The Interations between China and the World Economy[1]

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In 2003, the Chinse economy started to pick up strongly. For two consecutive years since then, China's growth rate surpassed 9%, while inflation was under 5% cent and droping. China's high growth contributed greatly to the global growth over the past two years. At the same time, the "China factor" has caused or worsened the shortage of some energy and raw materials, and drived many prices of energy and raw materials sky high. Faced with the rise of China, many people are worried about not only its current but also its long-run impact on the world economy. In this presentation, I will argue that China will be able to maintain a high growth rate for decades to go and China's impact on the world economy will be sizable. But the impact should not be exaggurated. China's current sharp increase in the demand for energy and minirial resources, to a large extent, is cyclica and will be tapering off fairly soon. China is fully aware of its international responsibility as a rising coountry. China will continue to enbrace globalization and abide by all international rules and norms. China will continue to the make efforts to maintain and improve the international order, and actively participate in regional economic and financial cooperation.

China's growth potential

Over the past 25 years, the Chinese economy registered an average annual growth rate of 9.4 percent. China's achivement is beyond any doubt. However, one question is still beseting many observors both within and outside China: is China's growth sustainable?

[1] A Presentation Prepared for Neikei Simbon Sympothim on April 5, 2005

To answer this question we need to return to basics, which is expressed by the famous Horrod-Domar model. According to this model, growth rate of the economy equals saving rate divided by the capital-output ratio. Due to the fact that China has a very high saving rate, as high as more 40 percent, even if China's capital-output ratio is high is low, China still can manage to achieve a high growth rate. There is no evidence that the Chinese households will change their saving behavior in the foreseeable future, while there are plentiful evidences that China still has room to raise its efficiency. Hence, it is entirely possible that China will be able to maintain a very high growth rate for years even decades. However, possibility is not equivalent to reality. There are many countries in the history of the world economy, which were able to achieve high growth rate for decades and then suddenly growth stopped and the countries fell into long-drawn stagnation. In this presentation, I am not going to dwell on what will shift China's growth trajectory. My focus will be on the possible impacts of China's growth on the global economy

Energy Demand

With GDP supassing 1.65 trillion US dollar in 2004, China's economic rise has begun to reshape the world in many ways, but perhaps its greatest effect will be on the global market for energy supplies. In 2003 China imported 1.8 million barrels of oil a day and its share of oil consumption in the world increased from 3.5% in 1990 to 7.7%. In the same year, China's share of import in the total consumption was 30% and its increased oil consumption accounted for 40.7% of the increase in the world consumption. In 2004, China's oil imports increased 35% to 122.7 million tons and its share of import in the total import of the world increased from 0.2% in 1990 to 5.1%. China has surpassed Japan to become the world's second-largest oil importer, next only to the United States that consumes 25.7% of the world total. The U.S. Energy Information Administration estimated that China would consume 8 million barrels of oil daily by the end of 2006. It is claimed that Chinese demand has been a big factor, pushing oil prices to record levels last year.

The Institute for Analysis of Global Security, a Washington think tank, predicts that in 20 years China will import as much oil as the U.S., or about 10 million barrels a day. Personally, I don't think that will happen. Firstly, China has alternative energy sources. Coal is China's main source of energy, which meets more than two-thirds of its energy needs. China has the world's largest coal reserves, and has the ability of making coal a clean burning source of energy. Hence coal can be made a more important source of energy in the foreseeable future. Nuclear and hydraulic powers are also obvious substitutes of oil. Currently, the share of nuclear power in the total supply of electricity is 2%. In contrast, the average share in the world is 16%, the average share in developed countries is 30%, and the share in France is 78%. China is planned to build 30 nuclear power generators with the capacity of producing 40 million kilowatt before 2020.[2] Secondly, the sudden surge of oil import in the past two years is due to the shortage of coal and electricity supply in China, which is a result of lack of investment since the later 1990s as well as strong demand since 2003. Following the cooling-down of the economy and the increase in investment in electricity and coal industries since 2003, China's current shortage of coal and electricity may end fairly soon, helping mitigate the demand for oil to generate power. The heavy oil-consuming industries such as the automobile, steel, agriculture, housing and transportation are expected to cool down in 2005. As a result, the oil import will return to a more normal level. Thirdly, thanks to China's low energy efficiency, the potential for China to raise efficiency is tremendous. China's energy consumption of per unit output value is more than twice the world average, and is 11.5 times that of Japan, 7.7 times that of Germany and France, and 4.3 times that of the U.S. On the average, unit energy consumption of major products in China is 40 percent higher than the international level. Over the past 25 years since China launched its reform and opening-up, the Chinese economy grew six times, while energy consumption jumped dozens of times, far higher than the consumption level in the early stage of

