Is the Chinese Growth Miracle Built to Last?

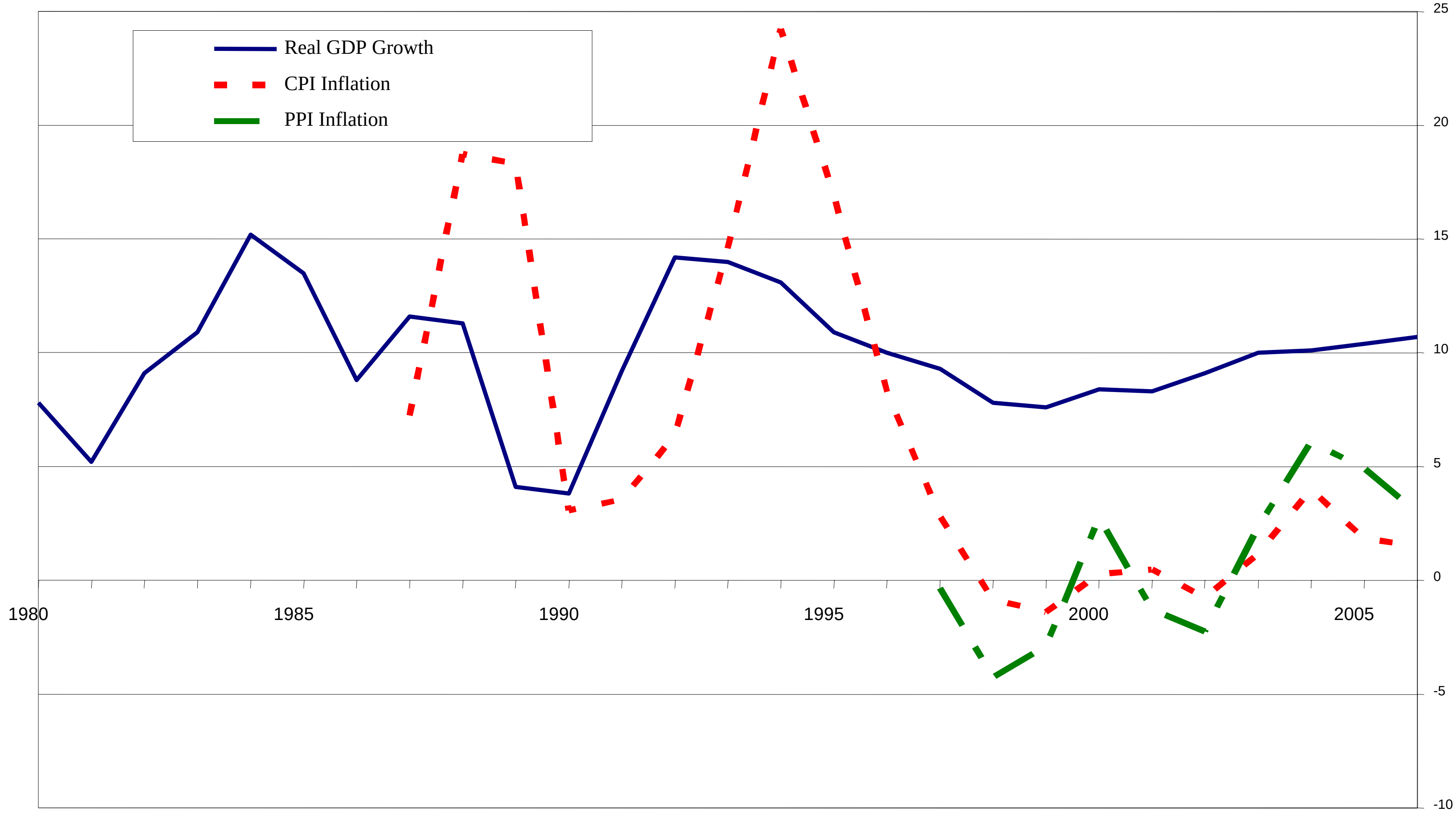
Eswar S. Prasad

Cornell University

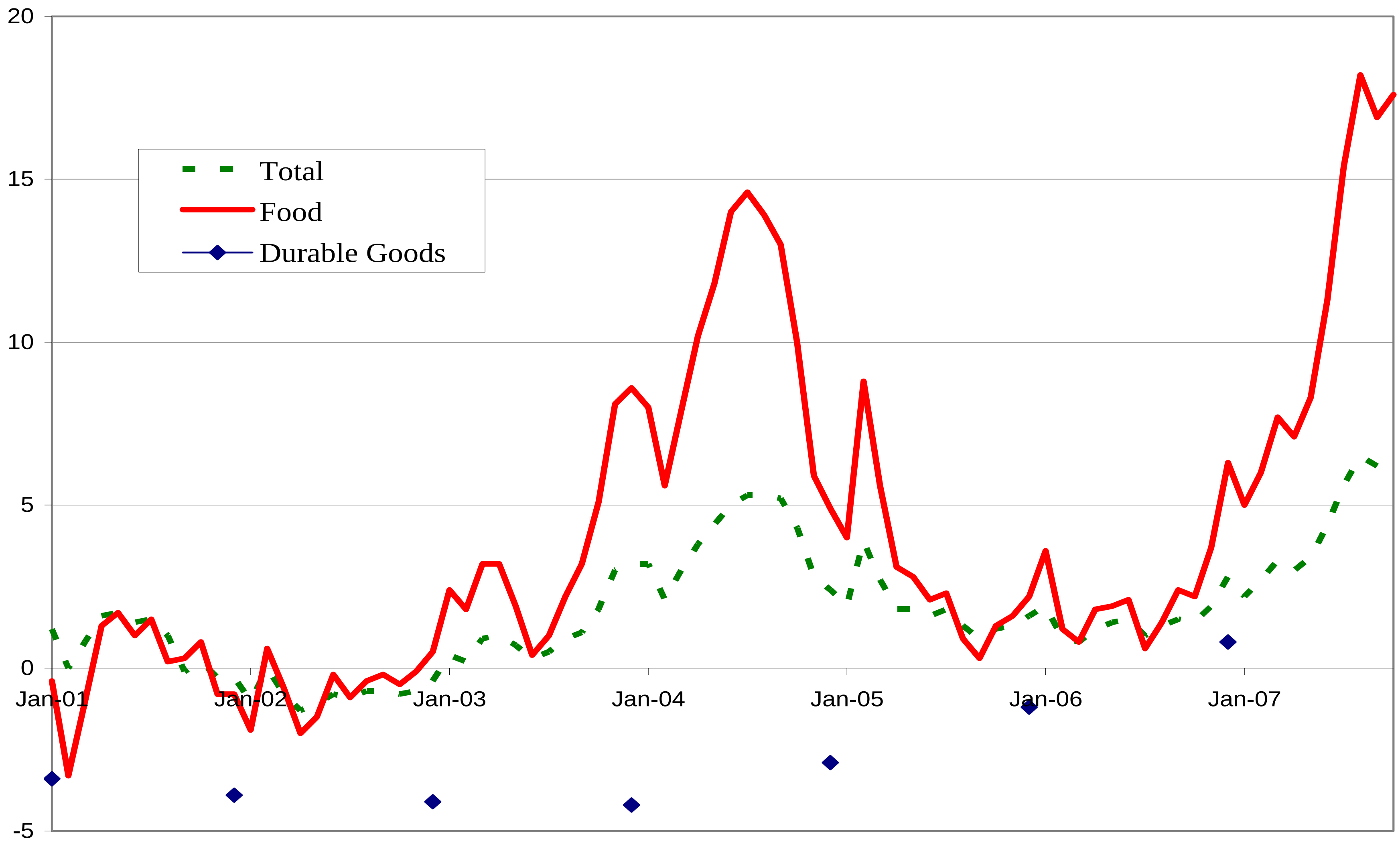
Outline of Talk

- Getting behind the growth story
- Sustainability versus welfare
- Reforms in a broader context
- Risks, possible triggers for growth slowdown

