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IS THE RENMINBI UNDERVALUED?

The myths of China's trade surplus and global imbalances

By Sylvain Plasschaert

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ABSTRACT

ALARMED BY THE persistent and large US trade deficit vis-à-vis China and the rapidly swelling Chinese foreign exchange reserves, influential US policymakers are urging the Chinese authorities to allow a substantial appreciation of the Renminbi (RMB). This paper establishes that the arguments advanced to this effect are quite weak, as they overlook salient features of the present international economy and of China's financial system. Indeed, the record growth of China's exports to the US stems largely from joint ventures and affiliates of multinational enterprises; exports attributed to China usually contain a large percentage of imported components with modest value-added attributed to China itself and – indeed, the Chinese export portfolio is in the process of being significantly upgraded. Neither are the gigantic foreign exchange reserves primarily linked to the modest surpluses of exports over imports of China, but they are fed by these large net inward direct investments; and, in recent years, by 'hot money' which sneaks into China, notwithstanding the non-convertibility of capital flows. Thus, a moderate appreciation of the RMB would not equilibrate the bilateral trade flows or remedy current account imbalances. On the other hand, the shift in China's growth strategy – away from export maximisation towards strengthening consumption in the vast interior – is likely to gradually bring about more balance, while appreciating the RMB in the process. There are also recent signs of easing of Chinese restrictions on international financial transactions.



JEL Code: E22, E52, E58, F14, F23, F31, F32, F42

Keywords: trade balance, trade, foreign exchange, China, current account, monetary policy, international economic order, currency reserves, multinational enterprises

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1. INTRODUCTION

WHETHER THE CHINESE national currency, the Renminbi (RMB), is undervalued remains a hot bone of contention. A climax was reached in October 2010, when 348 members of the US House of Representatives, amongst them many belonging to the majority Democratic Party, voted in favour of imposing a solid surcharge on imports from China. Equally, tough action against China's exchange policy is advocated by opinion leaders. During the Midterm elections of November 2010, candidates on both sides did not hesitate to attribute the high unemployment level to the onslaught of China's exports. Even in academic circles, views clash sometimes bitterly. Thus, Nobel Prize laureate Paul Krugman repeatedly called for a protectionist stance, in order to force China into acquiescing with a substantial appreciation of the RMB. Two other Nobel laureates, Robert Mundell and Joseph Stiglitz, have expressed opposite views to those of Krugman. The increasingly politicised dispute has inflamed official circles in both countries, although, in the wake of the international financial crisis, the bilateral trade (and current account) imbalances that were very high in 2008 have perceptibly abated.

In the same context, it is noteworthy that, whereas official IMF statements express the view that the RMB is somewhat undervalued, the IMF Executive Board, in its conclusions on the 2010 Article IV Consultation, frankly confessed dissension amongst its members.

Admittedly, the facts invoked by those who indict the Chinese authorities of deliberate downward manipulation of their currency, cannot be denied. 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 in recent years.

As can be inferred from Table 1, in the 2007-2010 period, US exports to China did not amount to one quarter of its imports. In 2009, 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 US exports to China.

TABLE 1. BILATERAL TRADE BETWEEN CHINA AND THE US.

(In billions of US dollars)

YEAR	EXPORT FROM CHINA TO THE USA	IMPORT INTO CHINA FROM THE USA	BALANCE
2007	322	63	+259
2008	338	70	+268
2009	296	69	+227
2010*	229	56	+173

* First 8 months of 2010

Over the same period, as shown in table 2, the EU-27 also underwent a substantial external deficit in its bilateral relationship with China—barely lower than that of the USA. On the export front for the EU-27, China ranks 4th, behind the USA, Russia and Switzerland. China is now the largest supplier country of the aggregate EU-27 imports.

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TABLE 2. BILATERAL TRADE BETWEEN CHINA AND EU.

