Zhou Xiaochuan: Remarks on China's trade balance and exchange rate

Summary of remarks by Mr Zhou Xiaochuan, Governor of the People's Bank of China, on issues related to China's trade balance and exchange rate, at the China Development Forum sponsored by the Development Research Center of the State Council, Beijing, 20 March 2006.

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Analysis of China's trade surplus

1. The process of globalization, cross-border outsourcing and restructuring of supply chains has been accelerating in recent years, supported by IT revolutionary progress and the improvement of infrastructures. It now becomes possible to outsource those activities which would be difficult to outsource to foreign countries in the past.

2. There is a time lag in changing the layout of competitive advantages. Some labor-intensive production activities and services are usually outsourced to developing nations like China and India, while it will take a certain period of time before the developed countries (where the production cost is high) could create new jobs and develop new export advantages. Trade imbalance could expand during such a period of time lag.

3. FDI (particularly, of MNCs) has been playing a dominant role in cross-border outsourcing into China and in changing the landscape of trade balance. China has grown into a re-export processing center mainly by foreign-funded enterprises, with the supply chains increasingly expanded and value-added steadily enlarged. Exchange rate elasticity of such production and trade is fairly small.

4. From 1998 to 2004, China's foreign trade was relatively kept in balance, with the annual trade surplus averaged between US$20 billion and US$30 billion. However, trade surplus suddenly escalated to US$100 billion in 2005, which could be mainly attributed to the slower growth of import in contrast to the steady growth of export (in 2005, export registered a growth of 28.4 percent while import increased by 17.6 percent). The slower growth of import was mainly caused by the declining import growth of equipments, a factor related to the structural adjustment of the Chinese economy.

5. FDI (particularly, of the MNCs) has drastically increased their production and sales in China, substituting China's imports. There are numerous foreign branded or foreign-designed products sold in the Chinese market, but a large part of these products have actually been produced by the FDI companies in China.

China's exchange rate regime reform

6. China conducted a successful reform of the RMB exchange rate regime on July 21, 2005, which has won objective and positive responses from the international community.

7. The policy analysis and forecasts conducted before the reform has produced different views about the reform impact, therefore, we need some time to observe and collect data to assess and confirm the impact of the exchange rate reform on the domestic economy and employment etc.

8. Six months after the reform, most of the Chinese enterprises have adapted smoothly to the reform after undertaking painful restructuring, however a few sectors suffered severely from the exchange rate adjustment. On such a count, we may conclude that the market force could be allowed gradually to play a greater role in the floating exchange rate.

9. Over the past eight months, great efforts have been made by China to cultivate and develop foreign exchange markets. Trading products were enriched in the market, risk hedging instruments like forward and swap were developed, market makers and OTC transactions were introduced in the inter-bank foreign exchange market. The Chinese enterprises and financial institutions need some time to learn and adapt to the changes in foreign exchange market, so that they could be in a better position to keep in line with the flotation of exchange rate.

10. Over the past eight months, China has decontrolled some unnecessary foreign exchange restrictions. Actions taken in this respect included relaxation of controls imposed on foreign exchange retained and use of foreign exchange under capital account by the enterprises, facilitation of foreign

exchange use by individuals under current account, and the exercise of applying comprehensive management of foreign exchange positions held by the banks. Through these efforts, the foreign exchange market will more objectively reflect the relationship between supply and demand of foreign exchange.

Gradualist approach or shock therapy?

11. Due to the accelerating development of globalization, cross-border outsourcing and adjustment of supply chains as mentioned before, it is likely that it will take several years before the global trade could reach a new equilibrium. China as a large developing economy with heavy employment pressures and a still fragile financial system, could only adopt a gradualist approach to adjust its economy in a controllable manner.

12. The IMF has recently held a conference to discuss the global imbalances, and most of the participants believed that it was appropriate to pursue a gradual adjustment, and radical measures could result in unanticipated consequences. Besides, some participants suggested that the US has been too slow in making an internal adjustment.

13. Some advisors have prescribed the "shock therapy" to Russia and Eastern European countries, but later on this was described as "shock with no therapy". We should be cautious to offer the same prescription again, so as not to have credibility jeopardized. China will only consider to take the gradualist reform approach that wins the trust of the masses of the Chinese people, rather than a "shock", not to mention that the US has not taken the lead to use "shock" to adjust its imbalances.

