Is the Renminbi Undervalued ?

By Sylvain PLASSCHAERT,

Em. Prof. of the University of Antwerp and the Catholic University of Leuven

Preliminary Version

Whether the Chinese national currency, the Renminbi (RMB), is undervalued has become a hot bone of contention. Already in 2005, a motion was introduced in the US Senate aimed at thwarting the imports from China by a 27.7% surcharge on American imports from China. While subsequently withdrawn, similar but usually less aggressive proposals have been formulated in the USA by lawmakers and opinion leaders, including Nobel prize laureate Paul Krugman, who recently (The New York Times, 31/12/09) advocated an import surcharge, of up to 25%, in order to force China into acquiescing with a substantial appreciation of the RMB. The increasingly politicized dispute has inflamed the official circles in both countries. In academic circles, views clash sometimes bitterly. For example, two other laureates Robert Mundell and Joseph Stiglitz, and Justin Lin, now chief economist of the World Bank, have expressed opposite views to those of Krugman.

Following the wise decision by the American Secretary of the Treasury to delay the regular inquiry about the possible manipulation of the RMB, at the time of this writing (around April, 20, 2010), the tension has abated perceptibly. The recent narrowing in the bilateral trade (and current account) balances, in the wake of the international financial crisis, is a contributing factor thereto, but future evolutions are nowadays uncertain.

Admittedly, the facts that are invoked by those who indict the Chinese authorities of deliberate downward manipulation of their currency cannot be negated--at least not until most recently. Indeed, the deficit of the bilateral trade accounts of the USA with China, (and to a smaller extent, its external current accounts), has grown ominously, whereas the Chinese surpluses have skyrocketed. In 2008, US exports to China, at $72 billion, were dwarfed by China's to the USA, at $296 billion, or only 21% of the imports. In 2009, the trade was still affected by the international recession, and Chinese exports to the USA declined by 12%; the resulting US deficit was still 3.2 times larger than the US exports to China. The EU-27 accounts, as a whole, also incur a substantial external deficit in its relationship with China. In 2008, the exports to China (in 4th rank of overall EU exports, behind the USA, Russia and Switzerland) were only 31% of the EU imports from China (at € 248 billion, by far topping the list of trade partners). Another topic in the debate relates to the rapid build- up of the official foreign exchange ('forex') reserves by China, which now has reached $2,450 billion, the highest in the world.

An appreciation of the Chinese currency vis-à-vis the US dollar and other currencies, and accordingly, the untying of the present peg of the RMB with the US dollar, would, according to the critics, reduce the Chinese trade (and current) account surplus(es) and would contribute to the rebalancing of the present disequilibria in the international economy and payments system. It is also often contended that China should reorient its alleged export- and investment-led growth strategy and strive at enhancing its presently comparatively low macro-economic consumption / GDP ratio.

These claims are now strongly rejected by the Chinese leadership who contend that China's surplus cannot be related only to the exchange rate; and that, even if undervaluation were proven, the recent massive reflationary injection of stimulus funds which the Chinese leadership has swiftly put in place at the unexpected outbreak of the worldwide financial tsunami, has delivered a potent boost to the resumption of growth in the world economy.

The discussion about the appropriate forex rate of the RMB could readily derail in boundless argumentation. Hence, within the time limits of this presentation, I restrict myself to briefly commenting upon a number of features of the Chinese scene, which seriously qualify the impressive data about the gross export trade of China, which lead many to believe that the merchandise with the label 'made in China' has already conquered the large parts of the world markets. Subsequently, I document that the massive foreign exchange reserves which the Chinese Central are not fundamentally deriving from the country's trade surplus. And finally, some comments are made about the saving-consumption imbalances, in the USA and in China, obviously with different signs, and which feed the discussions which circle around the current account imbalances of the countries involved.

In this analysis, I concentrate on the relationship between China and the United States. As a matter of fact, this bilateral relationship appears to be the most strained, and most unbalanced; and amongst the group of large countries, they do display the resp. highest surplus and deficit, in absolute amounts (in 2008). But the analysis attempted here is also largely applicable to the EU-Chinese trade relationship.

1/ A closer look at China’s export statistics

1.1. The exceptional growth of China’s economy

Since 1980, the Chinese economy has staged an impressive and exceptional growth of around 10% per year, in real terms. One should remind that this double-digit benchmark is an average, both in its time and in its space dimensions.

Per capita income growth has also been remarkable as, owing to a stringent birth control policy, the Chinese population is nowadays growing with less than 1% p.a. The per capita income has now reached $3,000, which ranks China already amongst the world’s lower middle-income countries.

