

China Strikingly Similar to 1971 Japan

Summary

The Chinese economy of today is strikingly similar to Japan at the end of its fixed exchange rate system around 1971. The pegging of the Renminbi (RMB) to the US dollar has led to a massive inflow of foreign capital in anticipation of a revaluation of the currency, and this makes monetary policy lose effectiveness. It is inevitable that the floating band of the RMB will be widened, in effect allowing the currency to appreciate. Eliminating the peg to the US dollar will be a positive factor for Japanese exports to China, but there is the risk that the yen will then appreciate against the dollar.

To a large extent, the Japanese economic recovery has been supported by the growth in the Chinese economy. Activity in the manufacturing industry, and in particular, the activity and the increase in investment in the raw materials industry has been realized thanks to the ripple effects of the rapid rise of the Chinese Economy.

In 2003, Japan's total exports to China, Hong Kong and Taiwan increased by 19.8%, and in 2004, they grew another 12.2%. From this increase alone, we calculate that Japan's real gross domestic product (GDP) was boosted by 1.1 percentage points from 2003 to 2004. Moreover, the steadiness in Japan's investment figures are in large part due to the investment in the export industries that have benefited from the activity to Asia, and are increasing their production capacity in Japan.

Increased Trade Friction, particularly between the US and China

The weight of China as a trading partner to Japan has increased. The share of Japan's total exports to China (including Hong Kong) was 19.4% in 2004, while the share of imports from China was 21.1%. From the total amount of imports and exports, China has surpassed the US as Japan's largest trading partner -- a position the US had held since the end of the Second World War.

In the meantime, the trade deficit of the US in 2004 marked a record high of 651.5 billion dollars. Of this, the deficit with China was larger than with any other country for the fifth consecutive year, and accounted for 25% of the total. The second largest deficit was with Japan, accounting for 11.5% of the total.

As China enhances its profile in the world economy, trade friction is also increasing. In particular, that with the US, where the trade deficit is rapidly

ballooning is becoming more and more intense.

From 2003 to 2004, the US had legislated emergency restrictions on textile imports, and an anti-dumping duty on color televisions from China. China's preferential tax system for semi-conductors was brought to the WTO with the charge that the tax violates WTO rules that a nation's tax policies must not discriminate against imports. This issue was resolved as China indicated that this policy would be eliminated.

The increase in trade friction between the US and China is a sign that the US industry is beginning to view Chinese competition as a threat. The RMB exchange rate has been essentially fixed to the US dollar at a rate of 1 US dollar = 8.3 RMB and there is much discussion in the US as well as Japan about a revaluation of the currency.

China's current account has been at a steady surplus since 1994 (Table 1). As foreign companies have been actively expanding into China, direct investment into the country has been marking levels of about 40 to 60 billion dollars every year since 2000. Moreover, with the anticipation that the currency will be revalued, there has been a massive inflow of speculative capital. As a result, China's foreign exchange reserves have risen rapidly and have grown by 206.6 billion dollars in 2004 to reach 609.9 billion at the end of the year. This is 37% of their nominal GDP and twice that of Japan.

Table 1. China's Balance of Payments
(as a share of nominal GDP, %)

Year	Exports of Goods and Services	Imports of Goods and Services	Balance of Trade of Goods and Services	Current Account Balance
1998	25.2	21.2	4.0	3.0
1999	25.3	22.0	3.3	2.7
2000	28.9	26.1	2.8	2.2
2001	27.8	25.2	2.6	2.0
2002	30.6	27.1	3.5	3.4
2003	35.6	32.4	3.2	4.0

Notes:

- 1) Source, IMF
- 2) Figures include Hong Kong

Japan also, around 1971, had a steady current account surplus as the international competitiveness of corporations was enhanced, and trade friction with the US had become more serious. Despite the strictly controlled exchange rate,

there was a massive inflow of capital in anticipation of a yen revaluation, and the foreign exchange reserves ballooned. Even if the economy were overheated, the Bank of Japan was put in the difficult situation of not being able to raise the interest rate as this would invite more capital into Japan.

Japan did not raise interest rates between 1971 and 1973 as their priority was to avoid a revaluation of the currency. As a result, Japan suffered from large-scale inflation. Consumer prices rose by 52% between 1972 and 1975. Though this was due in part to the first oil shock, the effects of the increase in import costs were not that great on domestic prices.

As pressure mounts for the RMB to appreciate, in order for the People's Bank of China (PBOC, China's Central Bank) to maintain the fixed exchange rate with the US dollar, the PBOC must intervene in the foreign exchange market and buy dollars and sell RMB. However, selling the RMB increases their monetary base, and this is tantamount to implementing a monetary easing measure, along the lines of the lowering of interest rates.

