Lucas Papademos: China and the European Union – global economic challenges and policy responses

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the Hamburg Summit: “China meets Europe”, Hamburg, 11 September 2008.

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I. Introduction

Dear Lord Mayor Von Beust, Excellencies, Ladies and Gentlemen,

It is a privilege and pleasure for me to be in Hamburg today to address this distinguished audience on some important and topical policy issues concerning the rapidly growing economic relations between China and Europe. The Free and Hanseatic City of Hamburg provides an ideal stage for addressing these issues. Hamburg’s history as a great port and trading metropolis bears testimony to how openness to commerce and exchange generates growth and prosperity. Still today, Hamburg is the second-largest port in Europe, and ranks ninth in the world. It is thus not surprising that China is Hamburg’s most important and fastest growing trade partner, accounting for more than one third of total shipments. Hamburg is, therefore, one of the most vital points where Europe meets China.

Today, I would like to discuss the economic relations between the European Union and China in the context of the major policy challenges being faced by both our economies in an environment of increasing global interdependence. I will examine, in particular, the role of economic reforms and monetary policy in addressing the challenges stemming from the marked slowdown in global economic growth and the persistently high inflation, and will assess their effects for the China-EU economic relationship. Let me start with a brief review of key features of the bilateral trade between the EU and China and related policy issues.

II. The trade dimension of the China-EU economic relationship

Trade between the 27 members of the European Union and China has expanded at an impressive pace, especially since China joined the World Trade Organisation (WTO) at the end of 2001. China has indeed become the second largest trading partner of the EU since 2005, while it was ranking fourth in 1999. From China’s perspective, the relative importance of the EU in total trade has grown even more impressively: the EU is now the first trading partner of China, having overtaken both the United States and Japan since 2005. Increasing trade with China has clearly implied major benefits for Europe. Our economy has benefited, at least over a certain period of time, from the favourable impact on inflation resulting through various channels from the lower cost of imported manufactured and intermediate goods. Moreover, increased competition has provided a further stimulus for the introduction of structural reforms to enhance the efficiency and flexibility of the European economy.

So, why do we Europeans occasionally express concern about the expanding trade and, more generally, the economic ties between the EU and China? I think that there are many bad and some good reasons. The main reason, in my view, is that Europe can not yet reap the full potential benefits of free trade owing to certain “asymmetries” characterising the EU-China trade relationship. Let me first illustrate this with some figures. While China is the EU’s main import partner, it is only its fourth largest export partner. In 2007, the value of EU imports from China was 231 billion euro, almost four times higher than the imports from Japan. The EU’s exports to China amounted to almost 72 billion euro, that is, less than one third of the imports from China. The EU currently exports more to Switzerland, a country with only 7.5 million inhabitants, than to China! As a result of this asymmetry, the EU’s trade deficit with China was 160 billion euro in 2007, accounting for 86% of the EU total trade deficit. To put it differently, the total trade deficit of the EU of 186 billion euro very much reflects the sizeable imbalance in the European-Chinese trade.

There are several explanations for the EU-China trade imbalance. A significant part of it is, of course, the natural outcome of market forces. For instance, the large Chinese trade surpluses in the textiles and IT sectors can be explained by China's competitive advantage and specialisation in labour-intensive production. In addition, due to its increasing role as an "assembling hub", China has become an export platform in Asia, meaning that several goods that were previously exported directly from other Asian countries are now exported from China. At the same time, while Europe has a comparative advantage in the production of high value-added goods, such as pharmaceuticals and machinery, we do not observe significant surpluses in the trade of any of these products.

Why does Europe not export more of the products where it has a comparative advantage to China? And, more generally, what other factors can explain the observed asymmetries in the EU-China economic relationship? One possible explanation is that European firms are not able to successfully export high-tech goods to China due to difficulties in accessing its domestic market. According to the European Commission, non-tariff barriers in China are indeed estimated to result in a loss of European exports estimated at 20 billion euro, or 30% of total trade.[1] Another likely reason relates to the exchange rate between the euro and the Chinese renminbi. While the bilateral exchange rate is only one factor affecting the growing trade deficit, it is difficult to argue that it has had a negligible impact over the years 2002-07: in that period, the Chinese trade surplus with the euro area almost tripled while the Chinese renminbi depreciated *vis-à-vis* the euro by a cumulative 30%. In 2008, however, the renminbi has so far appreciated against the euro by 9.4%, a welcome development for the balancing of our trade relationship.

