

China, the G20, and the currency issue

Angelica Wiederhecker, Shanghai

China and Brazil are starting to decouple from the US economy and open up a new cycle of trade and investment between them. Chinese policy-makers must still remain vigilant about bubbles in the country's property and financial markets, but the economy is already beginning to rebalance away from dependence on exports. That in turn should permit agreement between China and the US on international economic policy despite all the talk about "currency wars" — as long as US congressional politics does not get in the way.

These are the views of Li Daokui, one of the most influential economists in China. Li's day job is professor of economics at Tsinghua, one of two elite universities in Beijing. But since the start of the year he has also been a member of the

Monetary Policy Committee of China's central bank, which gives his opinions added authority. With one foot in academia and the other in policy-making, he is very well placed to give insight into how China views the global economy in this period of heightened trade tensions and uncertain recovery.

Progress

Li Daokui spoke to *The Brazilian Economy* shortly after the G20 finance ministers and central bankers met in South Korea in late October and before the full G20 summit in Seoul in mid-November. Although the international press is full of references to a currency war, Li takes a more relaxed view, arguing that the meeting of G20 finance ministers made "good progress" because the debate has shifted from "the surface issue" of nominal exchange rates to the "fundamental issue" which is real rebalancing.

He was referring to the proposal by U.S. Treasury secretary Tim Geithner to push for a commitment by the G20 economies to limit their current account surpluses or deficits to less than 4 per cent of GDP. Several governments, including Brazil, have argued against such a rigid target for current accounts, which they view as largely arbitrary. But Li thinks this is an important step forward because current account deficits and surpluses are at the heart of the problem.

In China policy makers and scholars are more worried about our trade surplus perhaps than many American policy makers. We know it's not healthy. It's not maximizing our own citizens' wealth.

"Now [the G20 is] talking about the substance. The substance is world trade rebalancing. That to me is the fundamental issue, much more fundamental than the nominal exchange rate, and they are now even willing to talk about numerical targets for current accounts," he says.

Such targets are likely to have some support in China, he says. "I think China is well positioned politically and economically to make adjustment numerically. . . . It is no big deal because market forces in China have been pushing the economy to make adjustments in this direction, even if we don't want to .... China should not be afraid of numerical targets for reducing its trade surplus."

He adds, "In China policy makers and scholars are more worried about our trade surplus perhaps than many American policy makers. We know it's not healthy. It's not maximizing our own citizens' wealth. So [the Geithner proposal] is consistent with our targets, with our objectives."

Not only is the proposal addressing the real issue, he says, but it is a way of damping down what he views to be the sterile debate about China's exchange rate. Li is among the academics and officials who have been calling for some time for the

currency to be allowed to appreciate more rapidly, to help rebalance the economy away from exports and to encourage more domestic consumption. But he insists that this has to be done slowly and for domestic reasons.

"A higher nominal exchange rate certainly helps the Chinese economy to make adjustments that we need," Li says. But the "political dynamics are extremely damaging in the long run if pressure from America or other countries turns into higher exchange rates." If China were to appreciate its currency sharply, and yet after six months or a year there was no real impact on the trade surplus, he says, there would be demands for further appreciation. "There is no end to that, right? No policy makers in the world will be happy to see this kind of passivity. You want to do it on your own, you don't want to be pushed around."

Any change in the nominal exchange rate should be modest and gradual because that "is the best way of sending the signal to exporters to force them to make adjustments while giving them a time window of one or two years to either exit the business or upgrade their exports. To me, this is basic economics. You want to do it gradually."

American politicians are already using the exchange rate and China's trade as excuses for their own problems. I worry that after the election, Congress will bring up this issue again.

And even if changes in the nominal exchange rate will be modest, the real exchange rate is appreciating much more rapidly, he reckons — by maybe 10% over the last six months. Not only is inflation higher in China than in the U.S. and many developed economies (China's CPI reached 3.6% in September), but wages are also increasing rapidly. "In terms of real exchange rate appreciation, it has been quite fast," says Li.

Criticisms

In the run-up to the G20 summit, many governments in developing economies complained loudly about loose monetary policy in the US, which they believe is sending a wave of capital inflows into their countries that exacerbates inflationary pressures. Indeed, China has voiced such complaints. "United States issuance of dollars is out of control and international commodity prices are continuing to rise. China is being attacked by imported inflation," Chen Deming, China's Commerce Minister said in late October. "The uncertainties of this are causing firms big problems."

Li takes a different view. He believes the Chinese economy is now large enough that it is much less vulnerable to surges in capital inflows — especially as China still has relatively strict capital controls. "If we have a large pool of water, a big elephant jumping in will not create as much of an impact as it would in a small pool of water," he says. "In these domestic debates I always say, do not blame only the inflow of hot money — managing our

own issues properly is of first importance."

But if he thinks the discussions about rebalancing between Beijing and the Obama administration are starting to move in the right direction, Li says he is very worried about what the U.S. Congress might do: "I am not so confident about American domestic politics. American politicians are already using the exchange rate and China's trade as excuses for their own problems," he says. "I worry that after the election, Congress will bring up this issue again."

He adds, "I think it is possible for the two governments, and also other governments, to have a certain kind of, if not agreement, at least a good understanding. But the problem is that in the U.S., the administration may not have complete say. Maybe the US Congress will pass some legislation. That's the uncertainty. That's what I don't fully understand and I worry about."

