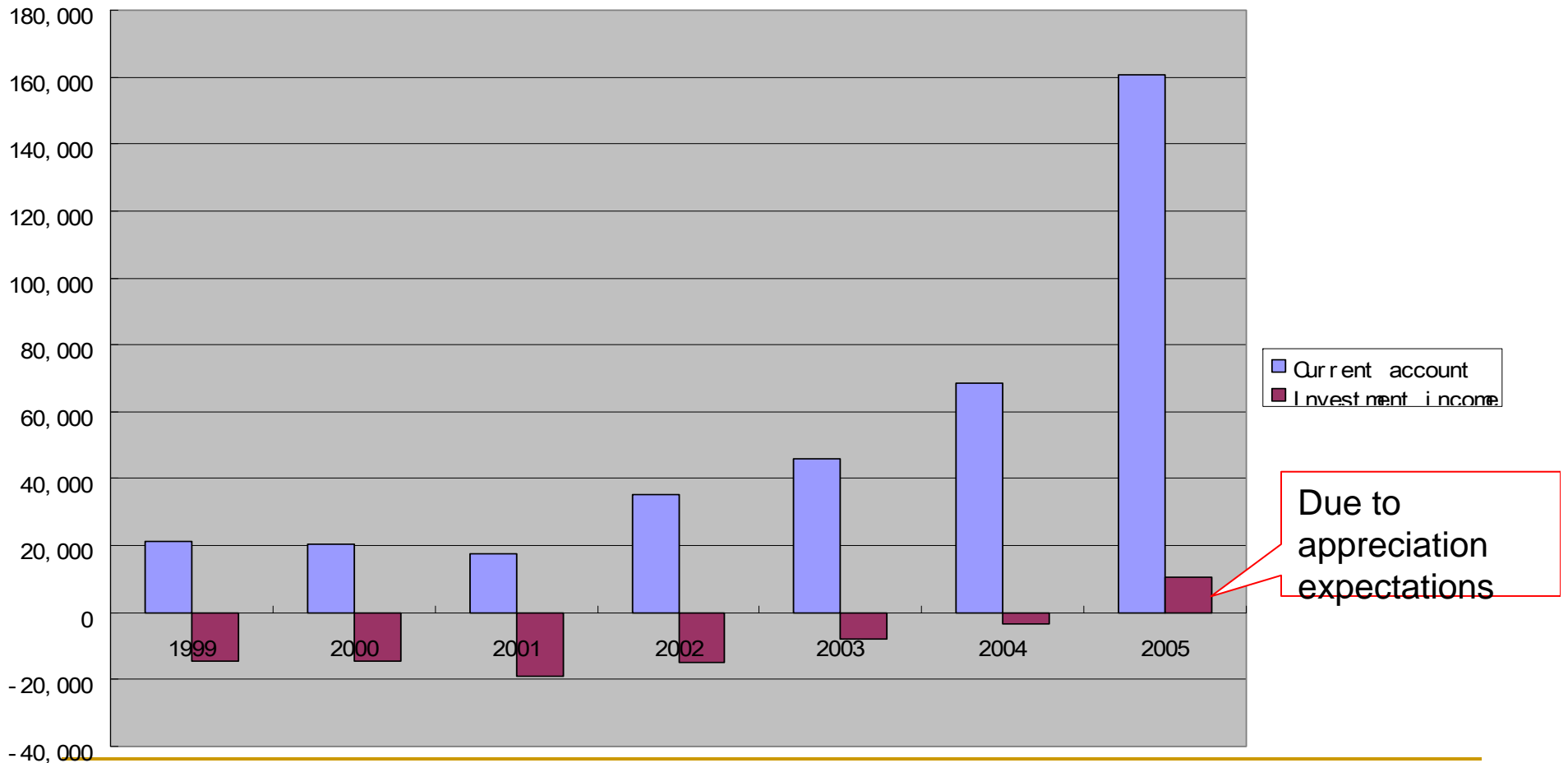


# Rewards for being a debtor



# Punishment for being a creditor:

## China's current account surplus and investment income deficit



Except for 2005, over the past 25 years, investment income balance has always been in deficit

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# China's Net International Investment Position

**\$120.3billion, the sixth largest creditor in the world in 2004**

**\$287.5billion, the third largest creditor in the world in 2005**

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2006年5月25日，中国国家外汇管理局首次公布了中国国际投资头寸表  
( IIP, International Investment Position )

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# Why a creditor country run investment income deficit

- China's assets consist of mainly low yield reserve assets: about 70%
  - China's liabilities consist of mainly FDI with high profitability: 60-70%
    - WB report: 22%
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# Twin surpluses mean misallocation of resources

