FRBSF ECONOMIC LETTER

Number 2007-06, March 9, 2007

Update on China: A Monetary Policymaker's Report

Each year, the President of the San Francisco Fed joins the Federal Reserve Board Governor responsible for liaison with Asia on a "fact-finding" trip to the region. These trips advance the Bank's broad objectives of serving as a repository of expertise on economic, banking, and financial issues relating to the Pacific Basin and of building ties with policymakers and economic officials there. The knowledge gained and the contacts developed are critical in understanding trends affecting the Twelfth District, in carrying out responsibilities in banking supervision, and in ensuring that policymakers have the understanding of global economic developments necessary to conduct policy and promote the stability of financial markets. This Economic Letter *summarizes President Yellen's report to the Head Office Board of Directors on her trip to China in November 2006.*

Our agenda took us to the two largest cities in China—Beijing, with about 15 million people, and Shanghai, with over 20 million—as well as to Chengdu, a "small" city (only 10 to 12 million people!) that is in Western China and that is the focus of intensive government development efforts. We met with senior government staff, including our counterparts at the People's Bank of China (PBOC) and the China Bank Regulatory Commission, bankers, representatives of U.S. and Chinese businesses, academics, representatives of the U.S. Embassy, and experts from a number of multilateral institutions. Our focus was the economy, with particular emphasis on banking and finance, developments in the information technology (IT) sector, and energy and the environment. (For a discussion of findings from the trip regarding the banking and financial sectors, please see the March 2007 issue of the Bank's publication, *Asia Focus* http://www.frbsf.org/publications/banking/asiafocus/2007/AsiaFocus-March07.pdf.)

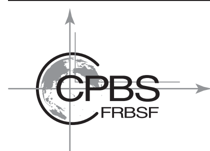
Rapid growth and the monetary policy response

In the nearly 30 years since China's economic reform process began, the economy averaged an annual growth rate of about 10%, a performance that is probably unrivaled in human history and that has lifted hundreds of millions of people out of poverty. This growth has been facilitated by China's abundant labor supply, which has been massively reallocated out of agriculture, where productivity is very low, and into the manufacturing and service sectors, where it is much higher. In addition, the pace of investment has been extraordinarily high, which has kept capacity growing. The efficiency with which the Chinese economy transforms inputs into output—what economists refer to as "total factor productivity"—has also improved.

Although rapid growth has propelled living standards higher, the Chinese government has tried to slow growth somewhat during the past few years, using for the most part the traditional tools of monetary policy, such as raising lending rates and increasing reserve requirements. Though these measures were expected to produce a mild slowdown in early 2006, the economy instead grew almost 11% in the first half of the year, the fastest pace since 1995.

Some analysts believe that the traditional tools are not terribly efficacious in the Chinese context, and, indeed, in the last six months, the government also has employed administrative measures to curb loan growth, local government investment, and property speculation, such as mandating that local authorities postpone or cancel investment projects failing to meet land use limits and other approval rules. These efforts, together with the more traditional monetary policy actions, did finally produce some slowing of real GDP growth in the latter half of 2006.

Given that consumer price inflation has remained low in the past year—1.9% year-over-year in November—it is natural to ask why Chinese policymakers perceive a need to slow growth (update March 2007: the average inflation rate



PACIFIC BASIN NOTES *Pacific Basin Notes* appears on an occasional basis. It is prepared under the auspices of the Center for Pacific Basin Studies within the FRBSF's Economic Research Department.

from January to October 2006 was only 1.3%; in December, it ticked up to 2.8% and then fell to 2.0% in January 2007). A primary rationale relates to concerns about the quantity and quality of investment. According to commonly cited figures, fixed investment in recent years has amounted to over 40% of GDP, and it actually accelerated during 2006. Policymakers are worried that this level of investment is too high, fearing that the overinvestment in the cement, steel, and aluminum sectors, as well as in real estate, could lead to excess capacity and a destabilizing boom-bust cycle. Policymakers are also worried that investment spending is not being efficiently allocated across sectors, reflecting concerns that banks still do not operate on a fully efficient and commercial basis; poor lending decisions could saddle banks with new rounds of bad loans just when real progress has finally been made in cleaning up the banking system.

Economists with whom we met at some multilateral institutions have observed that a substantial share of investment is financed not by banks but by firms from their own internal funds; in other words, enterprise saving is very high. This suggests that the high pace of investment poses fewer risks to the banking sector than it might otherwise. The Chinese government, with endorsement from the International Monetary Fund, has suggested that state-owned enterprises should distribute a larger share of their profits to the government via dividends, thus raising government revenue, which, in turn, could be used to fund social expenditures, particularly to strengthen the social safety net.

Trade and foreign exchange policy

China has long enjoyed an overall current account surplus, and recently it has grown enormously—from 2.4% of GDP in 2002 to 7.2% in 2005, with even higher prospects for 2006. This, combined with a sizable capital account surplus, has put upward pressure on the value of China's currency, the renminbi (RMB). Beginning in July 2005, the Chinese government officially unpegged the RMB from the dollar, and, since then, the currency has appreciated by about 6%. Chinese policymakers seem likely to allow this process of gradual RMB appreciation to continue, so long as it is slow and orderly. Few people, however, believe that even a more substantial RMB appreciation would have much effect on China's overall trade balance. For one thing, to the extent that China imports many components used in producing its export goods, an appreciation lowers the cost of those imports, offsetting somewhat the effect on export prices. For another, demand for many Chinese exports tends to be fairly strong, regardless of price, which implies a limited trade response to an appreciation. Most observers do not see China's trade surplus coming down until it ramps up government spending and domestic consumption, increasing its own demand for foreign imports.

