Jean Claude-Trichet: The emergence of China in the global economy – a European perspective

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the China-Europe Business Meeting, Frankfurt am Main, 8 November 2007.

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Ladies and gentlemen,

It is with great pleasure that I am here, today, to address this distinguished audience on such an interesting and topical issue such as the emergence of China in the global economy.

"Globalisation" is the catch-word often used to describe the current era, and one of those evocative terms that everybody tends to grasp in quite different ways: some as a threat, others as an opportunity. This also applies to one important ingredient of globalisation, which everyone would probably recognise as its most distinctive feature today: the impressive rise of countries such as China – but also Brazil, Russia, or India – in the world economy. These are only the most prominent economies in a much broader group which the World Bank labelled as "emerging countries" for the first time in 1981.

When focusing on China, however, it would be more appropriate to talk about a "re-emerging" country. Together with India, China was indeed estimated to account for nearly half of world output in 1820, on the verge of the industrial revolution. And after a historic trough in the mid-1970s of around 8% of world GDP, these two countries are now "back on stage", expected as they are to become the world's first and third largest economies by 2050.

The emergence of China and its impact on the global economy have both been well documented. As you all know, this topic has in recent years attracted the attention of public opinion, especially with regard to the economic relations between China and the United States. This relationship – one of the cornerstones of our global economy today – has brought great benefits to both economies and to the world at large, but it has often also been surrounded by no small amount of debate, for instance with regard to the contribution of China to the US current account deficit.

US-China developments have thus far been the focus of much debate, but what has perhaps received less attention is Europe's stake in this whole issue, particularly in the context of the impressive expansion of its economic ties with China over the past few years. A famous London-based economics magazine has recently gone as far as criticising European policy makers for having taken much longer than their American counterparts to "wake up" to the challenge posed by China's rise.[1] I believe that this impression has more to do with the specificities of the institutional setting of Europe than with a lack of awareness and initiative from individual European policy makers.

To be sure, today I will mainly take a European perspective on China. In doing so, I will first deal with two global aspects of the emergence of China that are of particular interest to my institution: its potential impact on (i) inflation dynamics and (ii) the patterns of international capital flows. I will then focus on (iii) the growing economic ties between Europe and China and their implications. Finally, I will conclude by providing a few comments on (iv) the constructive relations of European policy makers, including the European Central Bank (ECB), with our Chinese colleagues, in the broader framework of international policy cooperation.

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1 See "The China trade syndrome" in the Charlemagne section of the Oct 4th issue of The Economist.

1. Two important channels: inflation and capital flows

The growing weight and impact of China on the global economy has become an indisputable fact that no policy maker or business leader can ignore.

China overtook the UK to become the fourth largest economy in the world in 2006 in terms of nominal GDP and is already the second largest economy when measured in PPP terms. According to the latest IMF projections China could overtake Germany in 2008 and become the third largest world economy after the US and Japan.

In terms of contribution to global GDP growth in 2006, China accounted for 11.2% of global real GDP growth in 2006, compared to 14.5% for the US. On the basis of its relative weight in PPP terms it accounted for 31% of global real GDP growth compared to 10.4% for the US.

It will not surprise you if I start by addressing the implications for price stability. Although money and monetary policy ultimately determines inflation, globalisation seems to have embedded some effects on inflation in the short term. This takes the form of a two-sided coin. The doubling, from around 1.5 to 3 billion, of the global labour force after the fall of the Berlin wall – with new workers coming from formerly planned economies in the 1990s and then from population giants such as China – has exerted downward pressure on import prices of manufactured goods and on wage demand in mature economies, also compressing firms' price-cost mark-ups. But there have been other, opposite forces: certain resources, such as oil and minerals, have become relatively scarcer given the increasing demand from emerging economies. Accordingly, this has been a source of upward pressure on headline inflation in the past few years.