(In billions of US dollars)

YEAR	EXPORT FROM CHINA TO THE EU	IMPORT INTO CHINA FROM THE EU	BALANCE
2007	233	72	+161
2008	248	79	+169
2009	215	82	+133
2010*	125	53	+72

* First half of 2010

Another strand in the debate relates to the rapid build-up of the official foreign exchange ('forex') reserves by the Central Bank of China, People's Bank of China (PBOC), which have skyrocketed to more than \$ 2.5 trillion as of October 2010, and is now the largest in the world.

An appreciation of the Chinese currency vis-à-vis the US dollar and other currencies, would imply the untying of the peg of the RMB with the US dollar. This tie to the dollar was abandoned in July 2005 but was renewed in September 2008 at the outbreak of the international financial crisis; during that period, the RMB appreciated by 21 % against the US dollar, but depreciated against the Euro. In July 2010, it was announced that the RMB will again be allowed to fluctuate slightly against a basket of currencies, and will no longer be strictly tied to the dollar. According to the critics, loosening from the dollar and reflecting more closely forex market conditions, would reduce the Chinese trade (and current) account surplus and would alleviate 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 to enhance its presently comparatively low macroeconomic consumption-to-GDP ratio.

These claims are now strongly rejected by the Chinese leadership, who maintain that China's surplus is not primarily related 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 controversy about the appropriate forex rate of the RMB readily derails in boundless and emotional argumentation. Hence, in this paper, I restrict myself to briefly commenting upon a number of commonly overlooked relevant features of the Chinese scene, which seriously qualify the impressive data about the gross export trade of China that have led many to believe that the merchandise 'made in China' is unstoppably conquering large portions of the world markets. Subsequently, I document that the massive foreign exchange reserves of the People's Bank of China are not fundamentally deriving from the country's trade surplus. And, finally, I submit some critical comments about the macro saving-consumption positions in the USA and in China, (obviously with opposite signs), which feed discussions that 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 highest surplus and deficit respectively, in absolute amounts (in 2008). But the analysis attempted here is also largely applicable, mutatis

mutandis to the EU-Chinese trade relationship. Furthermore, this paper deals with the single question, whether the RMB, as officially quoted by the People's Bank of China, should be considered seriously undervalued. It reaches the conclusion that indictments of intentional manipulation of that exchange rate are poorly founded and overlook a number of specific features of the Chinese economy and financial system. This conclusion should not be construed as implying that complaints by the US or the EU about other policies in the China, or postures by Chinese authorities, are groundless. Thus, counterfeiting and violations of industrial property rights is rife. Public procurement practices tend to discriminate against foreign firms; protection of local firms against foreign ones occurs quite often, especially at local government level.

2 A CLOSER LOOK AT CHINA'S EXPORT STATISTICS

2.1 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 remember that this double-digit benchmark marks an average, both in its time and space dimensions. Per capita income growth has also been remarkable, all the more that, thanks to a stringent birth control policy, the Chinese population is nowadays growing by less than 1% per year. The per capita income now reaches close to \$3,000, which puts China already in the ranks of the world's lower middle-income countries.

Yet, although several industrial sectors in China have 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 that of the urban populations, and more particularly those in the coastal areas. Although one should be reminded that the *de facto* privatisation of the cultivation of the agricultural sector – not of the ownership pattern - in the early eighties has provided the initial, and major, push along China's growth path (see e.g. Naughton, 2007).

2.2 THE RECORD GROWTH OF CHINESE EXPORTS

ANOTHER PRINCIPAL ENGINE of growth relates to the spectacular growth of China's export trade, starting fairly early in the eighties, but exploding after China joined the WTO in 2002. In 1980, China's exports totalled only \$20 billion. At that time, international trade was arranged by a dozen state companies. Anyhow, as was typical for Soviet-type economies, which negated the time-honoured principle of the 'international division of labour', economic intercourse with the outside world was minimised. In 2005, the value of exports reached \$760 billion.