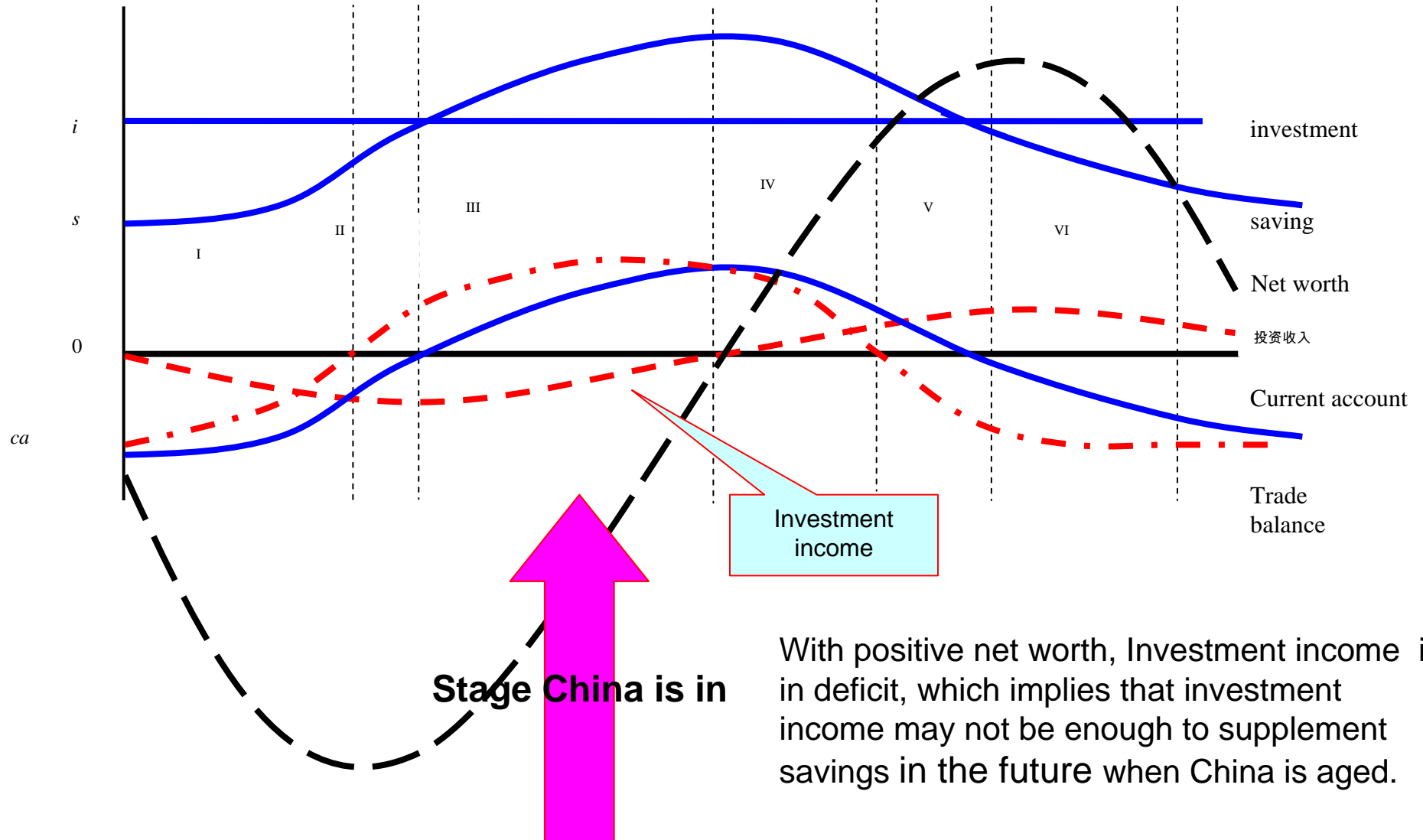
- The 128<sup>th</sup> poorest country in the world, the third largest capital export country in the world
  - The 3<sup>rd</sup> largest FDI attracting country, fails to translate capital inflows into current account deficit
  - The USD1.2 trillion foreign exchange reserves represent a huge subsidy to the US
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# Why China should be worried

- China's growth relies on the high investment rate supported by the high saving rate
  - China's high saving rate, in the long run, is attributable to the low dependency ratio
  - China is aging. "Demographic dividend" will disappear in 15 years
  - Need investment income surplus to supplement deficiency in saving, otherwise China will not be able to maintain a decent investment rate.
    - Japan's investment income surplus has surpassed trade surplus since 2005
-

# Six stages of economic development: where is China



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# A comprehensive policy mix has been adopted to address the abnormal pattern of international balance of payments

- A model of development putting safety before efficiency (1980s debt crisis etc)
- After 26 years growth, time has matured to adjust the growth strategy. Export promotion and capital attraction policies that resulted in market distortion will be dismantled. Policies are taken to stimulate domestic consumption.
- One of the key aims of the mix is to reduce China's trade surplus.
- Exchange rate policy should play important role in achieving the aim.

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# Uncomfortable Situation faced by the PBOC

- Current account surplus continues to increase
  - Equity price is soaring
  - Inflation rate is approaching the implicit target
  - growth rate of investment continues to be significantly higher than that of GDP
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## Is it a bubble?