GDP Growth and CPI Inflation



CPI Inflation (year on year)



Contributions of GDP Components (by expenditure) to China's Nominal GDP Growth

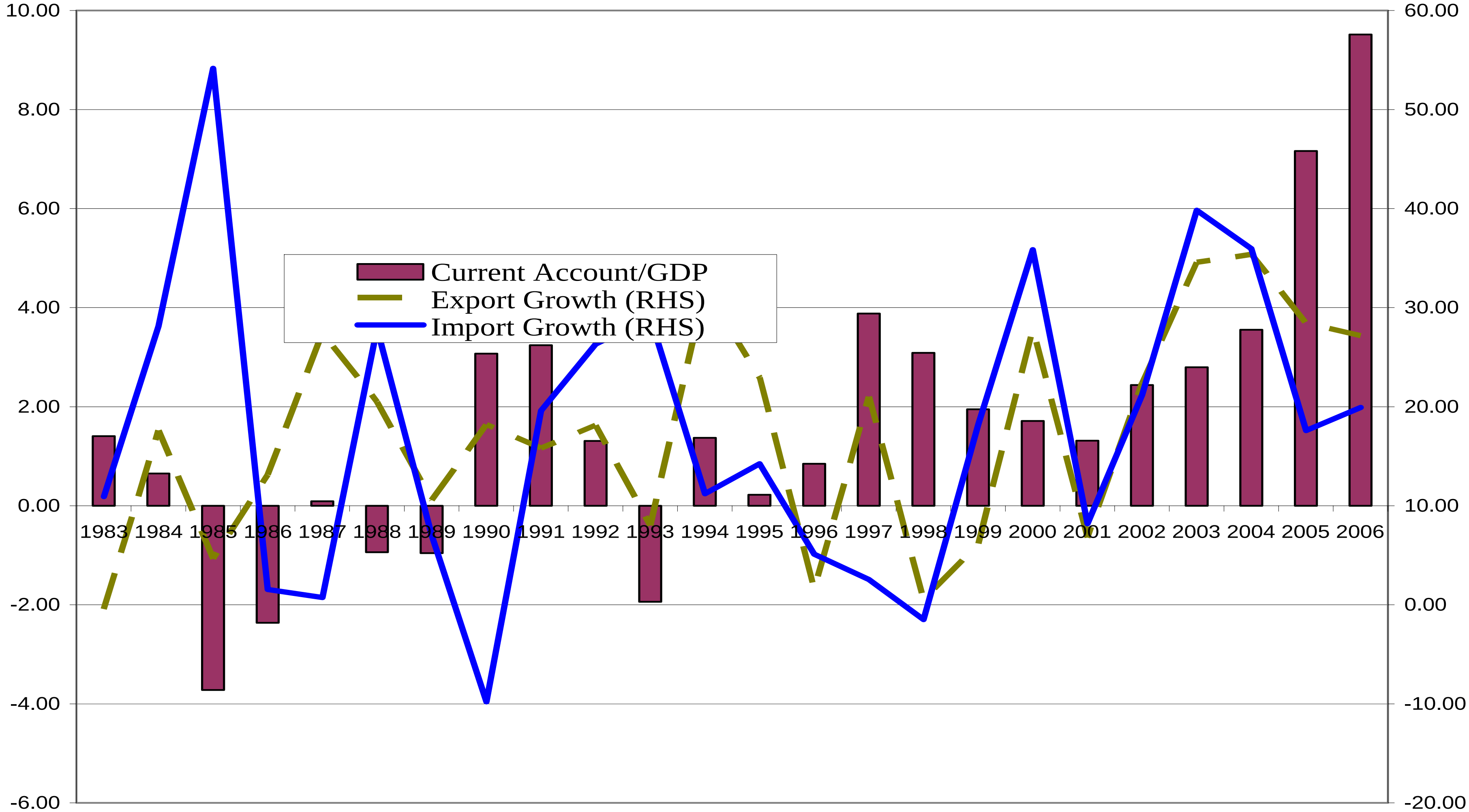
Weak Employment Growth

	Average 2000-06
GDP growth	9.6
Employment growth	1.0
Industry: output growth	10.8
Industry: employment growth	2.3