Losses on negative spreads, the PBOC's quandary

As the economy is appearing to be overheating lately, the PBOC has been absorbing the monetary base through selling operations of government bonds. This is otherwise known as "sterilized intervention". However, as they have bought huge amounts of dollars through market intervention, the PBOC does not have adequate government bonds for its selling operations, and from 2002 has had to issue short-term securities and sell them to banks in the financial markets. The outstanding amount at the end of fiscal 2004 has risen to 1.1 trillion RMB, and is equivalent to 24% of the foreign reserves held by the PBOC.

This is much the same situation as occurred in 1971 when Japan was faced with a massive capital inflow. The Bank of Japan did not have adequate means to conduct selling operations, and had to absorb excess yen funds by introducing bill-selling operations.

The PBOC is now investing its huge foreign exchange reserves into US government bonds. As the interest rates in the Chinese financial markets are higher than in the US, the PBOC is borrowing at high rates and lending at low rates and thus incurring a loss through negative spreads. There is obviously an inconsistency in this picture of China's central bank – that of a country still developing – to be exporting capital to the US whilst incurring a loss.

Moreover, China's monetary policies are inconsistent in that there cannot be a balance both internally and externally. In terms of the actual economy as it currently stands, the rate of inflation is gradually accelerating, the investment boom is expanding, and a hike in interest rates is called for. However, increasing interest rates means that there will be stronger pressure for capital to flow into the country.

Thus, interest rate hikes have been kept at a minimum, and to restrain investment, administrative measures such as restrictions on land use, and reinforcing credit rationing are being implemented.

However, this results in a reduction of both effective and non-effective investment, and thus creates a distortion in resource allocation. Moreover, as RMB funds are acquired without credit rationing, we have even seen the case where unnecessary direct investment from abroad was brought in. In addition, restrictions in land use will enhance the distortion in resource allocation when the restrictions are lifted, as excessive investment may occur, and there will be rush investment if there is anticipation that the restrictions could be implemented again.

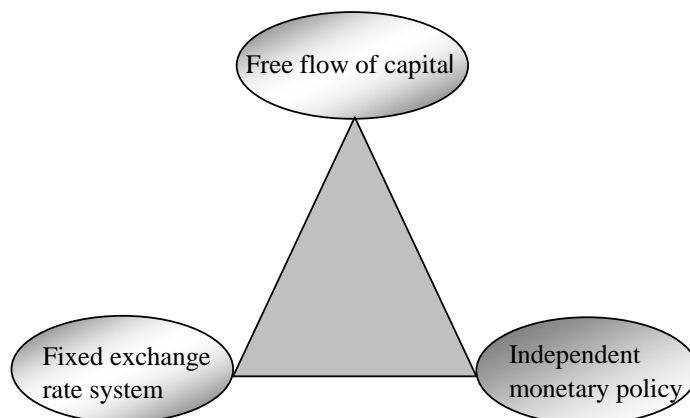
Fixed exchange rate curbs effectiveness of monetary policy

From the perspective of managing the monetary policy, the Chinese should maintain the real interest rate at a positive level so that interest rates can function to allocate resources. However, as they are required to maintain the fixed exchange rate system, they are not in a position to use monetary policy effectively.

Economist Robert Mundell in his works about international monetary policy, proposes an “impossible trinity” (Figure 1) that states that a country cannot have all three of the following: 1) a fixed exchange rate, 2) free capital movement, and 3) an independent monetary policy. If 1) and 2) are achieved, a massive movement of capital can occur, and the country is not able to independently control interest rates.

China has pegged the RMB to the US dollar, and has an independent monetary policy. However, they have strict restrictions on the flow of international capital. Yet, as the economy develops, the effectiveness of foreign exchange controls will become diminished. The reason that large amounts of capital flowed into Japan in 1971 despite the controls on foreign exchange, is that corporations and financial institutions’ activities became more “international”. Foreign subsidiaries and branches of Japanese companies procured funding from abroad and sent these funds back to Head Office. The situation in China is very similar to this one.

Figure 1. Robert Mundell's Impossible Trinity
Only two of the three can be achieved at any given time



If the flow of capital is liberalized, then either the fixed exchange rate system or monetary policy must be abandoned. An economy as large as China's cannot afford not to have an independent monetary policy, and so they have no other choice but to allow more flexibility into the foreign exchange market.

If they choose to maintain the fixed exchange rate system but have small, frequent revaluations, then they risk heightening anticipation of a future revaluation and create a huge capital inflow. The currency policy that China can take at this moment would entail their pegging the RMB against a currency basket of US dollars and Euros, weighted by their shares of trade, and then establish a wide band – of about 10-15% -- in which it could float.