- 100 million retail accounts (maybe half of them are active)
  - 200,000-300,000 new accounts a day since April
  - Price has tripled in less than 2 years
  - From 2000 to 3000: 18 months
  - From 3000 to 4000: 31 working days
  - Turnover surpassed London, Japan+13 major Asian economies in some trading days in May
  - Capitalization 18 trillion RMB surpassed the total amount of household deposits
  - P-E ratio doubles the international level
-

Exhibit 3

## Retail Investors Have Jumped on the Train at a Relatively Late Stage



Source: CEIC, Morgan Stanley Research

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# Over-estimating of enterprise earnings

- Share-holding companies transfer profits from unlisted subsidiaries to listed subsidiaries. Injecting new capital and revaluation gains are counted as profits
  - Cross share holding by an enterprise group just like what was done in Japan in 1980s.
  - Re-structuring. Even without any real improvement, the restructured enterprises have much higher capitalization
  - Auditing tricks, to record profits in book, which had been hidden, when a company is go public.
  - What should be the right P-E ratio? No idea.
-

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## **The Impact of the burst of bubble on the real economy may be limited but the social consequences could be serious**

Regardless, another big difference between China and Japan is that the Chinese stock boom has had very little impact on the real economy. The transmission channels—through consumer wealth, through a lower cost of capital—simply aren't well developed. There have been few IPOs, and thus limited fund flows through the market from consumers to the corporate sector. The economy was growing strongly before the stock market took off. It will continue to grow even if the market crashes, in our view. The domestic risks from the market are probably more social than economic.

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--Timothy Bond

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# Control of Excess liquidity holds the key

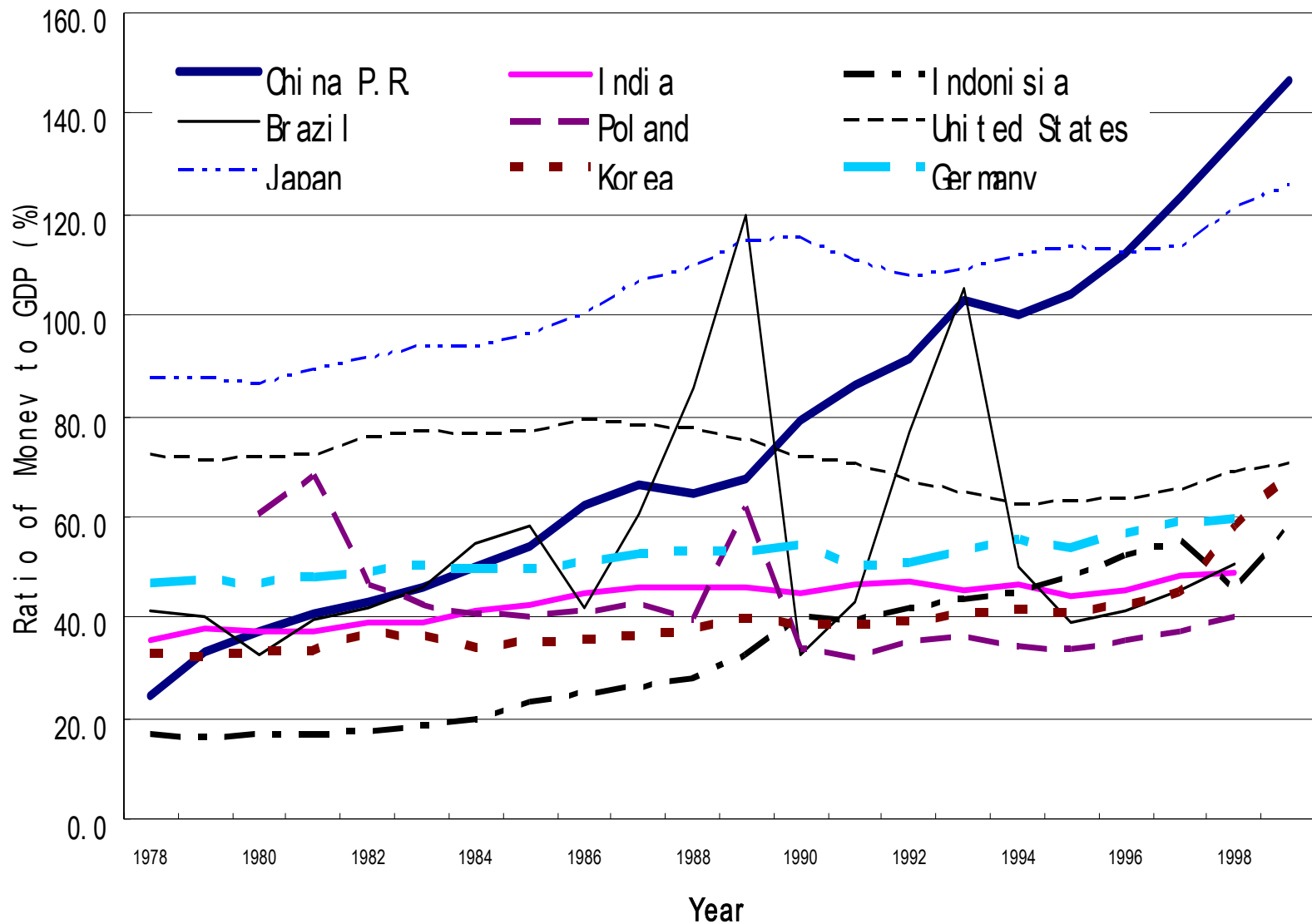
- Given the momentum of current account surplus
  - To achieve the objectives of
    - controlling inflation
    - assets bubble
    - slowing down the growth rate of FAI
  - excess liquidity must be mopped up
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# The source of excess liquidity

