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INTERNATIONAL CURRENCIES AND COMPETITIVENESS

THE RENMINBI

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I shall address three subjects: Chinese economic prospects; the revaluation of the renminbi; and the future of Japan-China relations.

The Future of the Chinese Economy

The Chinese economy is still booming. The development and the transformation of the Chinese economy over the last decade are truly phenomenal. Humankind has seldom seen the like of it.

In my view, the strengths of the Chinese economy can be traced to four factors. First, China has 1.3 billion people in a unified nation state under effective control by the Communist government. There is a broad-based aspiration toward development and ascendancy as a nation. Second, China is ruled by a kind of dextrous, developmental dictatorship. The leadership has succeeded in maintaining central control by the Communist Party while unleashing dynamic private entrepreneurship. It has contained social discontent to the minimum by providing a steady improvement of living standards and also a gradual enlargement of social and political freedom. Third, China is a huge centre of production and consumption. It is abundant with highly qualified labor force, and the population has very strong aspirations for material affluence. Fourth, China is enjoying a massive influx of foreign capital, technology and managerial skill. The point here is that these factors are not isolated. They have reinforced each other and generated massive upward momentum.

Needless to say, the Chinese economy has many weaknesses, and none of them is insignificant. I’ll cite four of them. One, the legacy of the centrally planned economy still haunts. The development of the Chinese economy has long been supported by the strong collaboration of state-owned enterprises and state-owned banks. Over time, such collaboration has produced inefficient and unproductive management of many bloated state-owned enterprises and deteriorated the balance sheets of state-owned banks. The Chinese leadership, when Zhu Rongji was prime minister, launched an ambitious reform plan. The progress so far, however, is still far from complete. State-owned enterprises still produce half of GDP and many of them are losing money. The difficulty of streamlining state-owned enterprises is daunting because they provide employment and welfare to tens of millions of people and play a pivotal role in many local economies. Four state-owned banks still hold 80% of total banking assets in the country. The ratio of non-performing loans is close to 20% by official account, which many experts consider underestimated. The government has already injected about 100 billion dollars to bolster their capital base. The job has not been completed though.

The second weakness is the widening gap between rich and poor. The gap is growing within cities and between cities and rural areas. It is true that the bottom level is rising, but the rapidly increasing inequality in the society does indicate a certain distortion in the system. It is interesting to recall that in the early days of capitalism in Western Europe, there was a serious soul-searching in the society trying to establish compatibility between profit-making and ethical conscience. In today’s China, communism has lost its
role as an ideology pursuing egality. Religious sense of social ethics is not familiar to many people in China. Rampant corruption and unbridled greed do highlight the weak spot in Chinese society.

The third weakness is the constraint on high growth: the rapid expansion of the economy is consuming an enormous amount of energy, materials and water, the supply of which is limited. China is already the second largest importer of crude oil, yet 70% of energy generation still depends on coal, a major source of environmental deterioration.

The fourth weakness is the possible conflict between the economic development and the lack of political and social freedom. When living standards are rising steadily from a low level, people do not feel strongly about the lack of freedom. However, when people become able to think about something else, the lack of social and political freedom will attract public attention. The crucial test is if and when Chinese people will be allowed to organize an anti-Communist political party. The leadership is clearly planning to proceed with a very gradual liberalization. We will see if it is a workable scenario. Also, the serious lack of a social security system and a huge reservoir of about 200 million farmers as potential unemployment pose a real challenge.

On top of the medium-term problems I described above there is an immediate and urgent item on the agenda: namely, how to rein in the current investment bubble. In 2003, capital investment increased by 47% over the previous year. The explosion was promptly largely by the change of political leadership in 2002. The new administration had understandable incentive to boost economic growth. Local governments, state-owned enterprises and banks responded eagerly. While consumption increased by less than 10%, there is inevitable accumulation of excess supply capacity, particularly in such sectors as steel, cement, aluminium and automobiles. The price of materials and energy rose while the price of finished products declined. The export drive mounted. Profit margins were squeezed in many corporations. The quality of banking assets also deteriorated. In order to reduce the ratio of non-performing loans, banks have further stepped up lendings. This situation remained unchanged going into 2004. But the leadership, particularly senior technocrats, have come to realize the looming danger and only recently started to undertake cooling measures. However, the political need to maintain high growth is still strong. It has yet to be seen whether the effort to try to shoot two birds with one stone will succeed.

The good news in this regard is that the fiscal situation in China is still considerably better than in most other developed countries. The current fiscal deficit is around 3% of GDP and total public debt is still about 30% of GDP. Thus, China still has some room left with which to patch up the imbalance using fiscal instruments. It is obvious, however, that the time left is not unlimited.

**The Chinese Renminbi**

The renminbi was continuously devalued from 2.8 renminbi per 1 U.S. dollar in the early 1980s until the major devaluation by 33% to 8.7 renminbi in 1994. Since 1997, it has been pegged to the dollar at 8.28 renminbi.