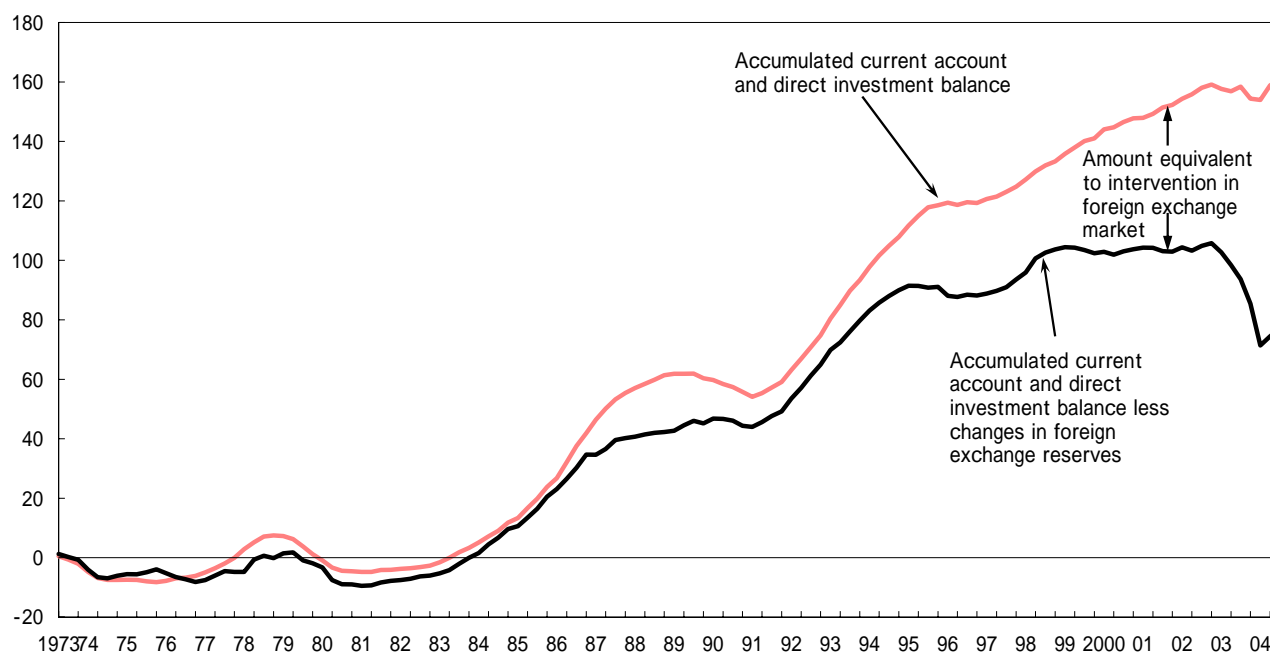
If the RMB were revalued, then this would be a positive factor for the competitiveness of Japan to China. However, as a result, there will be pressure for the yen to appreciate against the dollar. This is because revaluating the Chinese currency would have the effect of expanding Japan's current account surplus.

In fiscal 2003, the monetary authorities in Japan intervened in the foreign exchange market and sold 33 trillion yen for dollars in fiscal 2003. This was a much larger amount than the current account surplus of that year (of 17 trillion yen), and was equivalent to 6.5% of the nominal GDP. We can see that the government was keeping the yen at a relatively low level to help maintain the economic recovery, and trying to pull the economy out of deflation.

In fiscal 2003, the yen began at 119 yen to the dollar and by March 2004, it had appreciated to 103 yen. The massive intervention was not able to halt the appreciation of the yen, although it is thought that it was effective in preventing a

further appreciation of the yen. In theory, the fluctuation in the exchange rate should be explained by the sum of the accumulated current account balance and the accumulated direct investment balance, the change in the foreign exchange reserves (equivalent to the intervention into the foreign exchange market), and the real interest rate differential. From January 2003 to March 2004, the foreign exchange reserves increased by about 330 billion dollars and as this reduces the accumulated balances by that same amount, we believe that the intervention had the effect of keeping the yen rate down by 20% (Figure 2, Table 2).

Figure 2. Japan's accumulated current account and direct investment balance, and foreign exchange reserves.
 (Accumulated balances divided by nominal GDPs of 7 major countries, indexed, and on a quarterly basis.)



Source: "Balance of Payments Monthly", Bank of Japan, other

Table 2. Effects on Real Exchange Rates of Real Interest Rate Differentials, and Accumulated Current Account and Direct Investment Balances

	1% real interest rate differential	10 billion dollar surplus for Japan
April-June of 1973	1.25	10.90
April-June of 2004	1.70	0.63

Note: Yen selling-dollar buying market intervention has the same effect as reducing Japan's current account surplus.

At the time, fiscal and monetary policies were ineffectual, and the massive intervention by Japan to sustain the economic recovery was considered the only alternative, even by overseas authorities that gave their tacit approval. However, the deflation situation improved after 2003 when Japan achieved a relatively high rate of real economic growth and the GDP deflator – an indicator that shows the comprehensive domestic prices – fell by only 0.3% over the previous year in the October-December quarter of 2004. Thus, with Japan's current economic situation, a massive intervention similar to that in fiscal 2003 would very likely be met with more resistance internationally.

If the RMB peg to the US dollar is eliminated, then even if the does rise against the dollar, a massive intervention will not likely be possible. Japan must be cognizant of the fact that the way China's manages its foreign exchange rate will have grave effects of Japan's economic policies as well.