III. Global economic challenges, structural reforms and monetary policy responses

More generally, the observed "asymmetries" characterising the EU-China economic relationship reflect to a large extent differences in the structure and functioning of markets in the two areas as well as differences in the economic and monetary policies pursued. The latter are partly a consequence of differences in domestic economic circumstances and of differences in the policy responses to the global economic challenges.

At the present juncture, China and Europe face three main common challenges, albeit to varying degrees: first, a marked slowdown of the global economy and a deteriorating economic outlook; second, persistently high inflation over a prolonged period of time, as a result of past increases in oil and food prices as well as of rising underlying domestic inflationary pressures; and, third, continuing tensions in global financial markets that have intensified in recent months.

The magnitude and nature of the economic challenges being faced domestically varies across countries and economic areas. In advanced industrial economies, including the euro area economy, the deceleration of economic growth has turned out to be more marked and abrupt than previously expected. At the same time, the pace of economic activity in many emerging market economies has so far remained relatively strong, although it is moderating. Nevertheless, the further weakening of economic activity in most advanced industrial economies is progressively having spill-over effects, through trade and financial markets, on emerging market economies. The hypothesis of decoupling of the growth performance of advanced and emerging economies is increasingly being tested across the globe. The

1 See European Commission (2007), "Future opportunities and challenges in EU-China trade and investment relations 2006-2010".

notable exception is China which continues to experience robust growth, only moderately lower than the growth of 11.5% recorded in 2007.

To address these multiple challenges, policy instruments must be used in an effective and consistent way. Effectiveness requires to choose the appropriate policy instrument that can materially contribute to the achievement of an objective in a sustained manner. Consistency requires using the available instruments in a way that is mutually reinforcing. The effective and consistent use of policy instruments should produce outcomes that have a durable overall positive impact on economic performance. Let me elaborate on these propositions by examining the appropriate policy responses to the global economic challenges we face in the euro area and in China, and by assessing their effects on the EU-China economic relationship.

Policy responses in the euro area

In the euro area, although the slowdown of the economy is mainly the consequence of the impact of the significant past increases in oil and other commodity prices and of the direct and indirect effects of the ongoing financial turmoil, the growth performance of its economy over the medium and longer run will fundamentally depend on the implementation of further reforms that can raise trend productivity growth, by increasing investment in innovation and education, and raising the utilisation of labour, by enhancing the flexibility and adaptability of labour markets. Such reforms will simultaneously contribute to the moderation of unit labour cost growth and to the more efficient response of both product and labour markets to the adverse shocks buffeting the European economies. As a result, the adjustment of the economy will be facilitated and its shock-absorption capacity strengthened. Moreover, the international competitiveness of the euro area will increase and this will help to reduce some of the asymmetries characterising the China-EU relationship.

The question that some will raise is whether such reforms should or can be implemented during a period of heightened uncertainty and reduced consumer confidence. My answer is that if they are properly designed, adequately explained and effectively introduced, such reforms can also help boost confidence in the performance and prospects of the euro area economy, particularly in some of its member states that have experienced a substantial cumulative erosion of competitiveness over the past years.

Fiscal policy in the euro area can play a stabilising role during the current slowdown automatically, because our tax systems incorporate stronger income-stabilising mechanisms than is the case in other advanced industrial economies. At the same time, budgetary policies for 2009 and beyond should reflect and fully respect existing policy commitments. The implementation of fiscal policies that aim at sound fiscal positions over the medium-term will contribute to containing inflationary pressures and will enhance the functioning of the automatic stabilisers that can mitigate the impact of shocks over the economic cycle.

What is the role of the ECB in addressing the unfavourable combination of persistently high inflation, weakening economic growth and continuing tensions in the financial markets? The objective of the single European monetary policy is unambiguously clear. The overriding goal, in accordance with our mandate, is to preserve price stability over the medium term. The stance of monetary policy must ensure that the high inflation we have been experiencing over a prolonged period of time does not get embedded into medium and longer-term inflation expectations, which should be kept firmly anchored to price stability. Broad-based second-round effects from higher energy and other commodity prices on price and wage-setting should be avoided. In order to address these upside risks to price stability, the Governing Council raised the key ECB interest rates by 25 basis points in early July. We believe that the current monetary policy stance will contribute to achieving our objective. We will continue to monitor very closely all developments in the period ahead and will do what is necessary to preserve price stability in the euro area over the medium term.