For these reasons, measuring the overall short-term impact of emerging countries on inflation remains a challenge. This becomes even more difficult when trying to disentangle the specific effect of China on recent price developments in the euro area. In this regard, what we can, at present, say with a sufficient degree of confidence is that there has been a downward Chinese effect on euro area manufacturing import prices via both the increasing share of Chinese imports in euro area imports – an issue on which I will come back later – and the relatively lower prices of Chinese goods. Based on highly detailed data disaggregated both by sectors and countries over the period 1995-2004, the level of euro area import prices from China and the new EU member states are estimated on average to have been substantially lower than the price of imports from more mature economies. Overall, it is estimated that the increase in import penetration from low-cost countries over this period may have dampened euro area import prices for manufactured goods by an average of approximately 2 percentage points each year, an effect almost equally accounted for by China and the new EU member states.

Most recently, however, a noteworthy feature of the Chinese economy has been a significant upturn in domestic inflationary pressures, with consumer price inflation increasing from 1% in July 2006 to 6.2% in September 2007, largely on account of higher food prices. This has been coupled with some increase in Chinese export prices in recent months. Nonetheless, ongoing and expected developments in domestic prices and costs in Europe and China suggest that potential increases in import prices in the euro area originating from this country remain relatively contained. In particular, the ongoing rise in import shares from China combined with its continuing lower price levels should on the whole continue to put downward pressure on euro area import prices.

A second dimension of particular interest to the ECB concerns the current configuration of international capital flows and its global and domestic implications. A group of less than twenty emerging countries – especially China, but also oil exporters, Russia and a few other economies in Asia – have become, so to speak, the "financiers of the world". They are indeed large net savers with hefty current account surpluses. China's surplus, in particular, has increased very rapidly in recent years, from 1-3% of GDP in the early 2000s to 9.5% in 2006, and is projected by the IMF to reach 11.8% this year. As a result of large current account surpluses in economies such as China, and despite the fact that other emerging countries remain external borrowers, the "Southern hemisphere" of the world is – taken as a whole – financing the "Northern hemisphere". Since a significant number of years, capital is flowing from "poorer" to "richer" economies, especially to the United States.

Aside from "official" capital outflows related to the investment of central bank reserves China is also attracting increasingly large net FDI inflows. In 2006 China became the third largest recipient of FDI in the world and is the largest FDI destination amongst developing countries.[2] Although most FDI flowing into China originates within the Asian region, FDI flowing from Europe has also increased significantly over the last few years. Net inflows of FDI from the EU into China accounted for € 5.3 billion in 2005 up from € 2.9 billion in 2003.

Among many others, one facet of this surprising development has to do with the still incomplete nature of globalisation, which has progressed more rapidly in the real economic than in the financial sphere for emerging countries. A sound and deep financial system cannot be created overnight, and most emerging countries still have underdeveloped domestic financial systems, for instance in terms of low liquidity, insufficient supply of local safe financial assets, and borrowing constraints on the investment and the consumer spending side. China is no exception in this respect, and may currently be confronted with significant domestic financial challenges. This has contributed, among several other factors, not only to higher savings rates in China, but also to a sizeable re-channelling of Chinese net savings into financial investments abroad.

Interestingly, however, in the case of China – given its exchange rate policy and capital account restrictions – this process has almost exclusively taken the form of accumulation of official cross-border assets via reserve accumulation and, from end-September this year, the establishment of a sovereign wealth fund, China's Investment Company. The Chinese balance of payments has indeed been experiencing not only a strong trade surplus, but also net private capital inflows, including inward foreign direct investment and – most recently in 2007 – portfolio inflows.

The ensuing "twin" current and capital account surpluses have produced a strong upward exchange rate pressure in the economy and, as a result, the People's Bank of China (PBC) has continued to intervene massively in the foreign exchange market. At the end of July, foreign exchange reserves were equal to around US$1.4 trillion, or more than 45% of GDP. Reserve accumulation, amounting to about US$1 billion per working day in 2006, has more than doubled to above US$2 billion per working day in the first seven months of 2007.