In 2008, the aggregate exports of China rose to \$1,429 billion, but dived in 2009 to \$1,202, or 16% less, on account of the global financial crisis, which curtailed demand for China-made goods. The worldwide recession took a heavy toll on Chinese exports, especially those to the USA and the EU. The trade surplus (exports minus imports) of China vis-à-vis the USA declined in 2009 from \$268 billion to \$227 billion. As of the latter part of 2009, China's overall export trade has recovered rather strongly.

2.3 THE CLOSE LINK WITH INWARD FOREIGN DIRECT INVESTMENTS AND THE ISSUE OF 'RELOCATION'

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. To start with, a major part (around 60% of the exports out of 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'. In this context, one must be reminded that firms in Hong Kong and Macao are recorded as foreign invested firms, as they operate from territories that (although they belong politically to the People's Republic of China) are treated as separate economic territories.

At first glance, and in the minds of 'the man on the street', the productive facilities established by 'foreign-invested enterprises' within the territory of China, may be viewed as substitutes or alternatives to the exports that would otherwise originate in the home country, say in the U.S.A. This often prompts the complaint that such outward 'foreign direct investments' (FDI) entail 'relocation' of production capacity from the home to the host country. This is said to prevent exports, and destroy a considerable number of jobs at home.¹ Trained economists can easily refute the sophisms just aired. Hence, a brief digression on the 'relocation' of productive capacities abroad appears appropriate. Genuine relocation occurs when a firm stops producing at home, and starts the same production abroad. The indictment that firms in China are 'stealing', say, production and jobs in the United States, may then be valid. The trade balance of the home country would even be more impaired whenever the FDI is availed of to produce goods that are re-exported to the home country, which thus experiences a rise in its imports.

However, although counterfactual analysis, i.e. 'what would have happened to the firm, in the absence of such relocation?' – is naturally fraught with a dose of guesswork, quite a number of cases have been documented where domestic firms by moving their production to low-wage cost countries (such as China, or the Maquiladora frontier region with Mexico), or subcontracting the production to unaffiliated 'contract manufacturers' in the host country, would otherwise not have survived in an intensely competitive international environment.

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 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 presents itself as the comparatively more efficient 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; there may be an urge to expand the scale of production, which can then be located closer to the market.

The accusation of unfair relocation is particularly unfounded, when the manufacturing of the goods in question has already been terminated in the home country, as is the case for footwear in the USA. Ironically, in the case of ladies' underwear, the complaints by American producers in 2003 against imports from China were particularly hollow, as most of their 'production' was already outsourced to Honduras, within a USA-Honduras bilateral arrangement, which provided for duty-free re-entry of the processed goods into the USA (Plasschaert, 2005).

Relocation, in the strict sense, occurs especially within labour-intensive end- or intermediate-products – such as apparel, shoes and toys – in which China played a prominent role in the early

years of its ‘opening to the outside world’. However, 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); 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; and that (iii) the lower costs advantage reaped by locating production, or subcontracting in low wage jurisdictions, refers essentially to the manufacturing stage, typically only representing a low proportion of the value added during the total production chain, which extends to the servicing of the final customer at the retail stage, and also involves pre-manufacturing activities, such as design.²

Yet, already in the early days of China’s opening gambit, incoming FDIs, 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.

2.4 THE SIGNIFICANT ROLE OF HONG KONG AND OF ‘OVERSEAS CHINESE’

IT WAS ALREADY mentioned that, with respect to trade, Hong Kong and (to a much lesser extent) Macao, are viewed as foreign territories by China. 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 a major (immediate) destination of Chinese exports, amounting to 13.8 % of the total export value in 2009, although much of this export flow only transits through the former British colony on its way to other destinations.³ Besides, Hong Kong represents by far the largest geographical source of inward FDI into China.⁴ A recent tally (March 2010) mentions that, so far, 310,738 Hong Kong enterprises have accounted for 42% of the overall FDIs 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, to Shenzhen, or to other ‘special economic zones’, where wages were much lower and which welcomed FDIs with favourable incentive schemes.

