

# Newsletter



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## **Chinese economy, the Renminbi, and Japan-China relation<sup>1</sup>**

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### **1. Future of the Chinese economy**

The Chinese economy is still booming. The development and the transformation of the Chinese economy during the last decade are truly phenomenal. Humankind has seldom seen the like of it. In my view, the strength of the Chinese economy can be traced to the following 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 dexterous developmental dictatorship. The leadership has succeeded to maintain central control by the Communist party while unleashing the dynamic private entrepreneurship. It has contained the social discontentment to the minimum by providing a steady improvement of the living standard and 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 a very strong aspiration for material affluence. Fourth, China is enjoying 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 a massive upward momentum.

Needless to say, the Chinese economy has many weaknesses. None of them is insignificant. I will cite four of them. First, the legacy of the centrally-planned economy is still haunting.

The development of the Chinese economy has long been supported by the strong collaboration of state-owned enterprises and state-owned banks. Over time, the collaboration produced inefficient

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<sup>1</sup> This is a text of speech made at Trilateral Commission on May 7<sup>th</sup> and 8<sup>th</sup>, 2004.

and unproductive management of many bloated state-owned enterprises and deteriorated balance sheet of state-owned banks. The Chinese leadership, when Zhu Rongji was the Prime Minister, launched an ambitious reform plan. The progress so far, however, is still far from complete. State-owned enterprises still produce half of the GDP and many of them are losing money. The difficulty of streamlining state-owned enterprises is daunting, because they are providing employment and welfare to tens (hundreds?) of million people and playing a pivotal role in many local economies. Four state-owned banks still hold 80% of the total bank 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 to bolster their capital base. The job has not been completed, though.

The second weakness is in the widening gap between rich and poor in the country. The gap is growing within cities, and between cities and rural areas. It is true that the bottom level is rising. However, the rapidly increasing inequality in the society does indicate the certain distortion in the system. It is interesting to recall that, in 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 the communism has lost its role as an ideology pursuing equality. Religious sense of social ethic is not familiar to many Chinese people. Rampant corruption and unbridled greed do highlight the weak spot in the Chinese society.

The third weakness is the constraints on the high growth. The rapid expansion of the economy is consuming enormous amount of energy, raw 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, which is the 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 the living standard is rising steadily from a low level, people do not feel strongly against 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 on a very gradual liberalization. We will see if it is a workable scenario. Also, the serious lack of social security system and the huge reservoir of 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, i.e., how to rein in the current investment bubble. In 2003 capital investment increased

by 47% over the previous year. The explosion was prompted largely by the change of political leadership in 2002. The new administration had the understandable incentive to boost the economic growth. Local governments, state-owned enterprises and banks responded to it eagerly. While consumption increased by less than 10% there is an inevitable accumulation of excess supply capacity, particularly in such sectors as steel, cement, aluminum and automobile. The price of raw materials and energy rose while the price of finished products declined. Export drive mounted. The profit margin was squeezed in many corporations. The quality of the bank assets deteriorated. In order to reduce the ratio of non-performing loans banks have further stepped up lendings. The situation is still unchanged in 2004. The leadership, particularly the senior technocrats, came to realize the looming danger and recently started to take measures of cooling the risks. However, the political need to maintain a high growth is still strong. It is yet to be seen if the effort to try to shoot two birds with one stone will succeed.

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

## **2 . The Renminbi**

The Renminbi has continuously been devalued from 2.8 Rmb per dollar in the early 80's until the major devaluation by 33% to 8.7 Rmb in 1994. Since 1997 it has been pegged to the dollar at 8.28 Rmb

Recently, the view is widespread arguing that Renminbi is undervalued by around 15-25%. Reasons are; first, Chinese exports are soaring by 30% more than the previous year. Second, although the current account surplus is shrinking, capital inflow is large and as a result the foreign exchange reserves are piling up to almost \$500 billion. Third, there is \$125 billion trade surplus with the US under the pegged exchange rate.