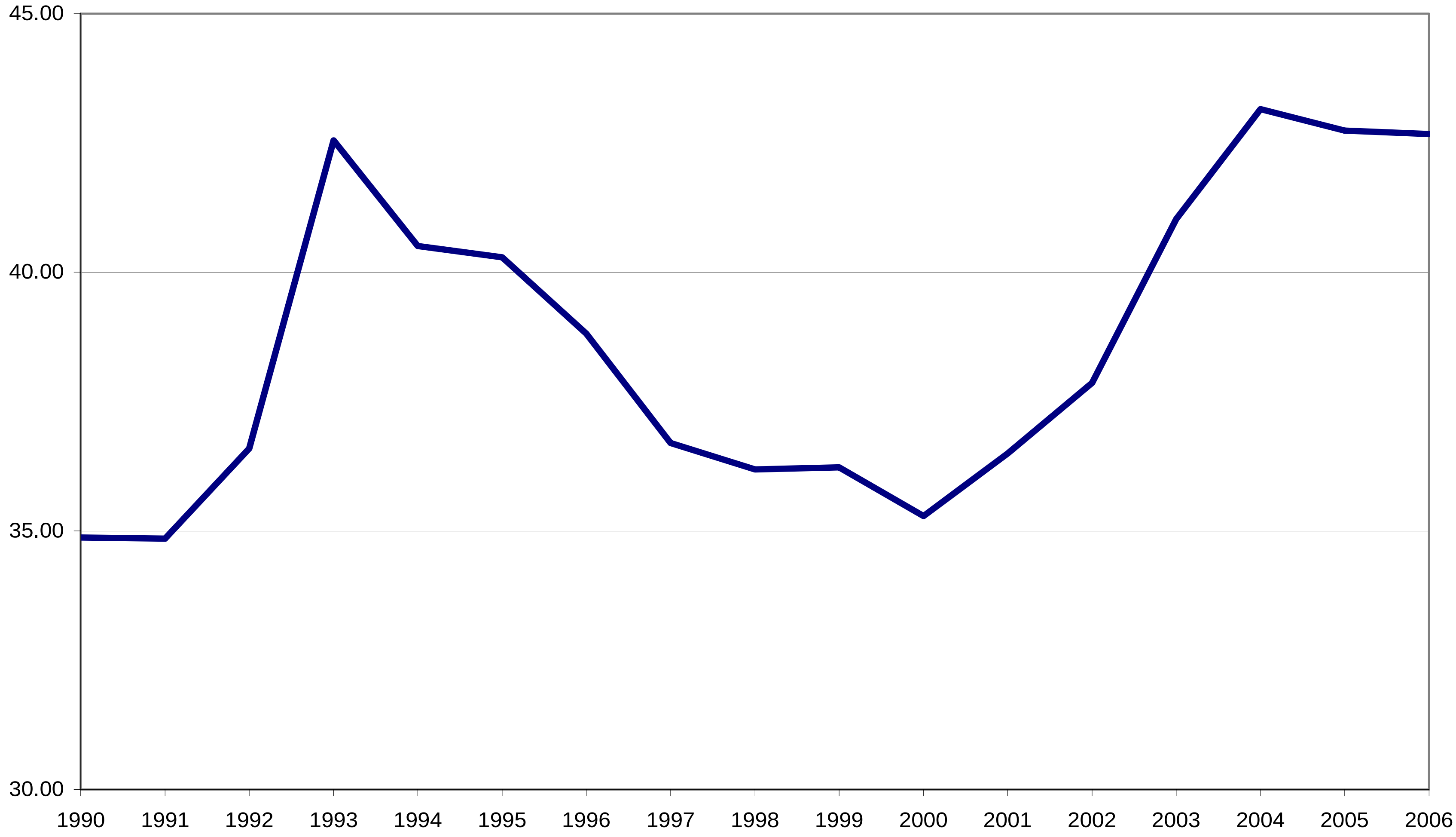
Savings-Investment Balance

- High level of investment financed by cheap credit, retained earnings
- High household and corporate savings
- So still large current account surpluses