More recently, and for essentially the same motive of a cheaper labour supply, the manufacturing of electrical appliances and electronic goods, particularly in their final stages of production, has largely been relocated from Taiwan to sites in Mainland China. This happened even prior to the recent political thaw in the relationship between the two regimes on both sides of the Taiwan Strait.

From the above it follows that, if East Asia were considered as a single area, the export record of China would loom less impressive, as part of it results from manufacturing production that has been relocated to Mainland China.

2.5 THE UPGRADING OF THE TECHNOLOGICAL LEVEL

ANOTHER NOTEWORTHY DEVELOPMENT is 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 labour, drawn from the tens of millions of otherwise underemployed people in the rural interior, has fast become a

major manufacturer of simple, labour-intensive goods. The Pearl River Delta, stretching from Guangzhou (Canton) to Hong Kong, earned the label of ‘the world’s industrial workshop’ (Plaschaert, 2006). Over the years, firms in China have been able to muster the production of higher-valued goods, confronted with fierce competition and often benefiting from the inflow of FDIs enhanced their productivity.

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 fell from 53% in 1992 to 27% in 2007, whereas the high technology segment (with radio, TV and communications; and office and computing machinery) 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 is performed. This is often the case with firms in China (whether in domestic Chinese or in foreign ownership), to which the assembly of the various parts and components is typically entrusted. This remark is closely linked to the subsequent one about today’s widespread geographical fragmentation of the production sequence.

2.6 THE SUBSTANTIAL ROLE OF ‘PROCESSING TRADE’

THE CUSTOMS STATISTICS of China distinguish between ‘processing trade’ and ‘ordinary trade’ or ‘general trade’. In ‘processing’ trade, components and other intermediates are imported from abroad, prior to their further elaboration and finishing. Processing trade accounts for more than half of China’s overall exports, although its relative importance now appears to be shrinking somewhat.

The fragmented manufacturing sequence has expanded rapidly in recent years, as can be inferred from 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 Agreement between ASEAN countries and China became effective as of January 2010, creating an immense bloc of free internal trade.

‘Processing trade’ partakes in the phenomenon of internationally fragmented production, in which firms from different countries are involved in the manufacture of the end product which is then exported, say, from China - even abstracting from the activities involved in the further commercialisation of such final goods towards the final customer. The incorporation of intermediate inputs, sourced from foreign countries, into the final product, significantly increases the import content of the exported products.⁵ 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 on the US market, \$163 is 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.⁶

There are frequent complaints from the Chinese side that such fragmentation results in a very modest value added in the Chinese stages of the manufacturing process. Firms in China quite often intervene in the finishing stage, especially when manual labour can still be usefully applied. The complaints relate mainly to ‘contract manufacturing’ (which involves only the manufacture, in line with specifications, ordered by their principal, of labour-intensive goods, or components).

These sectors have attracted numerous entrepreneurs from China or from elsewhere; they face fierce competition and low profit margins. In recent years, such profits have been further eroded by the appreciation of the RMB between 2005-08 and by an upward push in wages, brought about by the Labour Law of June 2007, which provides appreciable benefits to the labour force. The recent financial international tsunami, and the related interruption of large orders from US or European firms and supermarkets, has resulted in the loss of 20 million jobs in the coastal areas.

As already intimated, the fragmentation of the value chain in production, even if only at the manufacturing stage, 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. 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). The authors link this phenomenon to two properties of information-technology processes, namely their modularity and separability. Multiple, but standardised and loosely coupled components are thereby involved (*ibid.* note 2). They also notice that 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 steadfastly entertains high ambitions in that respect. Clearly, as firms in China increasingly source components and parts from within China, thereby substituting for imports, the local content of production in China is also bound to be enhanced.