If the Renminbi is undervalued what problems will it cause? The immediate problem is naturally the trade friction with the US and East Asian countries which are suffering from China's forceful export drive. Also, the large amount of the continuous dollar purchase intervention for Renminbi is putting constraints on the monetary policy, thus fuelling the overheating of economy.

Probably, the more serious medium-term problem will be the distortion of its industrial structure. When an economy has undervalued the currency for too long there ought to be a distorted resource

allocation concentrating on high growth sectors. That means the over-investment, over-borrowing and over-employment in the export-oriented manufacturing sector, creating the condition of over-supply. Indeed, the resource allocation as such may generate a high growth of the economy, but the prolonged undervaluation of the currency will eventually undermine the competitiveness of the industry and, when an inevitable adjustment takes place, it will create a bulk of non-performing loans. In other words, undervaluation needs to be corrected as soon as possible because the delay of correction will raise the cost.

I believe the Chinese leadership is smart enough to know the problem and they are seriously groping for the way out. However, it is also true that there are constraints which prevent quick solution. In practice there are four ways to achieve the revaluation of the Renminbi.

- (1) To revalue and repeg at the new level. This type of revaluation can be done either by once-for-all fashion or by the crawling-peg which means successive revaluations
- (2) To introduce a limited range of fluctuation
- (3) To peg the Renminbi to a basket currency, not to the dollar
- (4) To let the Renminbi float freely

I am afraid that at this moment none of the above is practicable. In introducing a new exchange rate regime China needs to be assured that a new stability be established and that a collapse of export and lending banks be avoided. None of the above methods seems to ensure the 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 on the reform by pledging a serious study. At the same time, the leadership will make their best effort to complete the preparatory works as soon as possible. However, they will not implement the actual reform until they can feel safe. I guess the timing of reform will be 2006 at the earliest when the WTO commitment on the banking liberalization needs to be carried out.

### **3 . Future of Japan-China relation**

The most crucial issue for East Asia in the coming decade or two 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 relations between the two countries is truly remarkable. Japan needs production center and export market in China. China needs Japanese capital, technology and sophisticated manufactured products. The traffic of all kinds of economic components between the two countries is booming.

However, problems lie in the future. Already in the field of diplomacy and security, China's presence in Asia is much bigger than that of Japan. If, although it is a big "if", China continues 7% growth for another 20 years, and if Japan is settled down to anemic growth and demographic deterioration, China will become the singular leader in Asia with Japan as an important subordinate. If that happens it will be a historic challenge for Japan, and Japan has to adapt itself to the new environment. Looking back we need to recognize that Japan-China relation is the longest bilateral relation in the history of the world extending to more than one and half millennium. Until the 19<sup>th</sup> century China was the indispensable teacher for Japan. It was only on the basis of absorption and digestion of Chinese culture that Japan could create its own original culture. Their relations have been, by and large, amicable except the foiled attempt of Yuan Dynasty in the 13<sup>th</sup> century to invade Japan. However, in the latter half of the 19<sup>th</sup> century, the total corruption and incompetence of Qing Dynasty and Japan's victory in the Sino-Japanese War changed the Japanese attitude toward China. It turned to be the one of superiority and arrogance which culminated in the devastating 15 year war from 1931 to 1945. The following defeat of Japan in the WWII and the phenomenal development of China since the 1980's have greatly confused the Japanese mentality toward China. Many Japanese today are still trapped in the sense of ambivalence, i.e., mixture of superiority complex and inferiority complex. The similar kind of ambivalence exists in China as well.

I would argue strongly that Japan has to reformulate the mental attitude to China fundamentally. It is yet unknown whether China will come to share the common values with us, especially in the respect of political democracy and individual human right. It cannot be denied, though, that China today is in the 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 qualities of US-Canada, US-UK, German-Dutch, and German-Franco relations. Obviously these bilateral relations are quite different from Japan-China relation, yet Japan and China should be able to learn many valuable lessons from these experiences.

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

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