At the same time, the ECB will continue to manage liquidity in the interbank money market in order to ensure that the very short-term money market rate remains close to the ECB's main policy rate, as required for the efficient implementation of monetary policy, and to alleviate the persisting pressures in the term money markets, so as to mitigate the impact of the financial turmoil on the banking system and the broader economy. Over the past year, the ECB money market operations have effectively contributed to containing risks to the euro area's financial stability without changing the stance of monetary policy – as defined by the key ECB interest rates – which remained firmly geared towards the price stability objective. Moreover, although the ECB supplied large amounts of liquidity to the banking system to offset or contain the impact of disturbances to the money market, the injection of additional liquidity was temporary. As a result, the overall amount of bank reserves – central bank money– in the economy has not been augmented, but only the intertemporal allocation and the maturity structure of the central bank funds provided has been affected.

Last week, we announced certain changes in the operational risk framework (collateral framework) of the Eurosystem's money market operations. These changes did not alter the key elements of this framework – as they did not affect the range of eligible counterparties or the range of eligible collateral – but they did refine some of the framework's features so as to better contain certain potential risks in the light of changing financial market developments and practices. The changes introduced, which will be effective as of 1 February 2009, aim at striking a balance between preserving the stabilising features of the collateral framework and mitigating risks which could be faced by the Eurosystem in an environment of protracted financial market tensions.

Policy responses in China

Let me now turn to China and focus on two policy issues that are particularly relevant to the global economic challenges we face and to the strengthening of the EU-China economic relationship. A bright spot in the clouded global economic environment is the continuing resilience of China's growth. Indeed, the latest consensus forecasts project very strong GDP growth of 9.9% in 2008 and 9.2% in 2009, only moderately lower than the economic expansion of 11.5% in 2007. The remarkably robust growth outlook of the Chinese economy is however surrounded by uncertainty in the light of the sharp slowdown in most advanced industrial economies and the declining pace of economic activity in a number of emerging market economies.

At the same time, inflation pressures in China intensified in late 2007 and early 2008. Although headline inflation declined in recent months, average annual CPI inflation is forecast[2] to be 6.9% in 2008, about 2 percentage points higher than the average annual inflation rate in the previous year and the inflation target set at the beginning of 2008. Moreover, the rise in underlying inflationary pressure is more visible in nominal wage growth, which according to some estimates was above 18% in the second quarter of this year, after having reached a peak of over 19% in the first quarter. If wage developments are indicative of domestic underlying inflationary pressures, a key issue is how China will contain potentially significant inflation risks which could undermine the sustainability of its extraordinary growth performance. A second important issue is the implication of the combination of fast growth and rising inflation in China for the global inflation prospects, both because of potential effects on the prices of its exports and, especially, because of the large share of the growth in the demand for commodities by China in the growth of total global demand for commodities.[3]

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[2] Consensus forecast for average annual CPI inflation in 2008.

[3] In 2007, it was estimated that the growth in the demand for oil by China accounted for just over 47 % of the increase in total global demand in that year.

These two issues are intimately linked because the sustainability of growth depends on establishing an environment of low inflation, of price stability. Moreover, to "maintain the stability of the value of the currency and thereby promote economic growth" requires the preservation of domestic price level stability. To secure these goals, monetary policy has to be fully geared towards achieving the internal price stability objective, as is the case in the euro area. But to successfully achieve price stability requires allowing for greater exchange rate flexibility, since pegging the exchange rate *vis-à-vis* another currency or a basket or currencies, or tightly managing the exchange rate, effectively limits the room of manoeuvre for monetary policy. These arguments underscore the importance of the steps that have been taken by the Chinese authorities since the exchange rate reform in July 2005: they have formally delinked from the hard peg against the US dollar, allowed an appreciation of the renminbi in effective terms, promoted the development of the local foreign exchange market, and set up a policy framework that has the potential to deliver even greater exchange rate flexibility. As a result of these measures, the renminbi has appreciated by almost 17% in real and around 15% in nominal effective terms. These developments are welcome and should be praised since they contribute to the achievement of external and internal stability. But are these steps sufficient in the light of the global and domestic challenges we all face?