2.7 CHINA'S IMPORT TRADE

ANOTHER IMPORTANT ASPECT in the debate about the allegedly unfair encroachment of Chinese exports on the US 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 it may badly need the latter.

Since it embarked on its successful strategy of opening up the country, China’s imports have in most years been somewhat, but not substantially, lower than the value of its exports. 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 import trade statistics whereas, as mentioned earlier, processing trade results in entries on both sides of the trade balance, especially as regards textiles and electronics.

2.8 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, to varying degrees. A few years ago, the Chinese authorities loosened some restrictions on capital outflows—as will be reiterated in sections 2.2 and 2.4.

Chinese firms invest in African and Latin American sectors of raw materials.

In the manufacturing sector, 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 becoming household names in the international market place; in this way, they establish commercial and even production affiliates abroad.

The outward thrust of Chinese firms is likely to gather more momentum. The entry of Chinese firms abroad is explicitly encouraged by the Chinese government. 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’, provide a potent instrument to finance China’s outward FDIs. This rapidly growing flow of such outward FDI flows is bound to counteract somewhat the presently unbalanced bilateral trade and financial accounts between China and the US (or the EU).

2.9 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 vis-à-vis all other countries matters when looking at the positioning of a country’s currency in the forex markets, 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 from East Asian countries, which supply it with parts and components.

2.10 THE ERRONEOUS OBSESSION WITH GROSS EXPORTS

THE MAIN CONCLUSION that emerges from the first chapter of this paper is that the almost exclusive concern, which, in most countries, political leaders and public opinions attach to the maximisation of export earnings is much overdone, as it is at odds with the present-day workings of the international economy. Almost everywhere, export lobbies are able to secure the audience of their government and to imprint a mercantilist bent to trade policies.

Admittedly, a country would reap a maximum of economic benefits, if it – more precisely, if its enterprises – would succeed in conquering market shares abroad for goods, composed wholly of domestic parts and components. The value-added in the production process would then accrue fully to the home country. This would be particularly advantageous in terms of jobs created, to which public opinions are more sensitive than in terms of other segments of the total value of the exported products, which are less directly embodied in human beings.

As amply analysed here, the myopic view and borderline obsession with gross export values, are mistaken. Today, even large countries cannot be fully self-sufficient; some natural resources, such as crude oil or cotton, must be sourced from abroad. Besides, domestic firms are often not in a position to serve foreign markets by way of exports from its home base, but are led to install a base in the targeted country. As an illustration, the Chinese Bureau of Economic Analysis has stated that, in 2007, the value of sales by foreign affiliates of US firms in China is triple the value of US exports. The frequent fragmentation of the manufacturing sequence over a number of countries, adds another break to the traditional analysis which tends to view trade as consisting of the exchange of goods, fully value-added in a single country.

3 THE GIGANTIC FOREIGN EXCHANGE RESERVES OF THE PEOPLE'S BANK OF CHINA

3.1. THE RELEVANCE OF TRADE BALANCES?

THE FOREX RESERVES⁷ of the Bank of China presently reach about \$2.6 trillion. China recently dethroned Japan from first place in the league of foreign reserves. This outstanding position is often invoked as an argument to buttress the need for a significant appreciation of the RMB. Such an event would, in turn, narrow the present imbalances in the trade, and current balances, between the US and China.

This argument is weak 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 China's net trade balance.

Even a quick look at the trade balance of China shows that while vis-à-vis the USA, annual export proceeds have generally exceeded China's import values, 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 stance of China. The addition of the trade surpluses over the 2000-09 period results in an aggregate surplus of around \$1 billion, or not even 40% of the present total amount of official reserves. Hence, other relevant factors ought to be taken into account.