- **High M2/GDP: 160% (previously frozen)**
    - The growth rate of M2 has been consistently much higher than that of GDP (“tighter” in the cage is out)
    - The most important component of M2 is household deposits receiving very low interest (the real rate more often than not below zero)
    - Attracted by much higher capital gains in the equity market
    - **Tiger is out (in April 170 billion household deposits left banks and entered the equity market)**
  - **twin surpluses (newly created)**
    - \$250 billion twin surplus
      - Trade surplus and normal capital inflows
      - Speculative capital inflows (what is the proportion?) aimed at
        - Assets Capital gain
        - Revaluation expectation + carry trade
    - PBOC intervention aimed at **RMB stability**
    - Increase in commercial banks’ deposits with the PBOC—**Reserves**
    - Fully sterilization is difficult (why?)
-

# M2-GDP ratios of different countries



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# To lure the Tiger back into Case?

- Higher real interest rates
  - More channels to invest
  - Lifting capital control somewhat? QDII
  - contain assets bubble
  - Monetary policy alone will not solve the problem of equity bubble.
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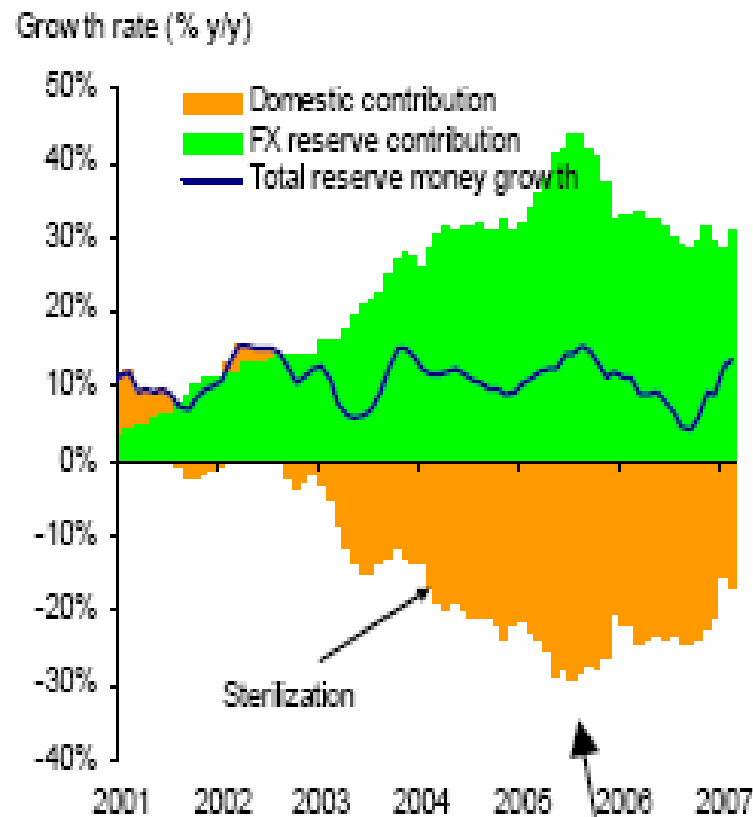
# Policy measures used to mop-up the excess liquidity

- ❑ To sell central bank bills to commercial banks
- ❑ To raise reserve requirements
- ❑ To raise interest rate
- ❑ To allow RMB to appreciate

These are measures when equity bubble was still not serious and household deposits move was still not a noticeable issue.

