

# Next Steps for China

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*Why financial sector reform is a crucial element of a long-term growth strategy*

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China's emergence as an economic power and its sheer size have put it firmly at the center of the global economic stage. Its remarkable pace of growth has attracted a lot of attention, with some observers speculating that it could become the world's second-largest economy if this rate of growth were to be sustained for the next two or three decades. Furthermore, in light of China's trade expansion and rapidly rising stock of international reserves, discussions of global current account imbalances invariably put the spotlight on Beijing. At the same time, the possibilities of overheating and excessive investment in China are raising concerns, because a downturn in its growth could reverberate not just domestically but also in the Asian region and beyond.

Indeed, China's recent move to allow for more flexibility of the renminbi's exchange rate (by linking it to a basket of currencies rather than a fixed peg to the U.S. dollar) is seen as a response to both domestic and international pressures. Some observers have dismissed this initial step, which included a small revaluation of the renminbi, as being too modest to make much of a difference to domestic or international imbalances. What is more important, however, is the symbolic as well as economic significance of this step in terms of setting in motion the shift toward greater exchange rate flexibility and the authorities' stated goal of eventual capital account convertibility.

But the exchange rate regime is just one piece of the broader reform agenda. This article provides an assessment of what China needs to do to ensure the durability of its economic expansion by addressing the looming issues of financial sector reform and the need to bolster balanced domestic-led growth.

## **Trade patterns and the reserve buildup**

To gain a better understanding of the implications of China's currency policy and growth strategy, it is helpful to examine the dynamics of China's international trade patterns and rapid reserve accumulation.

Let us begin with a regional perspective. China is becoming increasingly important in the Asian region in terms of both trade and financial flows. It now accounts for about 40 percent of all foreign direct investment (FDI) inflows into emerging market economies in Asia (including FDI flowing between Asian economies). On the flip side, Japan and the emerging market economies of Asia together now account for more than two-thirds of China's FDI inflows. This share remains well over half, even if one excludes a significant share of flows from Hong Kong SAR on the premise that these may represent round-tripping of capital originating from China to take advantage of preferential tax treatment afforded to FDI.

These patterns of intraregional capital flows are tied in to developments on the trade front, where China has become a major processing hub for goods manufactured in other Asian economies and destined for industrial country markets. Indeed, over the period 2000–04, the increase in China’s combined bilateral surpluses with the United States and the European Union was offset to a significant extent by the increase in its trade deficit with other Asian economies (see table).

### Swings and roundabouts

China has a big trade surplus with the United States and the European Union but a large deficit with its Asian neighbors.

**Bilateral trade balances with selected economies** (billions of dollars)

	2000		2004			2000		2004		
	Mainland China				change	China plus Hong Kong SAR				change
United States	30	80				62	110			
European Union	7	35			79	20	49			77
Japan	-2	16			-35	-65	-143			-104
Rest of Asia	-11	-46				-3	-41			
Others	24	33				0	-65			
Total										

Source: CEIC Data Co., Ltd.

Notes: By taking mainland China and Hong Kong SAR together, the second panel includes imports and exports to the mainland that are intermediated through Hong Kong SAR (during 2002–04, about one-fifth of the mainland’s merchandise trade was intermediated through Hong Kong SAR). "Rest of Asia" covers Cambodia, Indonesia, Korea, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Taiwan Province of China, and Vietnam.