3.2 THE ROLE OF NET FDI INFLOWS

FIRST AND FOREMOST, as recorded in the capital account (still not liberalised), China has today become the principal destination of inward foreign direct investments (FDIs), which mainly materialise 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 in the wake of China's accession to the World Trade Organization in 2001, and has only shrunk during the short-lived impact of the international financial crisis in 2008-09. Prospective inflows of such inward FDIs look equally favourable to China. Yet, an opposite flow, of outward FDIs, is gathering momentum. In 2009, substantial outward FDIs by Chinese firms counteracted the still huge inward FDI flows; the net FDI inflow declined to \$37 billion. Significantly, it is projected that outward foreign direct investments out of China – now at \$62 billion – will even slightly exceed the inward flow according to the IMF Staff Report for the 2010 Article IV Consultation.

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 to trade) are recorded in the country's financial account. The initial intention, expressed around 1997, to introduce convertibility for capital transactions for the RMB by the turn of the century, has been discouraged by the damage inflicted by the East Asian financial crisis on neighbouring countries in the region that had heavily relied on borrowing abroad. Afterwards, China's financial account has remained under rather strict government control.

3.3 HOT MONEY INFLOWS

ANOTHER CONDUIT WHEREBY funds, denominated in US dollars (or possibly 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 movements are not easily traceable. During

a long period, they were recorded as (large) ‘errors and omissions’ in China’s balance of payments statistics.

Although China’s capital account remains in principle strictly supervised by the State Administration of Foreign Exchange, there are various ways by which such funds sneak into the financial system of China. The anticipated appreciation of the RMB – a safe one-way bet in recent years – acts as a potent inducement to circumvent the restrictions on capital movements proper. Thus, the acceleration (‘leading’) of payments connected with exports to China, or, inversely, the postponement of payments (‘lagging’), for imports into China, may benefit from more favourable conversion rates into RMB. This gain can be enhanced by judicious manipulation of so-called ‘transfer prices’, i.e. those that are charged on intra-firm payments between entities of the same multinational firm⁸. One should be reminded that a large fraction of cross-country trade and payments nowadays occurs within an intra-company framework. Either the timing or the amounts of dividends remitted and interest payments can be modulated so as to enlarge the funds available in RMB.

3.4 THE RELAXATION OF CONTROLS ON CAPITAL CONTROLS

TWO ADDITIONAL COMMENTS regarding forex reserves are in order. First, the Chinese authorities appear aware that their present stock of forex looks like a genuine ‘war chest’, which evokes critical reactions abroad and which is also excessive, as it by far exceeds the value of 3 to 6 months imports which is usually considered an appropriate cushion. They also realise that, even assuming that international trade proper would become more balanced, inward FDIs and portfolio-type investment flows are expected to further swell the stock of forex reserves.

In recent years, some controls on capital flows have been softened, so as to alleviate the upward pressure on the accumulation of forex at the People’s Bank of China. This trend appears likely to be sustained. Let me mention a few of those measures. Chinese firms are now allowed to maintain forex assets in their foreign affiliates, instead of transmitting them to their parent company in China, which would in turn be obliged to get them exchanged into RMB. A start has also been made with using the RMB in deals with Hong Kong – where an offshore RMB market is being established – and, within bilateral agreements, with several countries in South East Asia. China also has sent purchasing teams 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 has been gaining strength. It was already mentioned that some major Chinese firms acquire control over foreign firms. 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.

4 THE CURRENT ACCOUNT CONUNDRUM

4.1 THE IMBALANCES OF THE US AND CHINA

MUCH OF THE debate about the ‘correct’ level of the RMB as against major currencies circles around the current account positions of China, and other countries, particularly the USA. Current account data measures the net international flows of goods and services. They are composed mainly of two subcategories, whereby the trade in goods and services exceeds by far the other rubric of net current factor payments, such as international dividend and interest payments, li-

censing fees, and remittances. In the Chinese case, these factor payments and receipts are almost in balance and the preceding analysis of China's trade flows and of the resulting balance is relevant to a discussion in terms of current accounts.

However, there is another reason why many analysts look upon current accounts with keen interest. Indeed, the current accounts provide a 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 whereupon it makes its surplus savings available, which earns it a return in the future. 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 equals a change in its net foreign assets.