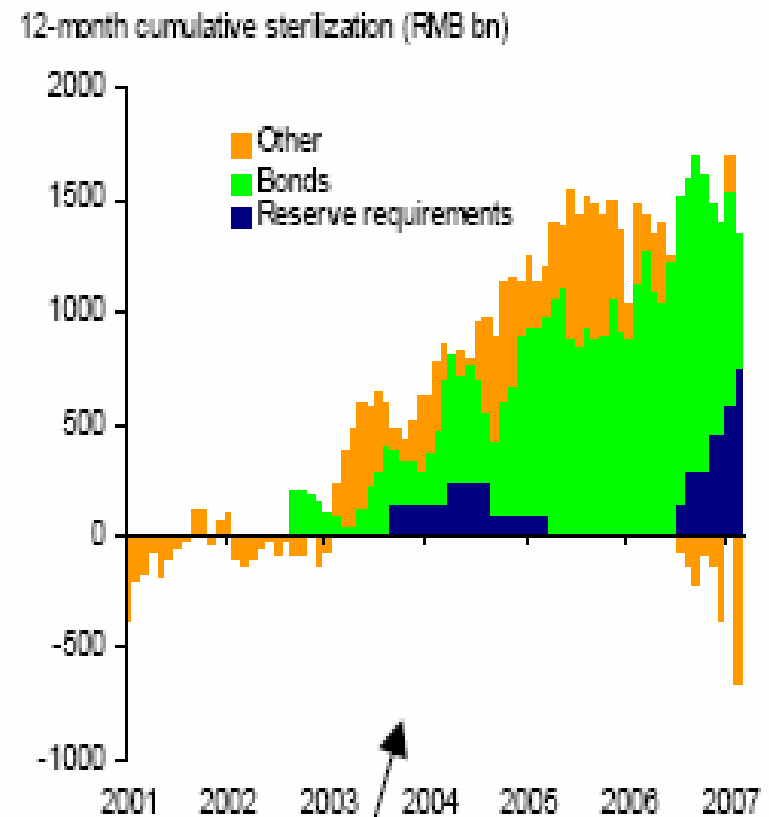
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### Chart 4: Sterilization operations



Source: CEIC, UBS estimates

### Chart 5: Sterilization by component



Source: CEIC, UBS estimates

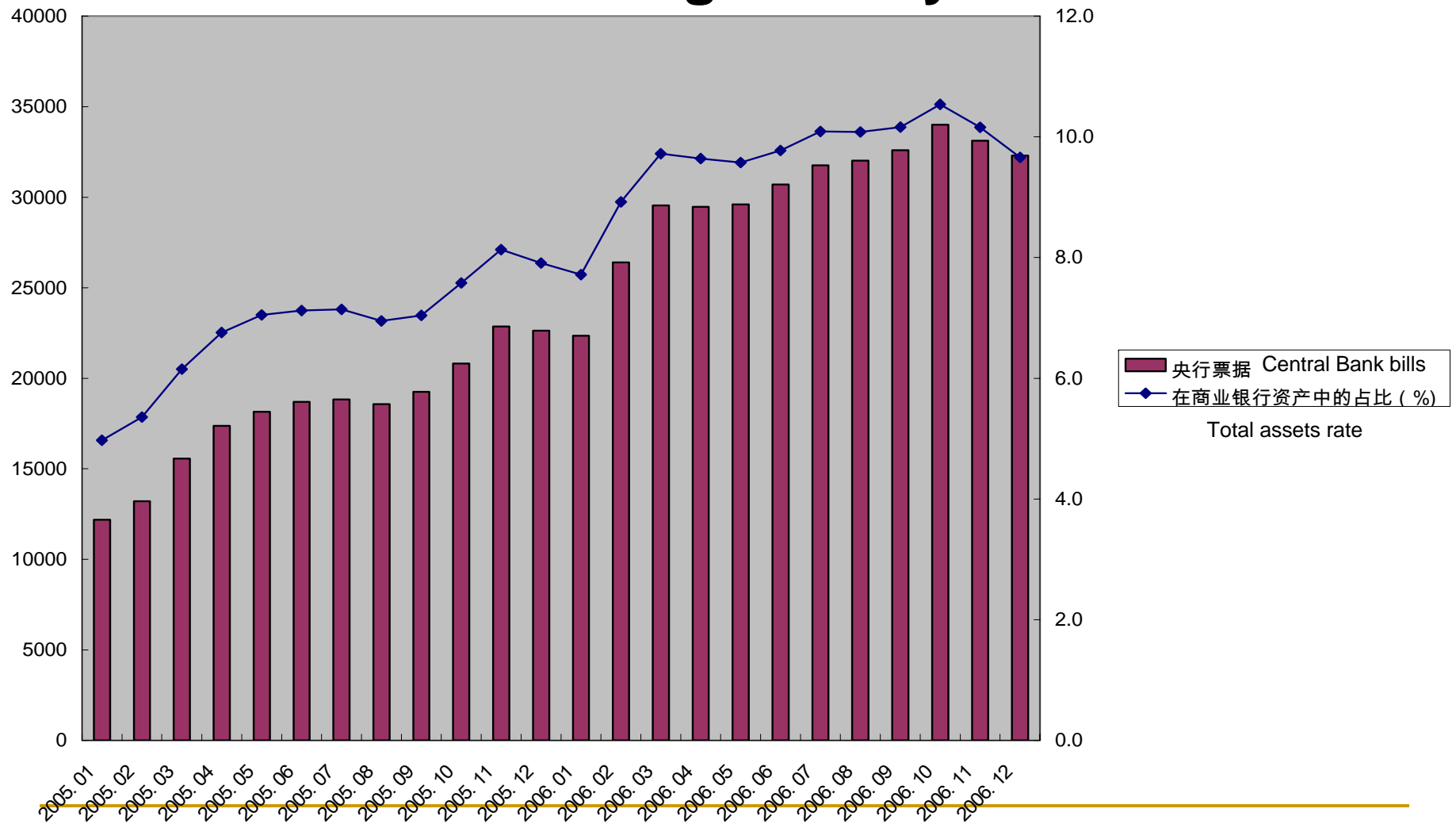
**Raising RRT and selling Central bank bills to mop-up liquidity  
The result of operation is the slowing down of reserve money growth**