Yet, although several industrial sectors in China have already reached a high degree of sophistication – witness the space flights and the announcement that a home-made jumbo jet, with about 165 seats, is slated to enter service in 2016 – China still shows many features of an (albeit rapidly) ‘developing’ country. The huge rural interior sector, where agriculture still performs a pivotal role, attains a much lower income level than the urban populations, and more particularly those in the coastal areas. Although the *de facto* privatization of the cultivation of the agricultural sector - not the ownership pattern - in the early eighties has provided the initial, and a major, push along China’s growth path.

1.2. The record growth of Chinese exports

Another principal engine of growth relates to the spectacular growth of China’s export trade, starting fairly soon in the eighties, but exploding after China joined the WTO in 2002. In 1980, China’s exports totaled only $20 billion. International trade was arranged by a dozen special state companies; anyhow, as was typical for Soviet-type economies, which negated the time-honored principle of ‘international division of labour’, economic intercourse with the outside world was minimized. In 2005, the value of exports reached $760 billion. In 2008, they rose to $1,429 billion, but dived in 2009 to $1,202, or 16% less, on account of the worldwide financial crisis, which curtailed demand for China-made goods. The worldwide recession took a heavy toll in Chinese exports, especially those to the USA and the EU. The trade surplus (exports minus imports) of China vis-à-vis the USA declined from $295 billion to $227 billion. As from the later part of 2009, China’s overall export trade has recovered rather strongly.

This, at first glance, overwhelming performance of China’s export trade must nonetheless be considerably qualified by several highly relevant features of China’s international trade.

1.3. The close link with inward foreign direct investments

A major part of the exports from China are operated by ‘foreign-invested enterprises’. This concept comprises both joint ventures between Chinese and foreign companies, and fully-owned affiliates of foreign enterprises, as well. In other words, the label ‘made in China’ is not synonymous with ‘made by Chinese firms proper’. Within the framework of

Balance of Payments Accounts, it follows that foreign firms also reap benefits from the activities of their affiliates in China. Amongst them, one should mention the dividends that are remitted to the parent companies abroad and the profits reinvested by the affiliates within China (both items are recorded as negative entries for China in the non-trade current accounts, and are corresponding positive entries in, say, the US current accounts). The substantial inflows of foreign direct investments (FDI's) from abroad are sizeable positive items in the 'financial (or capital) account'.

1.4. A digression on the relocation of productive capacity to China

Furthermore, part of the output of FDI projects in China, at various stages of processing, is commercialized abroad. Such goods, made in China, may be marketed in the home country of the multinational firms, where they replace output and destroy jobs in the home country. This can be defined as genuine relocation. The complaint that firms in China are 'stealing', say, production and jobs in the United States, would then be valid, although there are also strong indications that domestic firms, which moved their production to China, or low-wage cost countries (such as the Maquiladora frontier region with Mexico) -- or, what causes the same outcome, subcontract the production of such goods to unaffiliated, so-called "contract manufacturers" in, say, China -- may otherwise not have survived.

When, however, the output by foreign multinationals in China is destined to serve the Chinese internal market, the indictment of harmful relocation is not valid. As a matter of fact, any firm with a competitive product naturally strives at expanding its sales into foreign markets. But quite often, this profitable expansion of sales cannot be achieved from an export platform in the home country, whereas the setup of a production facility in the country of destination itself emerges as the more profitable alternative. The motivations thereto are diverse: prohibitive transport costs or import duties; the prior move by a major customer-firm, to which one supplies components; the need, anyhow, to expand the scale of production, which can then be located more appropriately close to the markets.

The accusation of unfair relocation is particularly unfounded, when the manufacturing of the goods in question has already been stopped at home, as is the case for footwear in the USA. In the case of ladies' underwear, the complaints by American producers in 2003 against imports from China were ironically hollow, as most of their 'production' was outsourced to Honduras, within a USA-Honduras bilateral arrangement (Plasschaert, 2005).

Relocation, in the strict sense, occurs especially as regards labor-intensive end- or intermediate- products, in which China played a prominent role in the early years of its 'opening to the outside world'. Against the direct loss of jobs in the home country, one must consider, that (i) provided, and to the extent that the lower wage, and production costs in China percolate into lower sales prices (at a given quality)in the USA or other home countries, they add to the real incomes of consumers (for final goods) or of further processors (when intermediates are concerned); and that (ii) the American, and other home-country economies, benefit from downward pressure on the overall price level and on inflationary tendencies, with resulting positive effects on investments and growth.