Recently, the view has become widespread that the renminbi is undervalued by around 15-25%. The reasons are as follows: first, Chinese exports are now soaring by 30% more than the previous year; second, although the current-account surplus is shrinking, capital inflow is large and, as a result, foreign-exchange reserves have piled up to almost 500 billion dollars; and third, a 125-billion-dollar trade surplus with the United States under the pegged exchange rate.

If the renminbi is undervalued, what problems will ensue? The immediate problem is naturally trade friction with the United States and East Asian countries, which are suffering from China’s forceful export
drive. Also, the continuous large amount of dollar purchases intervention for renminbi is putting constraints on monetary policy, thereby fuelling the overheating of the economy.

The more serious medium-term problem will probably be the distortion of the industrial structure. When an economy has an undervalued currency for too long, there ought to be a distorted resource allocation concentrating on high growth sectors. That means over-investment, over-borrowing and over-employment in the export-oriented manufacturing sector, creating a condition of oversupply. Indeed, the resource allocation as such will generate high economic growth, but a prolonged undervaluation of the currency will eventually undermine the competitiveness of industry and, when the inevitable adjustment takes place, create a mass of non-performing loans. In other words, the undervaluation needs to be corrected as soon as possible because a delay of the correction raises its cost. I believe the Chinese leadership is smart enough to be aware of the problem and they are seriously groping for a way out. However, it is also true that there are constraints preventing a quick solution.

In practice, there are four ways to achieve the revaluation of the renminbi. The first is to revalue and re-peg at the new level. This kind of revaluation can be done either in a once-and-for-all fashion or via the so-called crawling peg, which means successive revaluations. The second way is to introduce a limited range of fluctuations and the third is to peg the renminbi to a basket of currencies and not to the dollar. The fourth method is to let the renminbi float freely. I’m afraid that at this moment none of the above is practical. In introducing a new exchange-rate regime, China needs to be assured that a new stability will be established and that a collapse of exports and lending banks be avoided. None of the above seems to ensure these two objectives because banks are still too weak and the apparatus of exchange control is not effective. Thus, my hunch is that the leadership will repeat its positive rhetoric about reform, pledging a serious study. At the same time, the leadership will make its best effort to complete the preparatory work as soon as possible, but they will not implement reform until they can feel safe. I guess the timing of reform will be in 2006 at the earliest when China’s WTO commitment on banking liberalization needs to be carried out.

Future of Japan-China Relations

For East Asia in the coming decade or two, the most crucial issue is how to establish a stable and friendly relation between Japan and China. The continued development and prosperity of the region will very much depend on it. Indeed, the recent strengthening of the collaborative economic relationship between two countries is truly remarkable. Japan needs a production centre and an export market in China. China needs Japanese capital, technology and sophisticated manufacturers. The traffic of all kinds of economic components between two countries is really booming already.

However, the problem lies in the future. Already in the field of diplomacy and security China’s presence in Asia is much larger than that of Japan. If, though it is a big if, China continues 7% growth for another 20 years and if Japan settles down to anemic growth and demographic deterioration, China will become the singular leader in Asia, with Japan as an important subordinate. If this happens, it will present an historic challenge for Japan, and Japan will have to adapt to the new environment.

Looking back, we need to recognize that the Japan-China relation is the longest bilateral relation in the history of the world, extending to more than one and a half millennia. Until the 19th century, China was an indispensable teacher for Japan. Japan could create its own original culture only on the basis of the absorption and digestion of Chinese culture. Their relation has been by and large amicable, except the foiled attempt of the Yuan Dynasty under Kublai Khan in the 13th century to invade Japan. However, in the latter half of the 19th century, the total corruption and incompetence of the Qing Dynasty and Japan’s victory in the Sino-Japanese War changed the Japanese attitude toward China. It turned to one of superiority and arrogance that culminated in the devastating 15-year war from 1931 to 1945.
The defeat of Japan in World War II and the phenomenal development of China since the 1980s have greatly confused the Japanese mentality toward China. Many Japanese today are still trapped in ambivalence: namely, a mixture of a superiority complex and an inferiority complex. A similar kind of ambivalence exists in China as well. I would argue strongly that Japan has to re-formulate its mental attitude toward China fundamentally. It is yet unknown whether China will come to share common values with us, namely, the respect of political democracy and individual human rights. It cannot be denied, though, that China today is in an historic phase of national ascent. Japan needs to deal with China with due respect and clear objectivity. In this regard, it will be useful for both Japan and China to study the essential quality of U.S.-Canada, U.S.-U.K., German-Dutch, and German-Franco relations. Obviously, these bilateral relations are quite different from Japan-China relations, yet Japan and China must be able to learn many valuable lessons from these experiences.

The future of Asia is uncertain. Totally different scenarios are possible, but the importance of the Japan-China relation will always be central.

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