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# The constraints on sterilization

- The negative impact on commercial banks' performance
  - Resulting higher interest rates may attract more capital inflows
  - The impact on the real economy may be too great
-

# Central bank bills/total assets rate is increasing steadily



# reserve requirements are increasing steadily

time	adjustment
2003(09/21)	7%
2004 (04/21)	7.5%
2006	8%
2006	8 . 5%
2006	9%
2007 ( 01 )	9 . 5%
2007 ( 02 )	10%
2007 ( 03 )	10 . 5%
2007 (04)	11%
2007 (05)	11.5%

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# Impact on commercial banks' profitability

- Share of low yield assets over total assets may have surpassed 20 percent
  - The gap between deposits and loans is huge
    - *Lending rate × total lending – deposit rate × total deposits = 90 percent of total bank profits*
    - Sterilization reduce the ability of lending by banks and hence their profits
      - in 2005 financial institutes held 28.7 trillion deposits and extended 19.5 trillion loans.
      - The gap was 9.2 trillion, accounted for more than 30 % of deposits.
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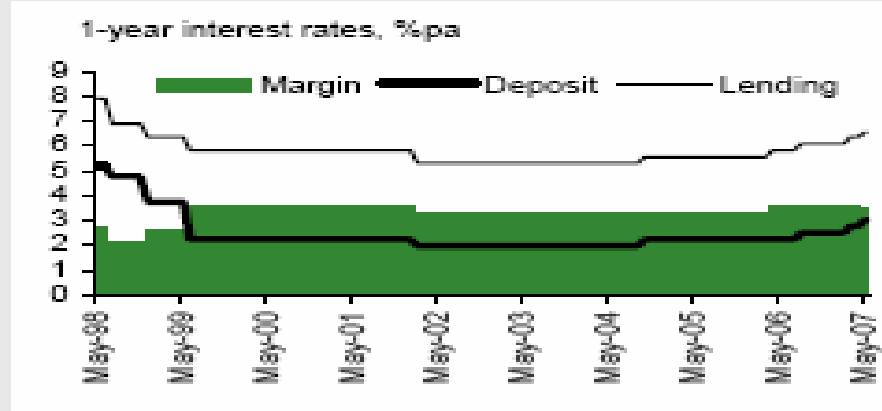
# Recent PBOC policy announcement

- Increase the band of floating from 0.3% to 0.5%
  - Increase reserve requirements from 11% to 11.5%
  - 27-basis-point (BP) hike in the deposit rate , lending rate hike is smaller for the first time.
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27-basis-point (BP) hike in the deposit rate (currently at 3.06% for 1-year deposit), the (after tax) real deposit rate remains negative.

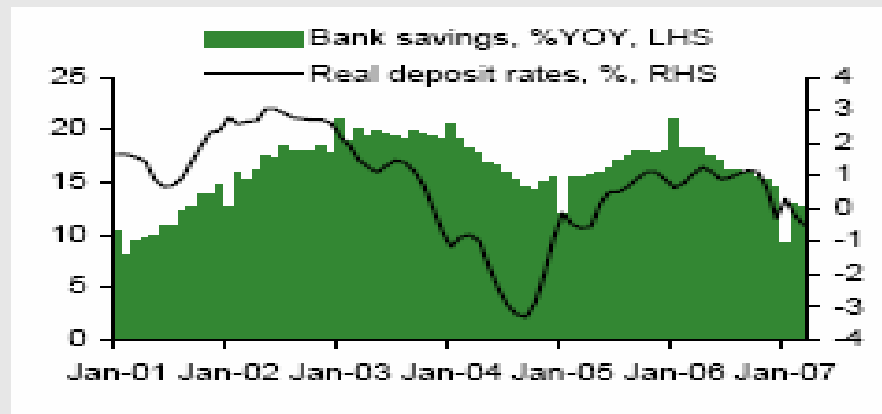
21 May 2007

Bank margins don't fall much...