[2] Special Report by International Finance News (國際金融報): *A Long March towards An Autonomous Development of Nuclear Power*, March 11, 2005

[2] China Economic Net: China becomes the largest buyer in the world, Last Updated Dec. 27, 2004.

industrialization in developed countries.[3] Higher energy efficiency can be achieved by industrial structure changes at the national level and efficiency improvement at the enterprise level. Fourthly, China has already begun to rethink of its growth strategy that can be characterized by export-driven, FDI driven and input driven. Many in China have begun to redefine the concept of modernization. For China, it is unaffordable to copy American's extravagant life style. "A billion Chinese driving gas-hogging SUVs," is just a fantasy. Believe me, Chinese are not so stupid. China has to and will reduce its reliance on oil import.

Currently, China is striking deals with oil exporters around the world to secure its supply. China's current strategy is to diversify oil supply sources all around the world. This is a costly and risky strategy. But would China have other options? Saudi Arabia, Oman, Sudan and Yemen already supply over 39% of China's crude, according to China's Customs General Administration. China had hoped to build a pipeline from Russia, but the hope was dashed by Russia's calculated chop and change. For the oil consumers, cooperation is extremely important. Faced with an oil supply cartel, the most stupid thing for the consumers to do is to fight with each other. China won't engage in an "oil race" with the U.S. and Japan. Chinese energy officials already made it clear that if world oil prices get too high, China will step up efforts to generate power from nuclear plants or from agricultural waste and coal. The Chinese government announced recently that it would issue an energy-planning memo this year to give world markets a look at China¹s future energy demand. China is seeking international cooperation to solve oil problem. I hope our neighbors can notice the new move of the Chinese government and respond positively.

Mineral Resources

China is the world's largest buyer of copper, the second largest buyer of iron ore, and the third largest buyer of alumna. China is also a major exporter, ranking among the top few countries in sales of tin, lead, zinc, magnesium and a host of minor metals and industrial minerals such as titanium, tin, tungsten, antimony, tantalum, bauxite, coal, molybdenum, niobium, silver, and lithium. China's total trade in mineral products has exceeded US$100 billion in recent years. Thanks to China's high economic growth, China's annual growth rate in the demand for industrial minerals has consistently been in the double-digits since the early 1990s. China accounted for almost half of the increase in global demand for industrial minerals over this period. It is expected that by 2010, due to the increase in domestic consumption, China may become an importer of some mineral sources that it currently exports.

The demand for iron ore increased drastically in recent years. One of the most important factors contributing to the dramatic rise in iron ore price is attributable to China's high demand for ore, which in turn is a result of China's dramatic increase in demand for steel used in real estate development. In 2004, China has produced 275 million ton steel, which registered a growth rate of 32.3% over the previous year, and accounted for a quarter of the total production of steel in the world. Chinese enterprises' anxiety to strive for resources against one another in the international market also contributed to the price hike of iron ore price.