It is well known that reserve accumulation, although partly sterilised, is one of the drivers of excess liquidity and credit growth in the Chinese economy. In this context, I took note with interest that that Premier Wen, Governor Zhou, and numerous other Chinese authorities, have repeatedly cited the fast growing trade surplus and excess liquidity and investment growth as some of the key domestic imbalances that the country needs to resolve in order to achieve a more sustainable growth pattern.[3]

2. Trade relations between Europe and China

Trade between the European Union (EU) and China has expanded at an impressive pace, particularly after China joined the World Trade Organisation (WTO) at the end of 2001. According to Eurostat, in 2005 China became the second largest trading partner of the EU, having moved up from the fourth place in 1999. And last year China displaced the United States as the largest source of EU imports. In 2006 China accounted for 14.2% of total EU

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[2] See 2006 World Investment Report by the UN Conference on Trade and Development.

[3] See, for example, the speech by Premier Wen Jiabao to the Davos World Economic Forum on 7 September 2007.

imports and 5.4% of total EU exports. As regards the euro area, in 2006 China accounted for 10.3% of euro area imports and 3.9% of our exports.

From China's perspective, the weight of the EU in its total trade has grown even more impressively. According to Chinese statistics, the EU is now the first trading partner of China, after overtaking both the United States and Japan in 2005. The EU accounted for 19.2% of China's total exports (the US for 21.5%) and 12.8% of its total imports (the US for 8.4%).The dramatic growth in the headline trade figures conceals a large divergence in the growth rates of EU imports from and exports to China. Whereas the EU enjoyed a trade surplus with China at the beginning of the 1980s, trade relations are now characterised by a sizeable and widening EU deficit vis-à-vis this partner country: approximately €128 billion in 2006, up from €55 billion in 2002. This represents the largest bilateral trade deficit of the EU.

One frequently mentioned aspect of the EU-China trade relationship is that the distribution of total EU exports to China across individual EU member states is much more concentrated than the distribution of EU imports from China. This reflects various factors, including the fact that China's investment-led growth pattern has thus far offered relatively better export opportunities for those European economies that have specialised in the production of capital goods.

Some analysts have argued that this unequal distribution of the "export benefits" – as opposed to what they define, wrongly in my opinion, as "import costs" – of expanding trade with China explains why it has been relatively more difficult for Europeans than for Americans to agree on whether China on the whole constitutes an economic "opportunity" or, rather, a "threat".[4]

I strongly disagree with this point of view, and would like to explain why.

Rapidly rising imports of low-cost consumer goods from China is nothing to be necessarily afraid of, since it can bring important benefits to European consumers as well as to the economy at large. Access to lower-priced goods boosts the purchasing power of consumers and, as mentioned, the broader economy can potentially also benefit from lower underlying inflationary pressures.

If one looks at the product structure of EU trade with China, it becomes also clear that much of it reflects the relative comparative advantages of these two economies. Indeed, most of the rise in the trade deficit of the EU with China is explained by our imports of: (i) Information Communication Technology (ICT) products (33% of total EU imports from China); and (ii) textiles and clothing (13.2%). China is indeed the main source of EU imports for these two types of goods.[5]

China is, at the same time, the main world exporter of these two categories of goods. In both cases this reflects the trend for global corporations to re-locate the production of such goods to China in order to take advantage of lower labour costs. Even in the case of so-called "high-tech" goods like ICT, China's role is still, to a significant extent, confined to the labour intensive assembly of electronic components which it imports.[6]

Interestingly, the EU has a trade surplus with China when it comes to goods like power and non-electrical machinery, as well as transport equipment. China is our second most important external market for these two categories of goods, which account for 43% of the

[4] See again "The China trade syndrome" in the Charlemagne section of the Oct 4th issue of The Economist.

[5] EU trade data are taken from Eurostat, based on SITC product classification.

[6] See, for example, the 2006 OECD report "OECD Information Technology Outlook".

total EU exports to China. This reflects the comparative advantage of Europe in the production of more capital-intensive goods.[7]

We should not ignore the competitive challenge faced by those European manufacturers and workers whose business remains tied to the production of those goods that make up the bulk of our imports from China. Still, it should be noted that a number of them are well placed to gradually overcome the challenge from China by relying increasingly on some of Europe's own comparative advantages, such as innovation, skilled labour, technology, and the ability to produce high-quality products attached to brand names with a reputation for excellence.