The debate about the appropriate forex rate of the RMB was exacerbated in 2008, when 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 terms of their respective GDPs, the deficit and the surplus stood respectively at -4.7% and at +9.8% (ECB, 2010). The imbalance has since then been narrowed thanks to the financial crisis and the serious downfall in international trade, but this outcome may be cyclical and reversible.

4.2 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). It should be stressed, however, that until the recent financial crisis, savings in China were not generated only by the household sector (who accounted for a comparatively high level of around 20% of GDP) but were even more generated by the business sector, including most subsectors. Thus, state enterprises that have survived the drastic reform and thinning out of their numbers in the first years of the new century, enjoy high profit margins in an often oligopolistic market constellation; moreover, until now they did not pay dividends to the state-shareholder and are often groomed by the state into national champions, called upon to flourish on international markets.

The motivations for the high savings behaviour of households are linked to the absence so far of a performing social security system, particularly in the rural areas, and to the wish to provide a fruitful education to their (often sole) offspring. There are also 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 revenues; the mammoth stimulus program to revive the economy has brought the government sector into a 2.5% - 3% budget deficit position, which is still sustainable.

Conversely, the overall savings ratio in the USA stood at 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 is now even capable of exporting in big amounts.

4.3. CONCEPTUAL WEAKNESSES OF THE CURRENT ACCOUNT YARD-STICKS

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. Savings are, by definition, defined, and measured, as the subtraction of consumption outlays from income. Thus, durable consumption goods, such as a refrigerator or a car, are treated as a consumption outlay whereas the purchase of a home is recorded as a constituent of savings; although the motivation to acquire such goods and to set aside a portion of one's income is similar in both cases.

Besides, one can at length discuss which level of imbalance is optimal, or acceptable. If all countries were achieving a zero outcome, there would be no room for the international 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 globalised 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 recipient country's infrastructure, even a substantial current account is much more acceptable than if the borrowing from abroad has been solicited 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.

5. SUMMARY: THE APPRECIATION OF THE RMB AS A CURE FOR IMBALANCES?

YET, ONE MUST admit that large imbalances between the USA and the EU on one hand, and China on the other tend to destabilise the world economy if they persist. This would be certainly the case, with disastrous results, if the creditors – China, Japan, not to forget the oil producing countries – were no longer willing to finance the deficit of the main debtor country, i.e. the US and would no longer have confidence in the US dollar. Obviously, one highly relevant peculiarity is that the United States enjoys the privilege of a seigniorage: it can pay its debts in its own currency, which, to an extent it can create itself, whereas creditor countries, such as China, are, in the wording of McKinnon (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 and the weak performance of its economy, will remain the predominant international currency for many years to come in its multiple roles of invoicing currency, exchange market medium, and reserve currency (Federal Reserve Bank of New York, 2010) implies that a crash of the US dollar would also spell disaster for China, which not only carries huge stock of dollar assets, but also has a vested interest in the US market as an outlet for its exports. The two countries, their disagree-

ments 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 was underwritten at the G20 Pittsburgh Summit in September 2009 and again at the Seoul summit in October 2010.⁹

Whether the revaluation of the RMB would make a major contribution to a collective rebalancing exercise is none the less doubtful, in the light of the preceding analysis. To achieve an effective impact on trade flows, the appreciation would have to be sizeable, which the Chinese economy, engaged in a growth marathon, could not stomach, and would not accept. Besides, the price-elasticity of simple US 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. Anyhow, the widespread ‘processing trade’ would partially blunt the price increase of China’s exports, when expressed in dollars, as the burden of adjustment on Chinese exporters, would largely be shifted to suppliers in adjacent countries (Ma and Van Assche, 2010). Finally, as already noticed, the Chinese export basket contains many items that no longer face competition from producers in the US.