In February 2005, Nippon Steel agreed to pay 72 per cent more in ore contracts with Rio Tinto and Companhia Vale do Rio Dolce (CVRD), the Brazilian miner. The punitive price rise set alarm bells ringing among steel producers all around the world. The increase is sure to squeeze the profit margins of the big steel producers. According to a report, Nippon Steel's apparent eagerness to agree to the sharp price rise, which they described as "unprecedented in living memory", suggested anxiety that supplies may not be secure, given the "ravenous Chinese consumption". For many Chinese observers the motivation behind the acceptance of the price hike by Nippon Steel is even more dubious. Japanese enterprises have stronger ability to digest price increases than their Chinese competitors. Chinese producers cannot help but to ask whether this is a move by Nippon Steel aimed at squeezing its Chinese competitors? This situation is most unfortunate. Both Japanese and Chinese companies are losers because of refusing to cooperate.

China's role in the current rise in the prices of energy and raw materials is limited and should be put in context. Do not forget the fact that, in per capita term, compared with developed countries, China's consumption of energy and raw materials is insignificant. However, as a responsible country, China is willing to establish a closer coordination with other countries, especially with its surrounding nations to stabilize prices and to maintain a sustainable global supply. The Chinese government's macroeconomic control is aimed at cooling down the excessive demand for metal materials as well as energy. The impact of China's macroeconomic control will be seen in the world market of mineral resources soon. On the one hand, China will reorganize the process of purchases to reduce the cutthroat competition among Chinese enterprises. On the other hand, Chinese government will negotiate with major buyers as well as major providers to seek long-term agreements to ensure the supply and to stabilize prices.

China's trade expansion

In 2004, with total trade volume surpassed 1.2 trillion US dollars; China has become the third largest trading nation, only after the United States and Japan. Since the early 1980s China has adopted export-oriented strategy of development. The aim is to gradually integrate the Chinese economy with the global economy on the basis of comparative advantages. As a result, China's trade/GDP ratio has rose from a negligible small figure in the early 1980s to more than 70% in 2004. China's openness has already surpassed almost all the major trading nations and become one of the most open economies in the world. In 2004, China's export and import were 540.3 billion US dollars and 401.4 billion US dollars, and increased by 25.7% and 26%, respectively, over the previous year. The trade surplus in 2004 was 32 billion US dollars.

China's commitment to free trade is firm and irretrievable. China's average tariff rate will fall from 23.7 percent in 2001 to 5.7 percent at the end of the transition period. Although the transition period is 10 years upon its WTO entry, the bulk of the tariff reduction will be completed within the first five years. China is committed to remove most quotas and other quantitative restrictions on agricultural as well as industrial products before 2006. China's **"tariff-rate quota" restriction** will be reduced significantly China already started to open up its service sectors and this process will also be completed before 2006. No one can accuse China of not being serious about its commitments. It is commonly acknowledged that China's trade regime is more open than Japan's. Unfortunately, some of China's trade partners are shamelessly abusing the **Safeguard measures** that were specifically designed against China and **Anti-dumping rules** that were based on denying China's status as a market economy for the purpose of trade protection. China will stick to its commitment to trade liberalization, no matter how regretful some Chinese are for what China has committed. However, on the other hand, China will contest any unjustified charges of injury and dumping vigorously. We hope that we are not going to see more trade disputes, and the disputes going to be nastier in the future.

China will actively participate in regional economic cooperation in the form of FTAs. The creation of FTA is inconsistent with the principle of a multilateral trading system. The popularity of creating new regional trading blocs is a response to the failure of the multilateral approach towards trade liberalization. After the Asian financial crisis, East Asian countries suddenly realized that they needed to redefine their identity and reshape their economic alliances. China has initiated the process of China + ASEAN 10 FTA. While it will strengthen cooperation with other developing countries such as Brazil and India to speak out for the interests of the third world, just as it did in Cancun, China will redouble its efforts in negotiating with its neighboring countries (economic entities) and the countries that are more sympathetic with China's positions to form various regional groupings to achieve trade liberalization. During its trade negotiations, China will strenuously demand for the recognition of its market economy status. Many Chinese economists hope that, as an ultimate goal, a strong East Asian Economic Union can be established, shoulder-to-shoulder with the EU and NAFTA.