Yet, already in the early days of China's opening gambit, incoming FDI's, were in their majority, aiming at nascent market outlets in China itself, instead of being involved in cheaper production of export-bound goods. Today, with the rapid extension ahead of the enormous potentialities of the Chinese market ahead, this is even more the case.

1.5. The significant role of Hong Kong and of 'overseas Chinese'

However, when looking at inward FDI, one should remind that Hong Kong and Macao are viewed as foreign territory by the PR China, with respect to trade. Both 'special administrative zones' run their own customs and currencies; yet, there are dense, and deepening links between them and China proper. Thus, Hong Kong is the main (immediate) destination of Chinese exports, although much of this export flow only transits through the former British colony on its way to other destinations. Besides, Hong Kong represents by far the largest geographical source of inward FDI into China. A recent tally (March 2010) mentions that, so far, 310,738 Hong Kong enterprises have accounted for 42% of the overall FDI's into China.

It follows that much of the outward trade of China is carried out by entrepreneurs and traders, who belong to the large 'overseas Chinese' community in East Asia. Thus, since the early nineties, the manufacturing of toys has predominantly been relocated from Hong Kong, across the border, to Shenzhen, or other 'special economic zones', where wages were much lower and which welcomed FDI's with favorable incentives.

More recently, and for essentially the same motive of a cheaper labor supply, the manufacturing of electrical appliances and electronic goods has largely been relocated from Taiwan to sites in mainland China, at least in their final stages of the production. This happened even prior to the recent political thaw between the two regimes on both sides of the Taiwan Strait. It follows that, if East Asia were encompassed as a whole, the export record of China would loom less impressive, as part of it results from production that has been shifted to mainland China.

1.6. The upgrading of the technological level

Another noteworthy development is that of the continuous upgrading of the product quality and of the degree of sophistication of China's export assortment. In the initial years of the 'opening to the outside world', China, thanks to its abundant supply of unskilled labor, drawn from the tens of millions of otherwise underemployed people in the rural interior, has fast become a major producer of simple, labor-intensive goods. The Pearl River Delta, stretching from Guangzhou (Canton) to Hong Kong, earned the label of 'the world's industrial workshop'. Over the years, firms in China, confronted with fierce competition and often benefiting from the inflow of FDI's, enhanced their productivity and have been able to muster the production of higher-valued goods.

This rapid climb along the technological ladder has been documented in several studies. Recently, Ma and Van Assche (2010), adopting the 4-level OECD classification of technological prominence, found that the share of low technology (with textiles, apparel and leather as the main subsets) in total exports had fallen from 53% in 1992 to 27% in 2007, whereas the high technology segment (with radio, TV and communications; and office and computing machinery) had jumped from 10% to 31%.

However, we must immediately proceed with the highly relevant remark that international trade statistics assign the geographical origin and the total value of the final product to the country where the last substantial processing has occurred. This is quite often the case with firms in China, to which the assembly of the various parts and components is typically entrusted. This remark is closely linked to the subsequent one about the today's widespread geographical fragmentation of the production sequence.

1.7. The substantial role of ' processing trade'

The customs statistics of China distinguish between 'processing trade' and ordinary, or general trade. In 'processing' trade, components and other intermediates are imported from abroad, prior to further elaboration and finishing. Processing trade accounts for more than half of China's overall exports, although its relative importance now appears to shrink somewhat.

Processing trade partakes in the phenomenon of internationally fragmented production, in which firms from different countries are involved in the production of the end product, exported, say, from China - even abstracting from the activities involved in the further commercialization of such final goods into the hands of the final customer. An iconic, and perhaps extreme example, is that of Apple's video iPod. Researchers at Berkeley University have figured out that out of the iPod, sold at $299 in the American market, $163 are captured by American companies, $132 by part makers in other Asian countries and only $4 by Chinese workers, who are employed at the final assembly stage. [1]

There are frequent complaints from the Chinese side that such fragmentation results in a very modest value added in the Chinese stages of the production process. The complaints relate mainly to the contract manufacturing (which involves only the production, in line with specifications, ordered by their principal, of labor-intensive goods, or components). These sectors have attracted very numerous producers from China or from elsewhere, and are involved in fierce competition, with low profit margins; in recent years, such profits have been further eroded by the appreciation of the RMB in the 2005-08, period, and some upward push in wages, brought about by the Labor Law of June 2007, which has provided some benefits to the labor force, many amongst whom came from the countryside. The recent financial international tsunami, and the related interruption of large orders from American or European firms and supermarkets, has resulted in the loss of 20 million jobs in the coastal areas.