Of course, while greater competition from China is welcome, this must be "fair" competition and in line with WTO rules. As a general rule, producers should never be placed at an unfair disadvantage with respect to exporters receiving direct or indirect public subsidies or engaging in dumping behaviour.

An undervalued exchange rate can also pose a negative externality to producers in other countries. Indeed, the widening of the euro area's trade deficit with China, which gained particular momentum after 2003, has paralleled a steady depreciation of the renminbi against the euro. Even after China reformed its exchange rate regime in July 2005, the euro has continued to appreciate against the renminbi. Although the renminbi has since 2005 appreciated by around 10-11% against the US dollar and the Japanese yen, it has depreciated continuously against the euro, loosing about 8% of its value against the single currency. Over the same period, China's trade surplus vis-à-vis the euro area has grown by more than 20%.

3. Concluding remarks

The ECB has always maintained an open and constructive dialogue with the Chinese authorities, particularly with our direct counterpart, the People's Bank of China and its chairman, Governor Zhou. A key ingredient in this fruitful co-operation has always been mutual exchange of information on, and understanding of, the economic challenges our economies are confronted with.

Regular, frequent contacts with high level officials from the PBC and the Chinese Ministry of Finance at bilateral or multilateral level – including in the occasion of the Global economy meetings of central bank governors in Basel as well as the active participation in the annual EU-China macroeconomic and financial dialogue co-organised by the European Commission – have helped the ECB to become increasingly aware of the many challenges faced by the Chinese authorities as they seek to transform their country into a modern, market-based economy. I personally have learned a great deal about China through these exchanges, and profess great admiration for the remarkable achievements made by China in its drive to modernise the economy.

Having outperformed all expectations in terms of real economic growth performance, the Chinese authorities are now rightly focussing their efforts on achieving a more balanced and sustainable pattern of domestic growth, which would also provide one important contribution to the smooth resolution of global imbalances. The Chinese authorities have recently spelled out their domestic policy plans also at a multilateral policy level, for instance, in the framework of the recent multilateral consultations convened by the International Monetary Fund (IMF): "(…) boosting domestic demand, particularly consumer demand, and rebalancing investment and consumption; (…) further promoting balanced external sector

[7] EU trade data from Eurostat based on SITC product classification.

development; (…) speeding up financial reform; and (…) further improving the exchange regime (…) in a gradual and controllable manner".[8]

Further improving the exchange rate regime is, therefore, first and foremost in China's own best interest, as repeatedly emphasised by Chinese authorities on many other occasions. On 21 July 2005 the ECB was indeed amongst the first in the world to welcome through a press release China's decision to increase the flexibility of its currency through the adoption of a new exchange rate regime.

More than two years later, I wish to recall the statement I have signed a few weeks ago, on 19 October, in Washington DC together with the other G7 Finance Ministers and Central Bank Governors. We wrote that allowing for "an accelerated appreciation" of China's "effective exchange rate" is an important element China's economic policy strategy, also in view of the "rising current account surplus and domestic inflation" in this country.

As part of the ongoing dialogue of the EU with China, at the end of this month I will travel with Messrs. Juncker and Almunia to Beijing, where we will further discuss macroeconomic issues with our Chinese partners. I am sure that this will provide a good opportunity to identify and share the common interests of the European Union and China.

In conclusion, there is no doubt that the global economy has benefited enormously from the emergence of China and that this new giant has brought new opportunities as well as challenges to Europe. In order for both China and the world economy to continue to reap these benefits, it is essential that China increasingly assumes the global responsibilities that inevitably accompany its growing economic clout.

I thank you for your attention.

[8] Quotation from the IMF's press release No. 07/72 "International and Monetary Financial Committee Reviews Multilateral Consultation" (14 April 2007).