Personally, I think China should readjust its growth strategy. A trade over GDP ratio over 70% is way too high for a large economy such as China. The Chinese government should scrap preferential treatments implicit as well as explicit for export enterprises and to stimulate domestic demand more vigorously. China should also speed up restructuring of its industrial structure to give more impetus to the development of non-tradable sectors and upgrading of its export structure from relying on labor-intensive products to high tech and high value-added products. The government should also encourage enterprises to impose self-disciplines to avoid unbridled export drive. The fear of Chinese products inundate international markets is a far-fetched imagination. The growth momentum of China's export will decelerate gradually. At the same time, China will further increase its imports. China needs to reduce its accumulation of foreign exchange reserves, which stood at more than $ 600 billion and rising fast. One way to do it is to increase imports. The strong growth of the economy and the possible reduction of the accumulation of foreign exchange reserves will definitely lead to more imports. Japan will be the first beneficiary of the increase imports by China. I am sure that the Japanese public has realized that it was utmost unfair to accuse China of exporting deflation in 2002. It goes without saying that Japan's economy has benefited greatly from China's rise. China and Japan should seek closer economic cooperation and not do things other way around.

Regional Financial Cooperation

During the Asian Financial crisis, in order to fence off a possible financial crisis, the Chinese government declared the adoption of a no devaluation policy.

Although China refuses to give a timetable, it has committed to a more flexible exchange rate regime and to allowing market forces to determine the exchange rate of RMB at a reasonable equilibrium level. RMB's delink with the US dollar is just a matter of time. Having eliminated the possibility of the maintenance of dollar pegging in the medium and long-run, the choices left for China in reforming the exchange rate regime are: managed floating, free floating, and participation in a regional common currency.

Among different forms of the managed floating exchange rate regime, China may choose a single currency—the US dollar as reference in determining the central rate and allow the rate to fluctuate within a band. This approach is basically a return to the pre-crisis exchange rate regime that China adopted. China may also choose to peg to a basket of currencies. If the pegging to a basket is chosen, there are several further alternatives. It seems that most Chinese economists would prefer the exchange rate regime of BBC that comprises three main elements: Basket, Band and Crawling (hence "BBC"). This exchange rate regime can reduce the variation of home currency vis-à-vis its main trading partners' currencies, when the parity of foreign currencies against each other is varying.

Some economists argue that China should revaluate the RMB so as to help to balance American current account deficit. My personal opinion on the RMB exchange rate is well known and I do not want to repeat it here. However, I strongly oppose to blame China for American trade imbalances. Simple economics tells us American trade deficit is a result of America's low saving rate and high budget deficit. If American households spend less and save more and the American government spends less money on war and collect more taxes, automatically, America's trade balance will be improved with or without changes in the RMB exchange rate. Without the changes in the behavior of American household and the government, even if the RMB appreciated, American trade balance will not change in any significant way.

Many studies found that East Asia fits the criteria of OCA quite well and that East Asian countries can form a monetary union without incurring too much opportunity costs of losing monetary independence and policy autonomy[4]. The most important characteristic of the current international monetary system is the domination of the US dollar. As a result, the United States is able to extract seiniorage from other countries. According to Mundell

[4] Tanawat Trivisvavet: Do East Asian Countries Constitute An Optimum Currency Area? Durham University. April. 2001.