Global imbalances and the role of exchange rate

14. The Chinese government has already started to apply a mix of policy measures, including expanding domestic demand, lowering down saving rate, opening up the market, floating the exchange rate and increasing import, so as to improve the balance of payments. With the implementation of these policy measures, the PBC anticipates that it needs a time span of 2-3 years to achieve an approximate trade balance. However, what is worrisome is that, according to the analysis by the Chinese economists, even China basically realized a global trade balance, the United States might still incur large trade deficits and it would still be very difficult to achieve a bilateral trade balance between China and the US. So the ball would be actually not in China's court.

15. The US and China should make joint efforts to address the trade imbalance between the two countries. When the Chinese government has been making an efforts as mentioned above trying to relieve the problem, complaints are also heard that the US has been slow in taking concrete measures to reduce its twin deficits and improve saving rate.

16. Some US economists assume that the exchange rate is the key to fixing the trade imbalance, while on the Chinese side there are economists from different schools and some also tend to believe in this assumption. However, such assumption failed in statistical test by using the trade data and real effective exchange rate recorded in China over the years. Besides, empirical knowledge about many other countries also does not support such a judgment. Therefore, we should be cautious to rely solely and excessively on exchange rate function to realize current account balance.

17. According to the Articles of Agreement of the IMF, "member countries shall have the right to choose exchange rate regime, either free floating, managed floating or fixed exchange rate, at their own discretion". In this sense, there exists no such an exchange rate regime that can be labeled as "manipulating exchange rate". China's gradual shift from a relatively fixed arrangement to an exchange rate regime with greater flexibility in line with the needs of economic reform and opening up has won extensive support from the world community, and those criticisms wrongly accused this action as "manipulating exchange rate" will not be widely accepted.

18. China's trade balance should be assessed within a time framework of a number of years, not of a single year. And relevant statistics do not support the view that China gains trade advantages from the exchange rate. Japan has recorded large trade surplus continuously for many years, and yet the notion that Yen exchange rate has been manipulated is not accepted.

The duality between savings gap and trade imbalances

19. Savings gap equals to the difference between savings and investment, and trade imbalance equals to the difference between export and import. Macroeconomics describes the duality relationship between them. Excess savings will result in trade surplus, and vice versa. Therefore, it is important to view the problem of trade imbalance from the perspective of savings.

20. There are many different reasons behind the high saving rate in China. Some of them are related to the economic transition process while others are more associated with the social, cultural and traditional characteristics. Besides, the crowding out effect of FDI on domestic investment is likely to further increase excess savings in China.

21. The Chinese government now works on a broader perspective as well as more policy initiatives and strategies consistent with the national condition to expand internal demand, particularly the consumption demand. It also needs a certain period of time to realize such an adjustment.

22. The high saving rate and large stock of foreign reserves in Asia are related to the Asian financial crisis. Many Asians complained some hedge funds from the US during the crisis, and were also disappointed with the insufficient role and slow policy responses of the IMF to the crisis. These factors have made countries and households in Asia to rely more on their own to prevent risks.

23. Saving rate in the US has gone to the other extreme. Both the US and China need to make efforts to level their domestic demand and saving rate, otherwise, it would be difficult to resolve the trade imbalance. We are of the view that a certain priority should be given to orchestrated structural adjustments, and the function of exchange rate should not be too much expected.

Foreign exchange reserves

24. After the exchange rate regime reform on July 21, 2005, there will be a time lag before the reform could have an expected impact on the development of current account balance and FDI in China, and the speculative factors are also unlikely to leave right away. Under the managed floating exchange rate regime, the PBC will gradually reduce its managing role in the foreign exchange market in line with the situation, which will lead to a slower growth of the foreign reserves.

25. After the Asian financial crisis, there emerged some new views and discussions with regard to setting a higher level as the rational foreign exchange reserve holding. These developments are also related to the severe shocks experienced and lessons learned by the crisis hit countries.

26. If two comparable countries have different sizes of external debts and different stocks of FDI, their foreign reserves should not be held at the same level. External debts need to be repaid, and FDI entails dividend remittances and they may even withdraw. Besides, some speculative hot money, if existed, could also seize the opportunity to exit at any time. All these factors bear some influences on the quantitative level of foreign reserve holding. If measured by per capita level, China’s foreign reserves are not high.

WTO rules

27. The WTO mechanism has established game rules on a multilateral basis that enable all members to win; it is also a win-win game for China and the US. Although members may dispute regarding some imbalances, it at least gives a room for the differences to be resolved through negotiations. If anybody designs a lose-lose game for US and China, it hurts both countries, and designer himself will be in a dilemma whether the game should go on or not. Thus we have to choose and play a win-win game of free trade and anti-protectionism.