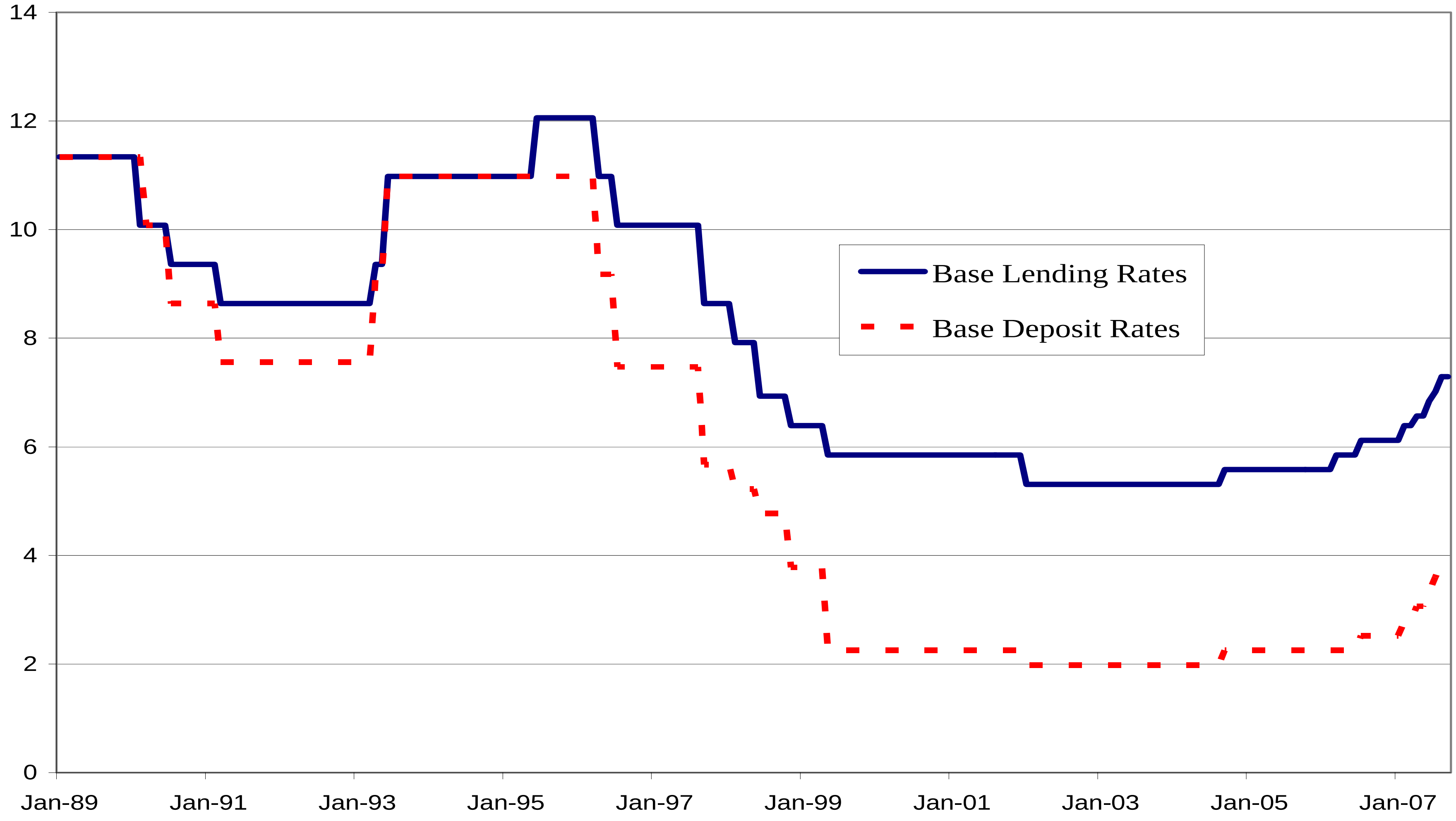
Current Accounts/GDP, Export and Import Growth