The fragmented manufacturing sequence has expanded rapidly in recent years (consult the successive annual issues of the UNCTAD's Investment Reports). This is especially visible in the East Asian region, where intra-regional trade acts as a major stimulus to the rapid economic integration in that part of the world, even before the Free Trade

---

[1] This, and other examples, are cited in EU Trade Policy Study Group (2010)

Agreement between ASEAN countries and China - which creates an immense bloc of free internal trade - which became effective as of January 2010.

The fragmentation of the value chain in production over a number of countries implies that the value added during the production sequence is not fully reaped by the country of the final transformation. Firms in China quite often intervene in the finishing stage, especially when some manual labor can still be usefully applied.

An interesting finding of Ma and Van Assche (2010) is that “while China’s export growth has been concentrated in the higher technology sectors, these are precisely the sectors in which China’s domestic content is small” (p.14). This is linked to two properties of information technological processes, namely their modularity and separability. Multiple, but standardized and loosely coupled components are thereby involved. (ibid. note 2).

The limited local content in China with respect to its high-technology exports implies that, generally speaking, China has not yet reached the pinnacle of technological mastery, which the crude export data suggest.

There can be no doubt, nonetheless, that China is making great strides in assimilating technological knowledge and in steadfastly entertaining high ambitions thereto. As firms in China source component and parts from within China, thereby substituting for imports, the local content of production in China is also enhanced.

1.8. <u>Misplaced exclusive focus on exports</u>

Complementing the comments which seriously downplay the *prima facie* overwhelming performance, since 1980, of the exports originating in China, one should stress that the exclusive attention, almost the obsession, which, in most countries, political leaders and public opinions attach to the maximization of export earnings, is overdone, as it at odds with the reality of the inter-national economy. Almost everywhere, export lobbies are able to secure the audience of the government and imprint a mercantilist bent on the international trade policies.

Admittedly, a country reaps most benefits and exhibits an unquestionable comparative advantage, if it succeeds in conquering market shares abroad for goods and services, composed wholly of domestic parts and components. In such cases, the value added in the production process accrues fully to the home country. This is particularly advantageous with respect to the jobs that are directly created in the production process of the exported merchandise. Public opinions are no doubt most sensitive to the employment aspect of the country’s international trade. Much of the public discourses about international trade implicitly refer to the traditional simplified theories about international trade, whereby the total value of the export products originates from home country sources. Such myopic view, through a nationalistic lens, is obviously mistaken. Natural resources, such as crude oil or cotton, most often must be sourced from abroad. Besides, as already reminded, often a firm is not able to serve the foreign market by way of exports from its home base, but will be led to install a ‘foreign direct investment’ base in the host, or destination, country.

1.9. China's import trade

Another important aspect in the debate about the allegedly unfair encroachment of Chinese exports on the American market also tends to be overlooked, namely that the exports out of China are largely offset by its imports. Indeed, without earning convertible foreign exchange by way of its exports, no country would be capable of paying for its imports, although the latter satisfy incontrovertible essential needs (such as food) or enable it to run its modern production systems (such as machinery or crude oil).

Since it embarked on its successful opening up- strategy, China's imports have in most years been somewhat, but not substantially, lower than the value of its exports (see table 1). As will be recalled in a moment, it follows that the phenomenal ballooning of China's official reserves has not been fed primarily by highly positive trade balances.

Moreover, as is the case in most countries, the composition of China's imports differs greatly from that of its exports. Raw materials and equipment stand out in the trade statistics whereas, as mentioned earlier, processing trade results in entries on both sides of the trade balance, especially as regards textiles and electronics.

1.10. Bilateral trade balances are misleading

The US trade balance with China is highly negative - as is that of the EU-27. But, obviously, it makes no sense to myopically focus on bilateral trade figures; only the overall trade balance matters vis-à-vis all other countries, when looking at the positioning of a country's currency in the forex market or when assessing the competitiveness of its businesses in the international market place. China's overall stance is much more balanced. Its surplus vis-à-vis the developed economies, the USA and the EU, is largely offset by a deficit against other countries, especially those from which it imports crude oil and other raw materials, or parts and components from East Asia.

1.11. Chinese multinationals on the march

A brand-new phenomenon is unfolding, namely the outward thrust abroad by a growing number of Chinese enterprises, mostly still under government control. A few years ago, the Chinese authorities loosened some restrictions on capital outflows. Chinese firms invest in African and Latin American sectors of raw materials. Some Chinese manufacturing enterprises have taken over foreign enterprises. Thus, Geely, although small even by Chinese standards, took over the Volvo business from Ford; Lenovo acquired the PC section of IBM. Other firms such as Haier, Huawei and BYD are on their way to project household names in the international market place and thereto establish affiliates abroad.