Optimism

One reason Li is still optimistic about the outlook for the debate about global imbalances — the US Congress aside — is that he is cautiously upbeat about the way the Chinese economy is shifting its own growth model. For most of the last five years, the Chinese government has been talking about the need to change the balance of the economy from dependence on investment and exports towards domestic consumption. Chinese Premier Wen Jiabao has famously described the economy as "unsteady, unbalanced, uncoordinated, and unsustainable" on several occasions. The release in October of the outline of the country's five-year plan for 2012–2017, which placed great emphasis on boosting consumption, has encouraged some observers that the authorities are going to put their weight fully behind the reforms needed to bring about that much-needed shift.

> The priority in the short term, Li says, is to prevent the huge amount of liquidity in the Chinese economy from creating asset price bubbles, especially in housing

"In the communiqué of the fifth plenary, if you read it very carefully, they use particularly strong words to talk about structural change. The Chinese version says that in the next five years they want to make substantial progress in strategic adjustment of economic structure," Li says.

Many of the reform ideas that are being mooted have been around for some time. They include abandoning the *hukou* system of urban residence permits that prevents tens of millions of migrant workers from settling in the cities where they work and becoming permanent residents and proper consumers. There is plenty of skepticism about whether the current leadership team of President Hu Jintao and Premier Wen Jiabao has the political capital to drive through some of these reforms in their last two years in office. But for Li, the important message from the

new five-year plan is that the top leaders are committed to pushing these ideas in the face of opposition from some local governments.

"The way I read Chinese general policies is that the senior leadership has for several years put significant and decisive political capital behind structural change. There is no question about it," Li says. "What is new perhaps is that they want to send an even clearer signal to local governments. The central government's political intention from the very top is already strong, because these are the people who travel to international conferences; these are the people who feel the international pressure first hand."

Bubbles

The priority in the short term, he says, is to prevent the huge amount of liquidity in the Chinese economy from creating asset price bubbles, especially in housing. An important step in that direction was the decision in October to raise interest rates for the first time in nearly three years, which was designed to "show bank depositors that the authorities are concerned about inflationary expectations and are taking steps to address negative real interest rates." The other important policy action, he said, was in the supply of housing — the government has to follow through on its pledge to significantly expand the stock of public housing that would be made available to low-income families. This would help both to keep prices under control by expanding supply and to reduce the political tensions surrounding high housing prices.

Brazil is one of China's top priorities, especially as in recent years China has come to appreciate the political stability that Brazil now enjoys.

Another reason for Li's optimism about the prospects for the Chinese economy is the rapid expansion in economic ties with other parts of the developing world. Before the financial crisis, there was considerable discussion about whether Asia was decoupling from the developed world — a debate that seemed to disappear when the crisis hit. Now China's rapid recovery since early 2009 has brought new life to the discussion.

"Decoupling has already happened," he says. "For China and the U.S., people said decoupling was impossible before. I said decoupling was going to happen and it did happen. Now the U.S. economy is not doing so well, while China and emerging markets are doing very well — this will further strengthen the trend of decoupling. Within emerging market economies, there are forces that reinforce each other's growth. This has strengthened the decoupling trend."

The key point, Li says, is that these economic links are not just based on trade and Chinese purchases of large volumes of raw materials: they are also now based on substantial flows of investment. "This is a new

development that we need to watch very carefully," he says. "China is now working closely with all these fast-growing emerging market economies. Not only is China importing a lot of raw materials from these countries, it is also finding increasing ways of applying its currency reserves in these countries that need capital. This is not in the form of hot money — China is making real investments, direct investments in infrastructure and manufacturing."

This shift toward the developing world is not an accident, Li says, or a temporary reaction to the crisis, but a realization that China had become too economically linked with the U.S. and Europe. "This is perhaps a counter-force against the previous policies," he says. "Policies in the past two decades have been encouraging investments from the developed countries, technologies from the developed countries. Arguably, this went too far. People have seen the negative impact when developed economies slow down. Now people see that there are dynamic forces in Brazil, why not? I would say this is a natural reaction to the financial crisis."

The two economies are complementary. Brazil has natural resources, needs capital, and you have your own domestic demand. China has extra capital to invest.

Promising partnership

Within this new push to reduce dependence on the U.S., Brazil is one of China's top priorities, especially as in recent years China has come to appreciate the political stability that Brazil now enjoys, where changes of government do not cause abrupt shifts in policy. "What is most exciting to me is that the politics in Brazil, to me, as an observer, are very stable. Chinese policy makers and academics can understand the political dynamics in Brazil better. That gives confidence to Chinese investors. I think people are less worried about protectionist moves in Latin America and, especially in Brazil, we are less concerned about a sudden change of government, a sudden change of regime."

The risk is that Chinese trade and investment creates a backlash in countries like Brazil, he says, and he often advises Chinese companies going abroad to try to avoid this by hiring locally. "I tell them to hire more local people, don't just bring Chinese workers, hire local executives, hire local lawyers, and communicate with local political leaders." But even with the backlash risk, he sees huge potential: "I do see a big future in increased investment in these countries. All the forces are working in the same direction. The two economies are complementary. Brazil has natural resources, needs capital, and you have your own domestic demand. We have extra capital to invest. So why not? This is a good direction to go."