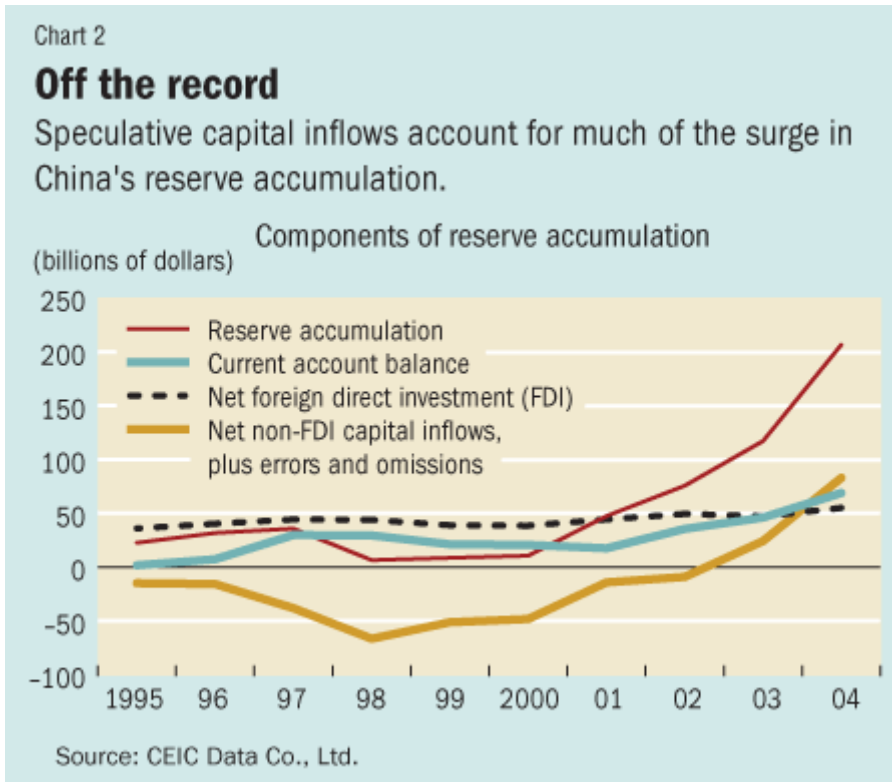
But this is hardly the full picture. China’s current account surplus rose to about \$70 billion in 2004, with the overall trade surplus accounting for the major portion of this increase. During 2001–04, Chinese exports grew at a remarkable rate of about 30 percent on average each year (imports grew at a similar rate, but the level of imports has remained lower than that of exports). While this rapid export growth since 2001 can be attributed partly to China’s low labor costs and accession to the World Trade Organization, there has been a contentious debate about the significance of the role of its currency regime in generating this trade expansion.

From 1995 to July 2005, China’s currency—the renminbi—was effectively maintained at a fixed parity relative to the U.S. dollar and there were indications that, with the decline in the value of the dollar relative to other major currencies over the last 2–3 years, the renminbi had become undervalued. Critics of China’s exchange rate policy have frequently pointed to the

country's rapid reserve accumulation as clear evidence of such currency undervaluation. Its gross international reserves have been on a sharp upward trajectory since 2001, with about three-fourths of the total buildup over the last decade taking place in just the last three years (see Chart 1). As a result, China now has the second largest stock of international reserves in the world (after Japan).



How have different components of the balance of payments contributed to this surge? As Chart 2 shows, current account surpluses and net inflows of FDI have been consistently quite large over the last decade. What is particularly interesting is that, until 2000, these factors were offset by the non-FDI financial account balance plus errors and omissions, the latter being the residual balancing category in the balance of payments that typically captures unrecorded flows in both the current and capital accounts. Since 2001, the sum of errors and omissions and the non-FDI capital account balance has swung around markedly, turning sharply positive in 2003–04. Indeed, this category has been the dominant contributor to the surge in the pace of reserve accumulation since 2001. A likely reason for the turnaround is that it represents large inflows of speculative capital in anticipation of a possible appreciation of the renminbi. Such flows may not enter through official channels since they would otherwise run afoul of capital controls.



This analysis of the forces influencing the recent sharp increase in the pace of reserve accumulation has some important implications. For one, it makes it less obvious that the rapid accumulation of reserves by itself constitutes clear evidence of a substantial undervaluation of the renminbi. Speculative inflows tend to feed on themselves and may sometimes bear little relation to macroeconomic fundamentals. But there are no doubt more fundamental forces putting continued upward pressure on the renminbi, including what appears to be a higher rate of labor productivity growth in China compared to its major trading partners.