This outward thrust of Chinese firms is likely to gather more momentum. It is explicitly encouraged by the Chinese government. Firms, which are successful on their home turf, naturally want to spread their wings in the wider world. Moreover, Chinese firms are eager to gain access to top-notch technology, by way of the purchase of patents or the take-over of foreign firms. The abundant forex reserves, partly set aside in 'sovereign funds', are potent instrument to finance the outward direct in investments.

Apart from the imports, the rapidly growing outside flow of such outward FDI flows, are bound to counteract somewhat the presently unbalanced bilateral trade and financial accounts between China and the USA (and the EU.)

2/ The gigantic foreign exchange reserves of the Chinese Central Bank

2.1. The relevance of trade balances ?

The forex reserves of the Bank of China presently reach $2.4 trillion and recently dethroned Japan from the first rank in the forex reserve league. This outstanding position is sometimes invoked as an argument to buttress the need for a significant upvaluation of the RMB, which would, in turn, narrow the present imbalances in the trade, and current balances, between the USA and China.

This argument is weak, essentially because it basically attributes the explosive growth of the forex reserves to the rapid expansion of the export earnings of China (stimulated by the allegedly intentional downward manipulation of the RMB) over the payments for its imports -- or in other words, to the net trade balance.

Even a quick look at the trade balance of China shows that while export values have generally exceeded China's import values, as regards the USA, and even in an overall, worldwide dimension, the net positive values over the last years cannot possibly explain the rapid build-up of the forex position of China. The addition of the trade surpluses over the 2000-09 period results in an aggregate surplus of around $1 billion, or about 40% of the present total amount of official reserves. Hence, other relevant factors ought to be taken into account, indeed.

2.2. The role of net FDI inflows

Foremost, as recorded in the capital account (still not liberalized), China is today the main destination of inward foreign direct investments (FDI's), which mainly materialize in 'green field' projects, and, to a smaller extent, by way of acquisitions of firms within China. The flow of such financial resources has become larger following China's accession to the World Trade Organization (2002), and has only been temporarily been abated during the short-lived impact of the international financial tsunami in 2008-09. Prospective inflows of such inward FDI's look equally favorable to China. But an opposite flow of outward FDI's is gathering momentum. In 2009, substantial outward FDI's by Chinese firms counteracted the still huge inward FDI flows; hence, the net FDI inflow declined to $37 billion.

Such inflows of FDI from abroad (again, not overlooking that the Special Administrative Zones of Hong Kong and Macao are recorded as foreign jurisdictions, as regards trade) are recorded in the country's financial account. Contrary to the initial intention around 1997 to achieve convertibility for capital transactions for the RMB at the turn of the century, and discouraged by the damage to other East Asian countries that had heavily relied on borrowing abroad, China's financial account has in principle remained under government control.

2.3. Hot money inflows

Another channel whereby funds, expressed in US dollars or other convertible currencies, get converted, through the banking system, into RMB and add to the forex reserves is most often referred to as ' hot money flows'. These are flows that are not easily traceable; during a long period, recorded under rather large 'errors and omissions' in China's balance of payments statistics.

Although China's capital account remains in principle strictly supervised by the relevant authority, i.e. the 'State Administration of Foreign Exchange', there are various ways by which such funds get sneaked into the financial system of the destination country, i.e. of the PR of China. The anticipated appreciation of the local currency – a safe one-way bet, in the case of China in recent years – acts as a potent inducement to thread paths that circumvent the restrictions on capital movements proper. Thus, in the hypothesis just mentioned, the acceleration ('leading') of payments connected with exports to China, or, inversely, the postponement of payments ('lagging'), for imports into China, of imports by China, may benefit from more favorable conversion rates into RMB. This gain can be enhanced by judicious manipulation of the so-called 'transfer prices', i.e. those that are charged on intra-firm payments, i.e. between entities of the same multinational firm [2]. One should be reminded that a large fraction of cross-country trade and payments nowadays occurs in an intra-company network. Other capital flows, betting on a revaluation of the RMB, may be disguised as legitimate current account transactions, such as by way of modulating the timing or their amounts, of remittance flows or dividend and interest payments.

2.4. The relaxation of controls on capital controls

Two additional comments are in order. First, the Chinese authorities appear aware that their present forex looks like a genuine 'war chest' and is excessive. It amounts to more than ten times the today's quarterly import values, whereas a cushion of only 3 to 6 months of imports is considered as appropriate. They also realize that, even assuming that international trade proper would become more balanced, inward FDI's and other portfolio-type investment flows will further swell the stock of forex.