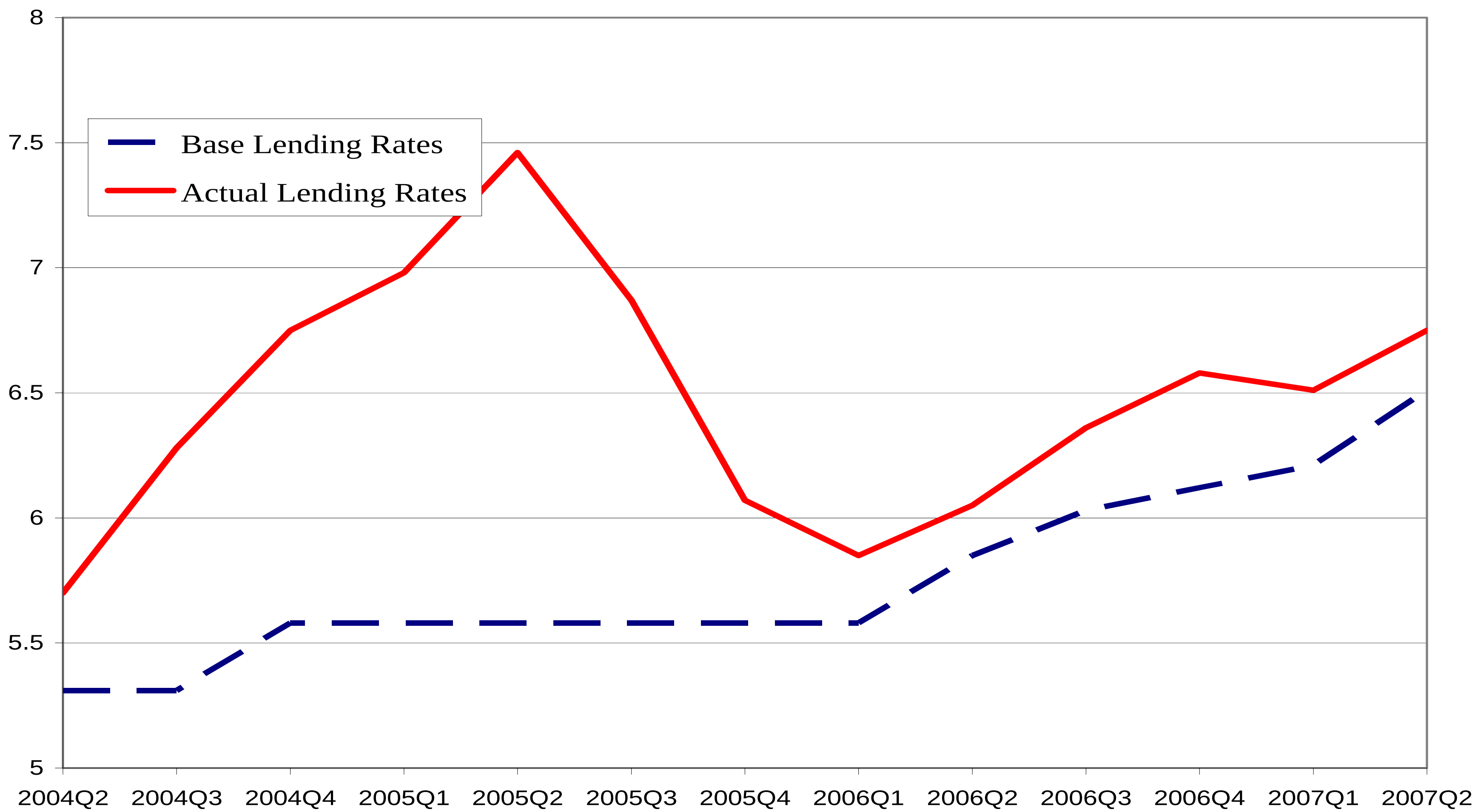
Capital Formation