To exert some control on slow and orderly movements in the RMB, the PBOC intervenes in the foreign exchange market, buying dollars with RMB that it issues. This intervention has resulted in the PBOC's accumulation of over $1 trillion in foreign reserve assets. Moreover, such intervention also swells the domestic supply of bank reserves. Therefore, to avoid inflation, the PBOC must offset the associated liquidity increase by sterilizing reserve inflows. It has accomplished this by issuing low-yield PBOC bills in open market operations and by progressively raising the reserve requirements of domestic banks. However, the policy of forcing low-yield PBOC bills on the banking sector works at cross-purposes with banking sector reforms, which are ultimately aimed at creating a banking sector that operates on a sound commercial basis.

A fundamental law of macroeconomics, which is well appreciated by our colleagues at the PBOC, holds that an independent monetary policy, free capital flows, and a fixed exchange rate cannot all mutually coexist. Thus, greater exchange rate flexibility will eventually be required for China to manage the economy via an independent monetary policy. In the short run, however, the authorities are concerned that the country's banks and firms are not yet fully prepared to cope with a free-floating currency. We discussed with the PBOC in Shanghai the progress that is being made in introducing hedging instruments, such as foreign exchange forward and swap contracts and the experience of banks and other domestic financial institutions in managing exchange rate variability. Of course, Chinese policymakers are also concerned that a large currency appreciation could have a deleterious effect on exports, particularly in sectors with low profit margins, such as textiles.

Energy and the environment

We spent some time learning more about issues relating to energy and the environment, which are of increasing concern to policymakers. China's current pattern of growth is highly energy-intensive, and energy use has been expanding proportionately faster than output. Oil accounts for only about 20% of energy use, but almost half is supplied from

imports; thus, China's rapid growth in oil demand has worked to push up global prices. The main source of energy (almost 70%) is domestic coal, and a very worrisome consequence of coal use is that it produces air pollution, which, in many Chinese cities, is among the worst in the world. Water shortages have also become more serious as a result of rapid urbanization, underpriced water costs, and water pollution. There is now much discussion of the need for sustainable development, and government officials discussed efforts to boost energy conservation and reduce environmental damage, including tightening controls on power plant emissions and implementing more market-based pricing of fuel and water use. One overall goal is to reduce the ratio of fuel to GDP by 20% over the next five years.

Business conditions

We met with U.S. businesspeople involved in a wide range of sectors, including banking and finance, IT, research and development, and retail and service-oriented firms. Overall, they continue to see huge opportunities associated with China's market size and low-cost labor.

China's coastal regions have traditionally attracted the lion's share of foreign direct investment. But a high priority of the Chinese government is to promote the development of inland areas, particularly Western China, out of concern with growing income inequality, poverty, and associated social and political unrest in these areas. This was our main focus in Chengdu. We saw some evidence of the city's success in the form of a large international retail chain store and a brand new assembly plant for a U.S. maker of computer chips. Logistics are a key problem for firms operating in this region. For export-oriented manufacturing firms, rail or river transport costs to the coast offset much of the advantage of the lower labor costs in this area. But firms that are able to use air transport find it profitable to operate, and the government is highly cooperative in minimizing obstacles.

Chinese policymakers are eager to see China move up the value chain and promote indigenous innovation. They are pushing foreign firms to contribute by shifting higher value-added activity to China. The executives at some high-tech firms with whom we met shared the view that Chinese-educated engineers and other professionals are technically very competent. But they regard their training as narrow and perceive a shortage of broader problem-solving and management skills. To address this issue, Chinese policymakers are now trying to encourage creativity in the educational system as well as entrepreneurship and risk-taking in the workplace. Some of those we talked to also regard protection of intellectual property rights as an ongoing concern.

Looking forward

As I have indicated, China's recent development path has been characterized not only by high investment and rapid growth, but also by concerns about income disparities, investment efficiency, and environmental problems. According to the 11th Five-Year Plan (for 2006–2010), China's top political leadership agreed to pursue structural policies that would emphasize more consumption over investment and exports as well as the growth of the service sector instead of industry, improve the efficiency of investment, and reduce income inequality and establish a more "harmonious society" through more social spending.

These are ambitious goals, and a number of policies are under discussion to achieve them. These include better pricing of energy, resources, land, and environmental damage, reducing implicit and explicit subsidies for manufactures and exports, establishing a dividend policy for state-owned enterprises to reduce corporate funds available for investment, and dampening local government incentives to pursue higher growth single-mindedly.

If such policies are put in place, a number of benefits may accrue. For example, raising domestic consumption demand would help to lower China's external surplus imbalance, thereby reducing current trade frictions and the risks of protectionism. In addition, focusing on the "quality" rather than the quantity of investment could generate productivity gains. Finally, greater government spending, particularly on pensions and health care, would reduce government saving and precautionary household saving.

Janet L. Yellen
President and Chief Executive Officer

ECONOMIC RESEARCH
FEDERAL RESERVE BANK OF SAN FRANCISCO

P.O. Box 7702
San Francisco, CA 94120
Address Service Requested

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Printed on recycled paper with soybean inks

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