In recent years, some controls on capital flows have been softened. Thus, Chinese firms, increasingly involved in acquisitions or in equity participations abroad, are allowed to maintain forex assets in their foreign affiliates, instead of transmitting them to their parent company in China, which is obliged to get them exchanged into RMB to the Chinese Central Bank. A start has also been made with using the RMB in deals with Hong Kong and, within bilateral agreements, with some countries in South East Asia. This alleviates somewhat the upward pressure on the forex reserves with the Central

---

[2] The tax authorities of a large number of countries, including China, nowadays attempt to thwart such transfer pricing gambits

Bank. China also claims that it has sent teams on a purchasing spree to the USA and to Europe.

Secondly, as already mentioned above, while the capital account of China is nowadays in surplus, recently a process of outward flows is gaining strength. I already mentioned that some major Chinese firms are conquering significant market outlets abroad. Chinese official financial institutions, such as the Eximbank, act as bankers in loans to a number of African countries. A sovereign investment fund, supplied with $200 billion, is seeking profitable equity investments abroad. Such new developments alleviate the pressure towards a further accumulation of China's foreign exchange reserves.

3/ The current account conundrum

Much of the debate about the 'correct' level of the RMB as against major currencies circles around the current account positions of the PR of China, and other countries, particularly the USA.

3.1. China's and America's imbalances

Current account data measure the net flows of goods and services. They are composed mainly of two subcategories, and foremost of trade in goods and services, which exceed by far the other rubric of net current factor payments, such as international dividend and interest payments, licensing fees, and remittances. As, in the Chinese case, these factor payments are almost in balance, the preceding analysis of China's trade flows and trade balance is in essence relevant to a discussion in terms of current account balances.

However, there is another reason why current accounts are looked upon because to many analysts, the current accounts provide lens for assessing the appropriateness of forex rates between countries. As a matter of fact, in terms of traditional macro-economic identities, an imbalance in a country's net current account position, also signals a divergence between its macro-economic domestic gross savings vis-à-vis its gross domestic investments. Thus, a country with a savings surplus normally builds up claims on the rest of the world, to which it makes its surplus savings available. The reverse holds for a country with a deficit on current account that is financed by funds procured from abroad. It also follows that the current account balance of a country in a given year also equals a change in its net foreign assets.

The debate about the appropriate forex rate of the RMB is exacerbated by the fact that in 2008, the USA had the highest current account deficit, in absolute terms, estimated at $673 billion, whereas China topped the league of the surplus countries, with an estimated $426 billion surplus (Monga, 2009). In relation to their respective GDP's, the deficits and the surplus stood respectively at -4.7% and at +9.8% (ECB, 2010). The imbalance gap has been narrowed, in the two countries, thanks to the financial crisis and the serious downfall in international trade, but this outcome may be cyclical and reversible (ibid).

3.2. China's record savings ratio

China's gross macro-saving ratio (to GDP) reached a record rate of 59% in 2008, which still outstripped the macro gross investment ratio of 49% (Bank for International Settlements, 2009). One should notice, however, that, until the recent financial crisis, savings in China were not generated only by the household sector, where they reached a comparatively high level of around 20% of GDP, but were even more generated by the business sector; amongst them, (larger) state enterprises that have survived the drastic reform and thinning out of their numbers, in the first years of the new century, enjoy high profits margins in an often oligopolistic market constellation; they do not pay dividends to the state-shareholder and are often groomed by the state into the role of national champions called upon to flourish on outside markets.

The motivations for the high savings behavior in households are linked to the absence, so far, of a performing social security system, particularly in the rural areas; the wish to provide a fruitful education to their (often only) offspring. There are also clear indications that a high propensity to save is inherent in the East Asian cultures. Until the recent financial tsunami, the government sector was able to generate a surplus, i.e. to finance a portion of public investments out of current public incomes; the mammoth stimulus program to revive the economy brought the government sector in a 2.5% - 3% deficit position, which is still sustainable.

Conversely, the savings ratio in the USA was 11.9% in 2008 as against 16% in 2001. The huge deficits both in the current external accounts and in the public finances are covered by foreign savings, largely provided by the placement of China's forex reserves in American treasury bonds.

Paradoxically, these respective positions of China and the USA contradict the tenets of economic theory, namely that a capital- rich country should, and would invest its surplus on current account in a capital- poor country. But China is awash in capital, which it even is capable in exporting in big amounts.