In July 2008, the Chinese authorities have emphasised at the highest political level that the central policy objective is "to maintain steady, comparatively fast growth while fighting inflation".[4] The continued emphasis on fighting inflation is especially significant during this period of still strong underlying inflationary pressure. But as a central banker, I would like to add that to win the battle against inflation in any country requires enhancing the room for manoeuvre for monetary policy and the effectiveness of the monetary policy instruments. This would imply allowing for greater exchange rate flexibility, as the continuing substantial foreign exchange inflows and the persistent current account surpluses of China keep augmenting domestic monetary liquidity and increase the costs of sterilisation operations. Moreover, it would require greater reliance on indirect means of monetary control, notably the use of the interest rates as an instrument to better manage liquidity in the money market and influence aggregate demand more effectively. To this end, structural changes are necessary to enhance the functioning of the interbank money market and, more generally, to promote the development of the financial system. Our colleagues at the People's Bank of China are fully aware of the importance of such reforms and have been taking pertinent measures to strengthen the effectiveness of monetary policy instruments in fighting the battle against inflation.

Two questions are often asked concerning two perceived trade-offs that may be faced by central banks and economic authorities: First, the potential trade-off between fast, sustained growth and inflation, and, second, the potential trade-off between exchange rate stability and internal price stability. These issues have also been debated extensively and intensively in China in recent years. Let me say that the European experience, as well as the evidence from other advanced as well as emerging market economies, clearly demonstrates that there is no stable trade-off between growth and inflation that can be effectively exploited by policy-makers. Containing inflationary pressures and preserving price stability over the medium term is the best contribution that monetary authorities can make to achieving the objective of sustainable growth. The pace of durable growth can only be strengthened through structural reforms that can increase the economy's efficiency and productive potential. On this front, we Europeans have made a lot of progress in recent years, but much more remains to be done.

With regard to the concerns that have been expressed about the potentially adverse effects of currency appreciation on export performance and the pace of economic growth in China, let me point to the lessons of history. It provides rich evidence from many countries which

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[4] Excerpt from the statement of the Chinese Politburo issued at end-July 2008.

adjusted their economy successfully to a stronger currency and became more prosperous as the domestic currency appreciated and internal price stability was secured. Germany's economic history over the past sixty years offers the best example. It demonstrates the benefits associated with the transition from a fixed exchange rate pegged to the US dollar, to a fixed but adjustable exchange rate, to the eventual adoption of a free float of the Deutsche Mark that allowed for greater monetary policy autonomy. This autonomy was essential for pursuing the primary objective of domestic price stability in Germany in the face of external price shocks without hampering – and indeed even helping to strengthen – its overall competitiveness performance over the medium and longer run. But there are also other success stories of achieving price stability without sacrificing competitiveness among emerging market economies, which, notwithstanding significant appreciation of their real effective exchange rates, have experienced stronger non-inflationary growth that was instrumental in securing those countries' competitiveness and keeping up export growth.

IV. Concluding remarks

The world economy is navigating through heavy seas at the moment. Both China and the European Union are confronted with a number of common challenges as well as specific domestic concerns. In order to address these in an effective and consistent manner, *all* available policy tools need to be used in an appropriate way. This requires continued progress in implementing the necessary reforms. I think it is fair to say that we all have our homework to do – though the focus of these efforts naturally differs. In Europe, it means, *inter alia*, focusing on labour and product market reforms, in order to enhance the growth potential of our economies; in China, it means, *inter alia*, reforms in financial markets and the banking sector, in order to improve financial intermediation and monetary control. As I highlighted in my remarks, one of the common challenges that we all face is the high inflationary pressure affecting the global economy. To master this challenge, it is essential to use monetary policy in an effective and determined manner. The global phenomenon of inflation is perceived in many countries or economic areas as the consequence of an "external" shock. This harbours the risk, if this shock is accommodated, that it will result in sustained inflationary pressure with adverse effects for growth in these countries and beyond. Therefore, concerted efforts by monetary authorities worldwide are needed to fight global inflation. Finally, the combination of stability-oriented monetary policies and continued structural reforms would also help to address some of the asymmetries I referred to earlier and thus further strengthen the bilateral economic relations between Europe and China.

Thank you very much for your attention.