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 convert them into RMB. As one of the transacting parties acts as a monopolist and, in fact, imposes the ‘price’ of the transaction, one cannot pretend that a genuine forex market exists in China. Moreover, even functioning forex markets are no longer reliable gauges for forex rates that bow to the market forces involved in international trade, as short-term transactions by powerful financial groups nowadays dominate the forex markets. Although many analysts, especially Western ones, maintain that the RMB, is undervalued (but differ about the extent of their undervaluation, 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, is advisable, although the effects of such policy take time to materialise. In fact, these rebalancing sequences appear to take hold, even abstracting from the seriousness of the multilateral commitments entered into at G20 level. The deep recession in the US, epitomised by an unprecedented unemployment rate and the steep declines in property values, render households much more prudent in their consumption behaviour, thereby dampening the recovery of the American economy. Whereas in China, the shift in the overall strategy, decided already some years ago, and which emphasises the uplifting of the vast rural areas, is bound to stimulate basic consumption, and hence to downgrade the relative role of exports as engine of growth.

In my view (Plasschaert, 2007), such re-orientation of the development strategy, away from an export-led growth path, is not only economically meaningful, as it can galvanise much potential in the rural areas, but it is also socially, and hence, politically, of crucial importance. As a matter of fact, the wide 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 more fundamentally because of their failing access to public health and educational facilities. In this connection, the presently rapid spread of a new rural co-operative medical system that covers serious health hazards is a significant step towards relieving dissatisfaction in the countryside, and less concern for medical expenses is likely to reduce the propensity to save.

However, contrary to what Western commentators tend to project and to hope for, the new strategy, now vigorously pursued, may not be highly instrumental in abating the very high investment ratio in Chinese rural areas. As a matter of fact, there are still large unmet investment needs, both public and private, in China's hinterland. Besides, it is too frequently overlooked that investment expenditures are equally a vector of immediate 'effective demand', but with favourable 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 that the country needs for the impressive extension and deepening of its manufacturing sector. 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 is also in the offing at least to some extent.

As argued earlier, the remodelling 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 worthwhile 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, who today receive a smaller slice of GDP than before. This upgrading of the relative position of labour incomes is now acknowledged by the leadership and is moreover facilitated by the overall rapid enhancement of productivity in the Chinese economy. Another economist, Yiping Huang, of Beijing University (2009), expresses a plea for the liberalisation 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.

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ENDNOTES

1. Although, outward FDIs indirectly generate some exports of intermediate goods or services.
2. For a detailed analysis of the value chain as regards the manufacturing of shoes in China, and its impact on the competitiveness of EU firms, see Kommerskollegium, 2007.
3. Thus, Hong Kong statistics show that in 2009 only 13 % of exports from Hong Kong represent ‘domestic exports’; the latter have been dominated since the early eighties by the re-exports of goods produced by Hong Kong –owned firms in China. On the import side, Hong Kong only represents 8.6 % of the overall value of imports by China. This statistic bears testimony to the rapid expansion of the absorptive capacity of harbours, such as Shanghai, Shenzhen, Ningbo, Dalian and others along China’s East Coast.
4. A non-negligible portion of these FDI must be ascribed to firms headquartered in China, which ‘round-tripped’ their investments through Hong Kong subsidiaries, in order to benefit from tax incentives, granted to foreign-invested enterprises. But, recently, the tax treatment in China of foreign and domestic firms has been uniformed.
5. The inter-national fragmentation of the production sequence also results in an artificial inflation of the overall export statistics, as compared to the case in which the value added, when producing a final good, would occur exclusively in a single country.
6. This, and other examples, are cited in EU Trade Policy Study Group (2010)
7. The broader concept of ‘official international reserves’ also encompasses gold, SDR’s and the reserve position at the IMF.
8. The tax authorities of a large number of countries, including China, nowadays attempt to thwart such transfer pricing gambits
9. However, Simmons (2006), who studied previous episodes of major imbalances in international finance, is sceptical about the chances of reaching a multilateral consensus.