[1997], most of the currency is outside the United States, being used as the international currency of the world. It was estimated that only 10% to 15% of the dollars in circulation would be held in the United States. With the US dollar as the single most important international reserve money, the US is able to finance its huge current account deficits and to accumulate more than US $6.5 trillion foreign debts. On the other hand, the rest of the world has to rely on the mercy of Fed's self-discipline. As a result of the Asian financial crisis, EA economies as a whole now hold more than US $2 trillion with very low returns. East Asians are footing the bills for spendthrift American households. Now East Asian countries are helplessly watching the value of their foreign exchange reserves evaporating quickly as a result of the depreciation of the US dollar. As pointed out by Mundell [1997], the United States would be the last country to ever agree to an international monetary reform that would eliminate this free lunch. The United States would not talk about international monetary reform, because a superpower never pushes international monetary reform unless it sees reform as a change to break up a threat to its own hegemony. Again according to Mundell, The dollar liabilities of the United States have been rising by bushels and bushels. From a national standpoint, the United States is never going to suggest an alternative to its present system because it is already a system where the United States maximizes its seigniorage. East Asia should not tolerate this situation forever. The forming of an Asian currency, side by side of Euro, will help to end the hegemony of the US dollar and impose disciplines on the American administration.

The other equally important, if not more important, reason why East Asian needs to work together to create a common currency is pure political. To preserve peace, we need economic integration. To make integration irretrievable, we need a common currency in the region. The formation of European Economic Community was a political decision. The creation of Euro is a logical result of the decision. In the literature, the main costs of a common currency area are the loss of the independence of monetary policy, giving up the possibility of changing exchange rate when the change is necessary for achieving fundamental balances of the economy. However, all costs of a common currency boil down to one thing: the surrender of a chunk of state sovereignty. Compared with this issue, whether East Asian countries, ASEAN 10 plus 3 more specifically, fit the criteria for OCA is not that important. If the countries concerned have the *political will*, physical, institutional and other elements of an optimum currency area can be created. Better-developed financial markets, deeper trade and factor market integration, liberalized capital markets are not only preconditions for monetary integration but also results of the efforts in promoting the integration in the region. As Frankel and Rose pointed out "Trade patterns and income correlations are endogenous…A country could fail the OCA criterion for membership today, and yet, if it goes ahead and joins anyway, as the result of joining, pass the OCA criterion in the future."[5] Unfortunately, under current political atmosphere in East Asia, when a country regards another as a threat, and mutual trust and good-will are running thin, would any country prepare to take action, say nothing of taking lead, in this direction? The prospects for any substantial progress in the creation of a common currency seem very deem.

Now let's forget about unpleasant and frustrating international politics for the time being. If a common currency is accepted as the ultimate goal, how should the East Asian economies proceed? Mr. Kuroda presented a road map for achieving this goal. According to him (2004) the first step toward a single currency in East Asia is already in place by way of the Chiang Mai Initiative, which envisaged the establishment of a network of bilateral swap arrangements (BSAs) so as to avoid and resolve future currency crises like the East Asian currency crisis of 1997-98. The second step taken is the Asian Bond Markets Initiative, which is aimed at promoting the development of functioning, integrated capital markets to tackle the problems of over-banking and maturity and currency mismatches in East Asia. For Kuroda, the free trade agreements (FTAs) are the third step towards a common currency. The fourth step will deal with intra-regional exchange rate stability According to Kuroda, a possible exchange rate arrangement may be a "basket regime," under which regional currencies are managed using as a reference a common basket of major currencies that should include the U.S. dollar, the euro, and the yen. Finally,

[5] Elinda Fishman Kiss: Optimum Currency Area: Euro as a Practical Paradigm? Rutgers, the State University of New Jersey. P3.

convergence criteria will be applied and a single currency will be introduced in the region.

I am sympathetic with many opinions of Mr. Kuroda’s. Efforts should continue to make to consolidate the gain in regional monetary cooperation, e.g.. CMI. However, due to the lack of conducive political atmosphere for the further progress in monetary integration, which involves the surrender of state sovereignty, the focus of the efforts have to shift to the construction of economic fundamentals that are conducive to economic integration and monetary integration. Maybe, more efforts should be made in promoting trade liberalization, investment facilitation, technological assistance and tourism promotion. When political will is absent, we have to return to economics. Hopefully, mutual economic benefits will inject new dynamism into the process of monetary cooperation in East Asia.