3.3. Conceptual weaknesses of the Current Account yardsticks

The framework within which the dispute is carried out is open to some serious conceptual frailties. For one, the traditional dividing line between savings and non-savings, or consumption, is largely predicated on conventions. Thus, 'durable consumption goods', such as a car or a refrigerator, is treated as a consumption outlay, although people often set aside, i.e. save part of their income with a view to acquiring such goods, whereas the purchase of a home is recorded as a saving. Besides, one can at length discuss which level of imbalance is optimal; if all countries were achieving a zero outcome, there would be no room for the inter-national transfer of surplus savings to countries that wish to complement their domestic savings by foreign ones. Hence, zero balances are not ideal in an open economy framework. Another consideration is that "specific trade-related factors cannot by themselves explain large and sustained current account balances, which are in fact determined by many other variables, including foreign and domestic incomes, asset prices, interest rates, exchange rates” (Monga, 2009, p.12). In a worldwide globalized financial arena, in which market parties gauge risk-adjusted returns across borders, “global imbalances (may) become an equilibrium outcome of differences in potential growth rates and asset supplies” instead of being anomalous (Xafa, 2005: p. 17).

And, finally, the impact of current account developments on the economies concerned depends essentially on the destination of the surplus or of the funds borrowed to cover the deficit. If foreign savings are availed of to strengthen the country’s infrastructure, an even substantial current account is much more acceptable than if the borrowing from abroad has been attracted to boost consumption -- as was the case in the USA. Whereas the surplus countries, such as China and the oil exporters, should ask themselves whether there are rational alternatives to the amassing of large reserves and their redeployment by way of financing deficits abroad; there may be few alternatives, indeed, especially in developing countries, which rightly deem that they cannot yet allow convertibility on capital account, as their financial systems are still weak...

3.4. The upvaluation of the RMB as a cure for imbalances ?

Yet, one must admit that large imbalances between the USA and the EU, on the one hand, and China, on the other hand, if they would persist, tend to destabilize the world economy. This would be the case if the creditors - China, Japan, not to forget the oil-producing countries - were no longer willing to foot the bill of financing the deficit of the main debtor country, i.e. the USA and would no longer have confidence in the strength of the US dollar, or if the dollar would collapse. Obviously, one highly relevant peculiarity is that the United States enjoys the privilege of seigniorage : it can pay its debts in its own currency, which it can create to an extent itself, whereas creditor countries, such as China, are, in the wording of Mc Kinnon (2009) ‘immature creditor countries‘ that cannot lend their surpluses in their own currency.

The very fact that the US dollar, notwithstanding the terrible crisis in its financial system, remains the predominant international currency, in its multiple roles of invoicing currency, exchange market medium, and reserve currencies, for many years to come (see the Federal Reserve Bank of New York, 2010) implies that a crash of the value of the American dollar would also spell disaster for China, whereas it equally has a vested interest in the US market as an outlet for its exports. The two countries, their disagreements notwithstanding, appear condemned to co-exist and to seek cooperative schemes.

Analysts of the present systemic balances in the world rightly recommend that each major participant should shoulder its part of the rebalancing task. This is no doubt advisable and has been underwritten at the G20 Pittsburg Summit in September 2009. [3]

Whether the revaluation of the RMB would be a major contribution to collective rebalancing exercise is doubtful, in the light of the preceding analysis. To achieve an

[3] Simmons (2006), who studied previous episodes of major imbalances in international finance, is sceptical about the chances of reaching multilateral consensus.

effective impact on trade flows, the upvaluation would have to be sizeable, which the Chinese economy, engaged in a growth marathon, could not stomach, and would not accept. The price-elasticity of American imports from China is high; in the face of more expensive goods 'made in China', importers could easily turn to other suppliers, e.g. in Vietnam. The widespread 'processing trade' would partially blunt the price increase of China's exports, when expressed in dollars. And the Chinese export basket contains many items that do not meet competition from producers in the USA. Another consideration is that the absence of clear indications about the (equilibrium?) level of the forex rate in actual exchange markets renders it difficult to derive a reliable yardstick. As a matter of fact, exporters from China and investors into China must deposit their forex assets in an account with a bank in China, which in turn must transform them in RMB. To the extent one could pretend that a forex market exists in China, one of the transacting parties acts as a monopolist and, in fact, imposes the 'price' of the transaction. Although many analysts, especially Western ones maintain that the RMB, at present again tied to the dollar, is somewhat undervalued, others take a diverging view (Cheung a.o. 2007).