### Flexibility reduces risks

As has been evident in recent years, resisting such fundamental forces for currency appreciation by maintaining a fixed exchange rate regime has spurred large capital inflows. Such inflows typically have deleterious consequences by flooding the monetary system with liquidity, which could end up in a misallocation of resources and fuel domestic inflation.

China has been able to counteract some of these domestic pressures by undertaking sterilized intervention—that is, withdrawing from the financial system the liquidity increase that would otherwise result from capital inflows and the associated accumulation of reserves. The explicit costs of such sterilization have been held down simply by requiring the state banks to purchase government (or central bank) bonds at low interest rates that are close to, or below, the rate of return earned on reserve holdings. This approach has been facilitated by the relatively closed capital account and the fact that the banking system is state owned.

Of course, even China cannot escape the basic laws of economics. In truth, the broader costs of sterilization may just not be obvious. For instance, a major part of the costs has been implicitly borne by Chinese households who, for want of other investment opportunities, have left their deposits in the state-owned banking system and earned very low real returns on their savings.

A greater concern engendered by the fixed exchange rate regime had been that, over time, the capital controls would prove increasingly ineffectual as the incentives to evade them became stronger. Maintaining a fixed exchange rate system in the face of the inevitable erosion of capital controls could have posed risks to the financial system, which remains weak in many respects.

Thus, in many ways, moving toward greater exchange rate flexibility will mitigate some of these costs and help foster economic stability in China. But that is hardly the end of the story.

### **Concentration of investment**

A different perspective on the balance of payments is that the current account, in effect, represents the balance between domestic saving and domestic investment. Chinese saving rates are very high, with gross national saving amounting to almost half of GDP—this includes saving by households, the corporate sector, and the government. Perhaps the real question is why the current account surplus is only 5 percent of GDP since even this implies a ratio of investment to GDP that is an astonishing 40–45 percent of GDP, with a substantial fraction of this investment being undertaken by enterprises. Cheap bank credit has played an important role in financing the recent investment boom.

Such high investment rates are, in principle, a boon for a developing economy, since most such economies tend to be labor-rich but capital-poor. Indeed, one could point to China's relatively well-developed infrastructure—much better than in many other economies at a similar stage of development—as a positive effect of such investment. But the disturbing fact is that, in recent years, investment growth has been mostly concentrated in a few sectors such as aluminum, autos, cement, real estate, and steel.

While demand growth has been strong, there is a fear that annual rates of investment growth exceeding 50 percent in some of these sectors—fueled by cheap credit and overoptimistic expectations about future growth in demand—are likely to result in a buildup of excess capacity. Indeed, in some sectors such as autos and steel, there is already some evidence that rising competition and excess capacity are beginning to drive down prices. This could result in an accumulation of new nonperforming loans in the banking system, setting back a good deal of the progress that has been achieved in recent years.

In short, one basic problem in China is that the high degree of thrift that fuels such rapid investment growth has a low payoff because of the fragile threads holding the economic picture together. Providing cheap capital to enterprises, especially state-owned firms, requires low interest rates. Sustaining bank profits then requires correspondingly lower rates

of return on deposits. Thus, maintaining economically unviable state enterprises and supporting them through the banking system results in large implicit costs.

But why does all of this matter if growth remains as robust as it has in recent years? Could not China simply grow out of a lot of its problems? Growth is undoubtedly a wonderful tonic. But there is a potential dark side associated with the fact that a significant portion of this growth in recent years has come from investment, with rising fixed investment becoming the main driver of output growth since 2001 (see Chart 3). A good chunk of this investment is likely to prove unproductive from a long-term perspective. Even building bridges to nowhere can raise output in the short term but is hardly a good use of resources. For it is ultimately consumption rather than investment or even output that is a true measure of economic welfare.