Source: CEIC, Macquarie Research, May 2007

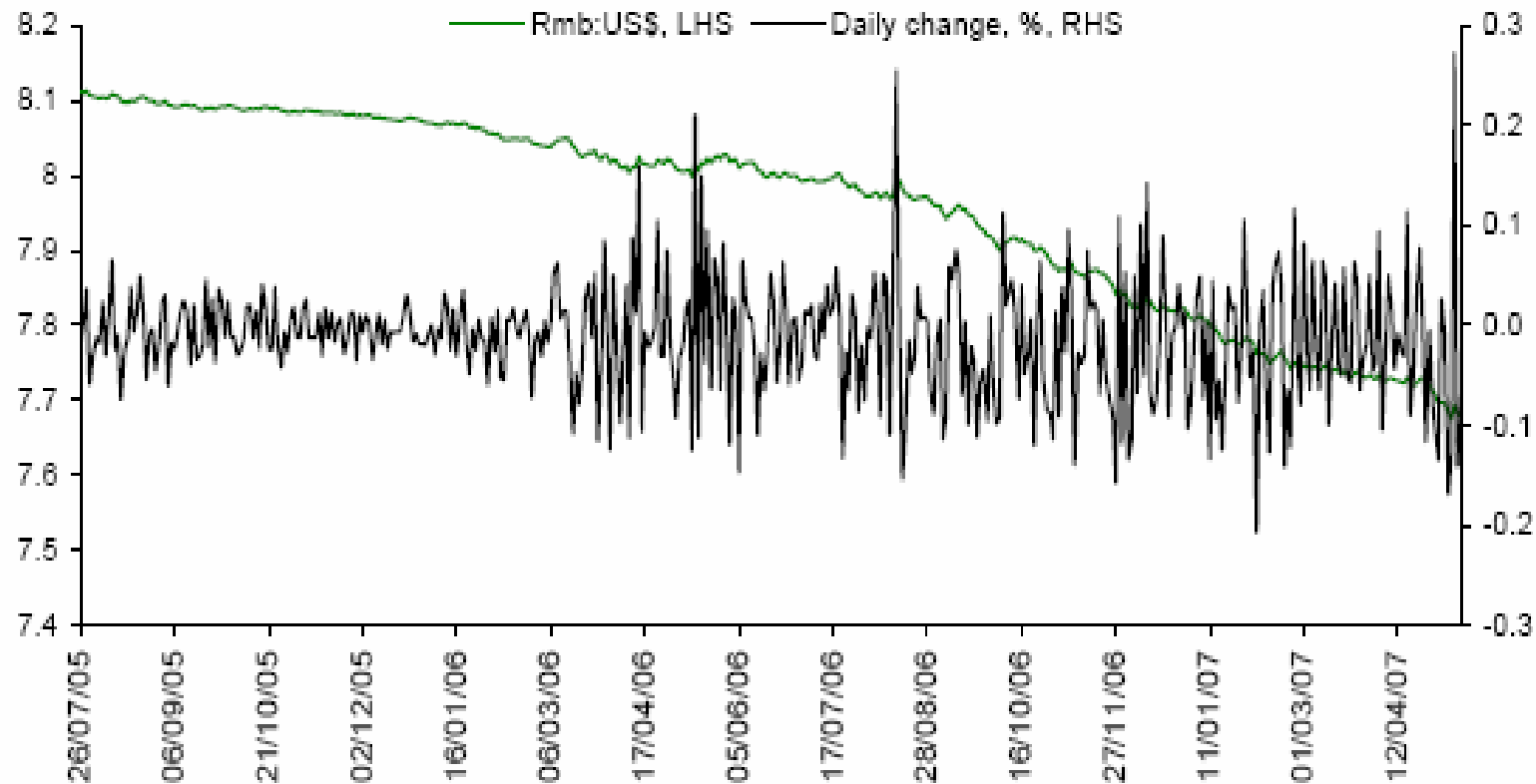
..and real rates are still low



Source: Macquarie Research, May 2007

# Expanding the floating band: symbolic

Fig 9 Some more volatility, but still not a lot



Source: CEIC, Macquarie Research, May 2007

**Market maker system in China's foreign exchange market**

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# Why appreciation is slow

- Why pace for RMB exchange rate appreciation is so slow: textile, 19 million, 3.5% profitability, massive unemployment
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# Will the pace of appreciation speed up?

- **It depends on**

- Development of current account surplus
  - Development of inflation and assets bubble
  - Growth of FAI
  - Sustainability of sterilization operation
  - Effectiveness of the management of capital account
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# A more positive attitude towards appreciation should be adopted