Hence, a significant reduction of the US macro-consumption ratio, accompanied by a resumption of positive savings, on the one hand, and a relative inflexion of the high savings ratio in China towards more consumption, on the other hand, are advisable, even although the effects of such policies take more time to materialize. In fact, these rebalancing sequences appear to take hold, even abstracting from the seriousness of the commitments entered into at Pittsburg. The deep recession in the USA, epitomized by an unprecedented unemployment rate and the deep declines in property values, render households much more prudent in their consumption behavior. Whereas in China, the shift in the overall strategy, decided already some years ago, and which emphasizes the uplifting of the vast rural areas, is bound to stimulate basic consumption, and hence to downgrade the relative role of exports as engines of growth.

In my view (Plasschaert, 2007), such re-orientation of the development strategy, away (to an extent) from the export-led growth path, is not only economically meaningful, as it can galvanize much potential in the rural areas, but it is also socially, and hence, politically, of crucial importance. As a matter of fact, the deep gap vis-à-vis the East and the urban population is deeply resented by the rural people, not primarily because of their lower per capita income, but because they lack adequate access to public health and educational facilities. The rapid spread of a 'new rural co-operative medical system', that cover the more serious health hazards, is a significant step towards less dissatisfaction in the countryside, which probably no other developing country has so far attempted, on China's country-wide scale. Less concern for medical expenses is also likely to reduce somewhat the propensity to save.

Contrary to what Western commentators sometimes project, the new strategy, now vigorously pursued, may not be highly instrumental in abating the very high investment ratio in the Chinese rural areas. As a matter of fact, there are still large unmet investment needs, both public and private, in China's hinterland whereas it is too often overlooked that investment expenditures are a vector of immediate 'effective demand', but with favorable capacity-enlarging effects on the economy, which consumption outlays cannot possibly claim.

Yet, a gradual revaluation of the RMB appears plausible, less because of insistence from abroad, but in the light of some solid arguments. The renewed rapid growth carries the germs of some degree of price inflation; a higher value for the RMB would cheapen somewhat the imports which the country needs for the impressive extension and deepening of its manufacturing. The de-linking with the dollar would also render monetary policy in China less dependent on US monetary parameters. In the longer run, and with the gradualism, that has been a hallmark of China's remarkable growth journey, more freedom in international capital transactions are also in the offing.

As argued earlier, the remodeling of the development pattern, to the benefit of the rural sector, can be expected to enhance consumption outlays, thus reducing the sky-high savings ratio. Several influential Chinese economists follow basically the same line. They add some arguments. Thus, according to Justin Lin (2009), now chief economist at the World Bank, the next steps in China's reform saga should aim at enhancing the incomes of the wage-earners, which, today, receive a smaller slice of GDP than some years ago. Another economist, Yiping Huang, of Beijing University (2009), expresses a plea for the liberalization of factor markets, such as oil, gas and electricity, which are rather cheap, and benefit from subsidies, resulting in high profits and associated business savings.

References

- Bank for International Settlements, 79th Annual Report, Basel, 29 June 2009
- Cheung,Y-W, Chinna, M.D. and Jujii, E. "The Overvaluation of Renminbi Undervaluation", NBER Working Paper 12850, Cambridge, MA 2007
- European Central Bank, "Prospects for Real and Financial Imbalances and a Global Rebalancing", Monthly Bulletin, April 2010
- EU Trade Policy Study Group, "A modern trade policy for the European Union", Jan. 2010
- Goldberg, L. and Dillon, E.W "Why a dollar depreciation may not close the U.S. trade deficit", Federal Reserve Bank of New York, Current Issues in Economics and Finance, June 2007
- Huang, Y., "Fixing China's current account surplus", East Asia Forum, December, 13, 2009
- Lin, Justin, "Development and Transition : Ideas, Strategy and Visibility", Cambridge University Press, 1995
- Ma, A. and Van Assche, A., "China's Role in Global Production Networks", mimeo (2010)
- Ma, G. and Mc Cauley, R.N., "Do China's capital controls bind ? Implications for monetary autonomy and capital liberalisation", BIS, Monetary and Economic Department, August 2007

- Mc Kinnon, R. and Schnabl, G., "China's financial conundrum and global imbalances", BIS, Monetary and Economic Department, Working papers n. 277', March 2009
- Monga, C., "Hegelian Macroeconomics. The Dialectics of Global Imbalances" World Bank Working Paper Series 5175, 2009
- Plasschaert, S., "Relocating productive capacity to China ? or elsewhere ?", Briefing paper, European Institute for Asian Studies, Jan. 2005
- Plasschaert, S., "China: Inzicht in zijn Doorbraak", Leuven, Davidsfonds, 2007
- Simmons, B., "The future of central bank cooperation", BIS, Monetary and Economic Department, February 2006
- World Bank Office, Beijing, Quarterly Update (on China's Economy), March 2010