### Squaring the circle

So how does one square the circle? The answer—one that the Chinese authorities themselves recognize as being crucial to China's sustainable long-term growth—is financial sector reform. Whether or not the financial system becomes more efficient at intermediating China's large pool of saving and directing it to the most productive investments will have

major repercussions on long-term growth. Reform of the state-owned banking sector is an essential component of this agenda since banks continue to dominate the financial landscape, with the stock and bond markets still relatively underdeveloped. But development of the broader financial sector cannot be ignored, because this will be essential to provide alternative vehicles for saving and alternative sources of financing for firms and households. This would have the added benefit of promoting banking reforms by exposing state banks to domestic competition.

Progress has already been made in improving the oversight of the banking system. The formation of the China Banking Regulatory Commission in early 2003 and its mandate to improve the supervision and regulation of the banking system have provided a kick-start to banking reforms. Capital injections into three of the major banks have improved their balance sheets and are bringing their capital adequacy ratios in line with international norms. And foreign strategic investors, who are being invited in and have begun taking stakes in the large banks, are expected to bring in technical expertise and inculcate improved corporate governance practices.

But it is difficult to turn around behemoths on a dime. And notwithstanding measures taken to streamline their operations, the large Chinese banks are still massive by any standards—with hundreds of thousands of employees and tens of thousands of branches in far-flung areas. This makes the reform process a logistical challenge. Furthermore, rooting out the legacy of government-directed lending, and training banks to make lending decisions based purely on commercial considerations, with adequate regard to viability and riskiness of projects, remains a major reform challenge. The recent liberalization of lending rates, which will allow banks to price risk appropriately, should improve the commercial orientation of banks' lending practices.

If these reforms were to lead to an increase in interest rates, might it not trigger a reduction in investment and increase saving, thereby adding to China's current account surplus? This is far from obvious. Consider saving first. Providing households with opportunities to use financial markets to smooth consumption could in fact reduce the level of saving for precautionary purposes. It would also allow individuals to borrow against their future income and could thereby spur consumption growth. Saving by enterprises could also decline if they had better access to financing for commercially viable projects and did not have to rely as much on retained earnings.

In any case, wouldn't a decline in investment growth hurt China's long-term growth prospects? Quite the contrary. Reducing China's overall investment growth and directing capital toward more economically efficient uses is in fact essential to help ensure the durability of China's economic expansion. Moving in this manner toward domestic demand-led growth, and tilting domestic demand itself toward consumption-led rather than investment-led growth, would help put China on a more sustainable growth path.

This is where exchange rate flexibility comes in as well. The link is a subtle one. Since most Chinese saving is intermediated through the banking system, a more commercially-oriented banking system would ensure a more efficient allocation of resources in the economy. And

this, in turn, would require that banks respond to market-based measures to control economic activity. The instruments that are typically employed in such circumstances in market economies include the short-term interest rate. In the absence of exchange rate flexibility, however, the independence of monetary policy had been greatly constrained, even if capital controls insulated the monetary system to some extent. This resulted in the monetary authority having to use nonmarket measures such as moral suasion to control credit and investment growth, an outcome that may have had short-term benefits but that vitiated the process of banking reforms. The need to sterilize large waves of capital inflows had also put a heavy burden on the central bank.

While exchange rate flexibility by itself is hardly going to be a panacea, attaining monetary policy independence through greater flexibility will eventually remove an important shackle that has hindered financial sector reforms and restrained other key aspects of the move toward a more market-oriented economy. This will also provide a useful tool to deal with external shocks that China will increasingly become exposed to as it continues its integration with the world economy. Indeed, there is no looking back for China as its trade and financial linkages bind it ever more closely to economies both within and outside the Asian region. China's rising prominence means that there is much at stake in the outcome of its reform efforts, not just for China but also for the Asian region and the world economy.

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