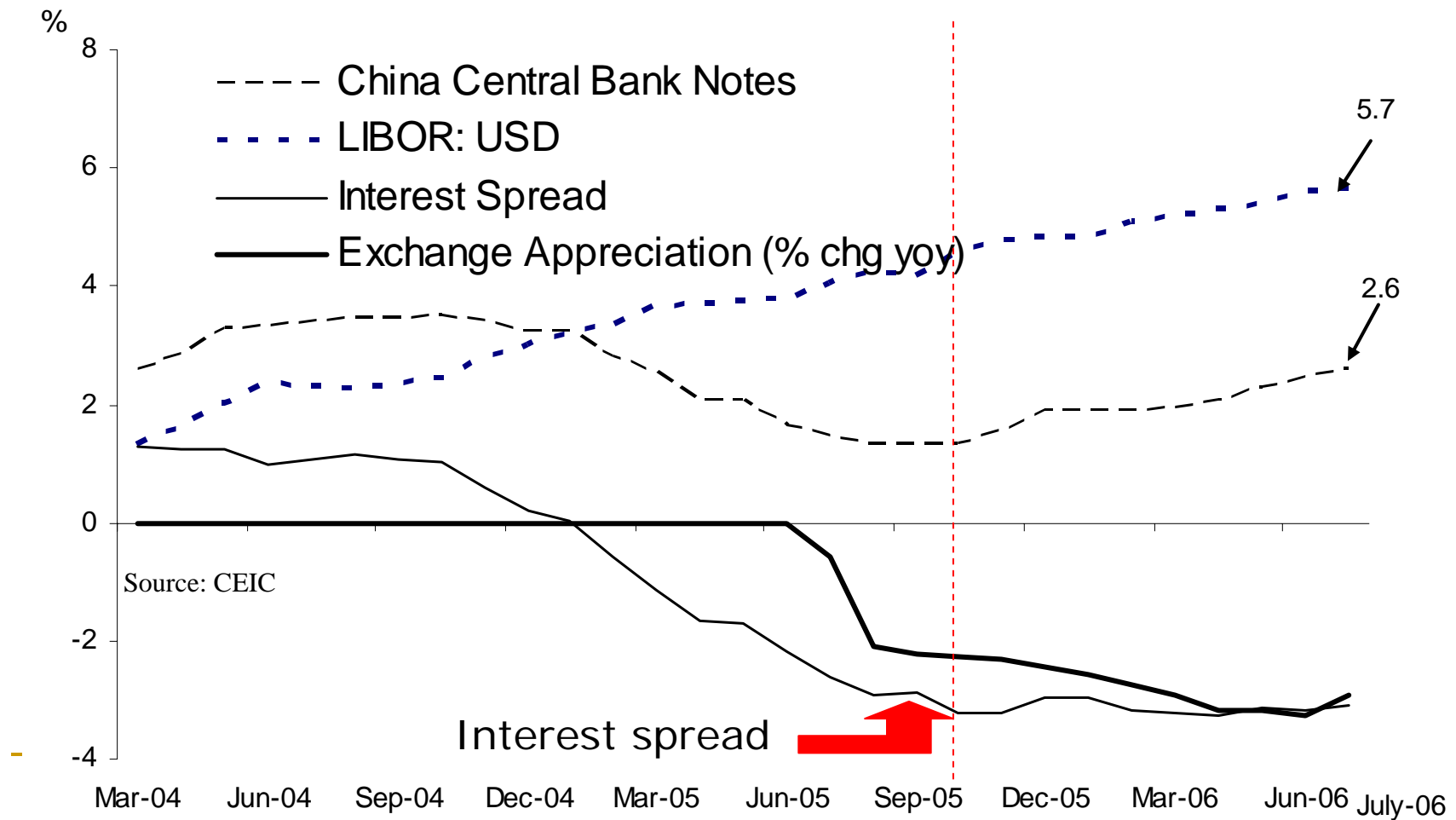
- RMB should be revalued to
    - Help to reduce trade surplus , which is more than we need
    - Provide enterprises impetus for upgrading their positions in the value chains
    - Improve terms of trade
    - Reduce trade frictions
  - To share the burden of reducing excess liquidity
  - Illusion should not be given to enterprises so that time will not be wasted and opportunities will not be lost
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# Uncovered interest rate parity?

- Is the benchmark interest rate in China set in such a way that the interest rate differentials between China's benchmark interest rate and USD libor are equal to the exchange rate appreciation target?
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# Interest Rates of China and the United States and Yuan/Dollar Exchange Appreciation, 2004-2006



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# Is there such a rule?

- No and yes
  - Yes, interest rate differentials are important consideration when the PBOC is deciding bench market interest rates.
  - But, there are other considerations. In deciding China's interest rate level, an equally, if not more, important consideration is assets bubble and to a less degree, inflation.
  - Therefore, interest rate policy may pay less attention to speculative capital inflows
  - However, the use of interest rate policy is still constrained by exchange rate consideration. Impossible trinity still applies
-

# Policy mix in the near future

- **Monetary policy may be tightened, dependent on the development of inflation, assets bubble and FAI**
- **More flexibility should be given to the exchange rate within the current exchange rate regime**
- **Cross- border capital flows should be better managed to give more scope for the tightening of monetary policy and RMB appreciation**
- **The reform of the social security system and so on should be speeded up, and governments at all levels should play a more active role to protect the welfare of workers**
- **Price distortion should be further eliminated (preferential treatment to FDI, policies aimed at export promotion, low energy prices and lack protection of environment )**

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# Thank you very much!

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