

COMMENTARY

China needs to change economic strategy

By Motoshige Itoh

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On May 11, the day before a major earthquake struck Sichuan Province, China, I was in Beijing to exchange opinions with economists there about the state of the Chinese economy. In this column,

I want to depict what I felt during the meeting. The following day's quake had nothing to do with the Beijing conference, but, in retrospect, I thought what we discussed one day before the temblor was meaningful in observing the Chinese government's post-earthquake management of the economy.

The Chinese economy continues to grow rapidly, but its pattern of growth is different from what other emerging economies usually experience in the process of economic development. As in the past cases of Japan and South Korea, fast growth of newly industrializing countries would usually entail trade deficits because they had to import huge quantities of capital goods and natural resources, all essential for economic development. South Korea relied on capital inflows from abroad to make up for its trade deficit in and after the 1970s, and so did Southeast Asian economies in and after the 1980s.

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China's situation is totally different—it has been enjoying massive surpluses not only in its trade account but also in its capital and financial accounts, thanks to the enormous amount of funds coming in from abroad. How can the rapidly expanding economy of China post a trade surplus? This is because China's growth has been driven by the combination of a stupendous volume of direct foreign investment and the abundant supply of domestic labor. Many of the foreign manufacturers operating in China take advantage of the country's gigantic workforce and actively export products to the West and Japan as well as other overseas markets. Given that foreign-capital firms account for about 60 percent of China's overall exports, its export activity owes a great deal to foreign businesses.

However, domestic demand in China has failed to keep pace with the overall economic growth. As a result, China's exports hugely exceeded imports, resulting in the accumulation of a phenomenal trade surplus. With the burgeoning trade surplus and FDI, China has kept amassing foreign currency reserves—most of which presumably are U.S. dollar-based. Without any monetary remedy on the part of the Chinese government, the massive influx of money from abroad would theoretically accelerate the sale of dollars and the purchase of yuan on the foreign exchange market. But Beijing does not want to see any rapid appreciation of the yuan.

Excess liquidity

To ward off the upward pressure on the yuan, the Chinese government has continued intervening on the foreign exchange market by buying dollars in exchange for yuan. Consequently, foreign currency reserves held by the People's Bank of China have now risen to the tune of \$1.5 trillion, the world's largest, all comprising foreign currencies bought through market intervention. In other words, the Chinese

central bank has injected yuan funds equivalent to \$1.5 trillion into the economy through such market operations. To keep foreign exchange market intervention from causing an excessive increase in money supply, the Chinese government issues bonds to absorb excess liquidity, a measure that can hardly rectify the issue of the excess liquidity.

Excess liquidity has been spilling into the Chinese stock and property markets. As Chinese participants in the Beijing conference referred to the presence of "100 million investors," the Chinese stock market has obviously overheated. For example, the Shang-

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hai Stock Exchange Composite Index, the benchmark gauge of Chinese stock performance, jumped to the 6,000 mark in mid-October last year, compared with a year earlier level of about 1,500, and then crashed to about 3,000 over a short period of time. The Chinese stock market thus has been rampantly volatile. The overheating phenomenon is apparent on the property market, too.

Despite this trend, the Chinese economy has been growing by continuously luring FDI and expanding exports. However, China's early-stage growth strategy—the phrase that was also used by Chinese experts during the Beijing conference—has reached a turning point. Many economies, including that of Japan, would be terribly affected if the bubble on the Chinese stock and property markets burst. Even if

the asset bubble in China does not burst anytime soon, the Chinese economy will continue suffering badly from inflation—its consumer price index has been rising at an annual rate of about 8 percent. Newly industrializing economies, such as China, are prone to be hit much harder by soaring prices of natural resources elsewhere in the world.

The issue of regional economic disparities in China, a phenomenon that has resulted from its quest for rapid export-driven economic growth, has come to light in a symbolic way—many school buildings collapsed in the Sichuan earthquake and parents accuse authorities of jerry-building facilities in order to cut costs. It would be difficult to maintain political stability by prioritizing economic growth. China also has to cope with the issue of environmental destruction, which is going on unabated there.

Viable solutions

What policy options should China pursue to resolve a host of challenges, including those mentioned above? During the May 11 conference in Beijing, the views held by myself and my Chinese counterparts as to what should be done were not far apart. To begin with, the Chinese government should have second thoughts about the existing policy of attracting FDI by all means and, instead, adopt a strategic approach to accept investment from abroad more selectively. In this context, China should stop providing preferential treatment to those foreign manufacturers that just want to transfer production facilities that cause pollution in China and benefit from the country's low-cost workforce. Of course, it makes sense to continue welcoming advanced technologies and investments in strategic industrial sectors, such as automobiles.

China then should end its excessive export-driven policy and shift its policy priority from exports to domestic demand. Measures to do away with the re-

gional gaps, such as post-quake rehabilitation steps and incentives for economic development in impoverished areas, are likely to be key parts of the central government's changeover to domestic demand. It should tolerate some fall in the country's economic growth rate, a development that would lower inflation. To be specific, the Chinese monetary authorities would have no choice but to tighten credit policy.

The key to the success of such a policy shift would be to accelerate the pace of the upward correction of the yuan's foreign exchange rate, an approach the Chinese side remains reluctant to agree to. In reality, China would only see "hot money" or highly speculative investments gather momentum once it gave any sign of tolerating a rise in the foreign exchange value of the yuan. Naturally, the Chinese authorities would like to avert any financial market turbulence. Nevertheless, it should be noted that Beijing's bold decision to let the yuan's exchange value appreciate sharply would be a policy path effective in keeping a tight rein on overheating asset-class markets, accelerating the shift from export-driven growth to domestic demand-oriented expansion. Such a decision also would help reduce inflation pressure and prove to be the most effective way of placing China in a favorable position in importing crude oil and other natural resources at a cheaper price.

As set out above, the Chinese economy is at a crossroads. From a different viewpoint, the presence of various economic problems means that China has the potential to proceed to the next phase of economic growth—a stable growth stage. Can China drastically change direction to reach such a positive destination? Or will it be overwhelmed by the shock waves of the overheating of its economy without changing its policy course? It is difficult to predict precisely what will happen. We should keep a close eye on the Chinese economy.