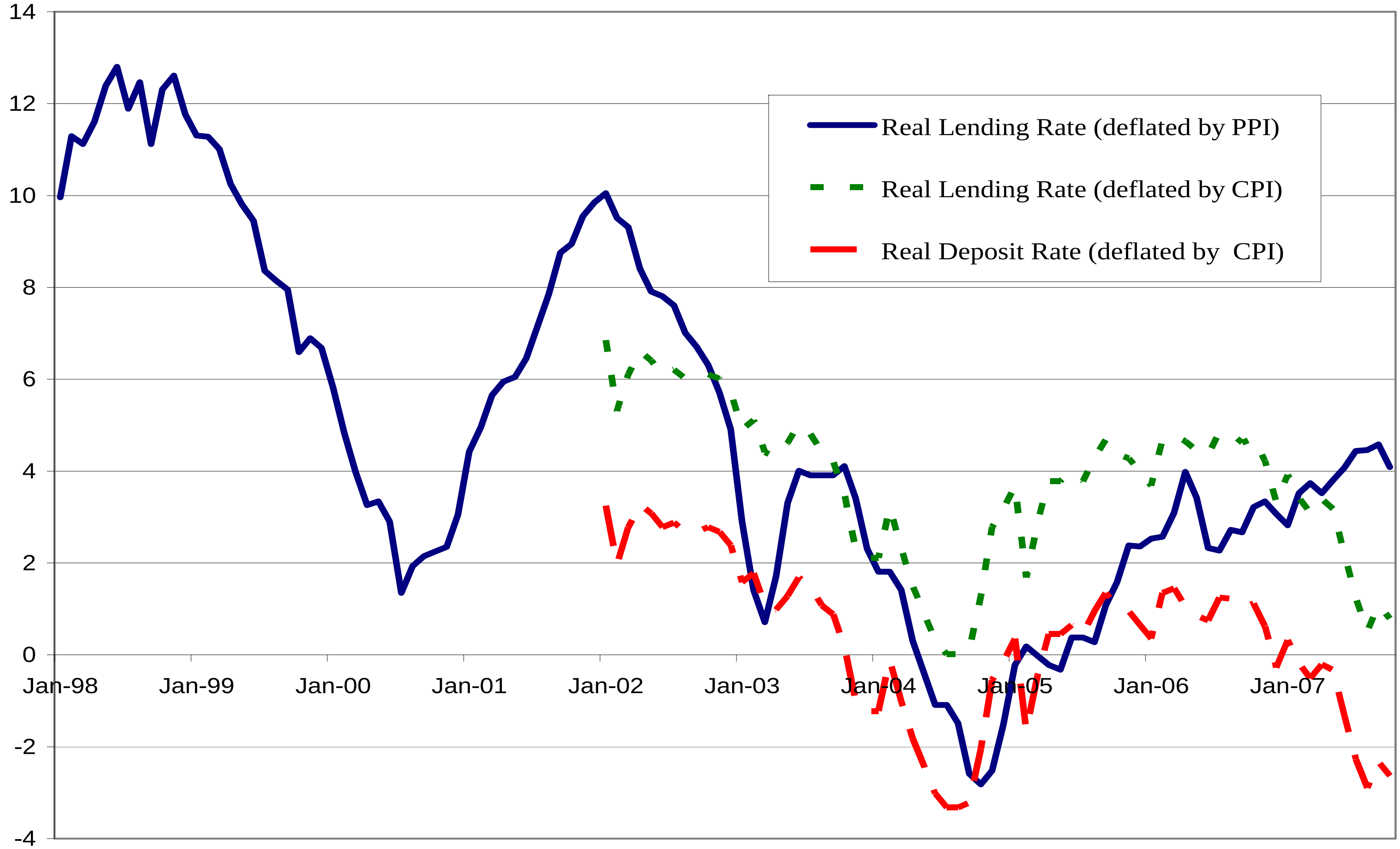
Base Lending and Deposit Rates
(1-year rates, in percent)



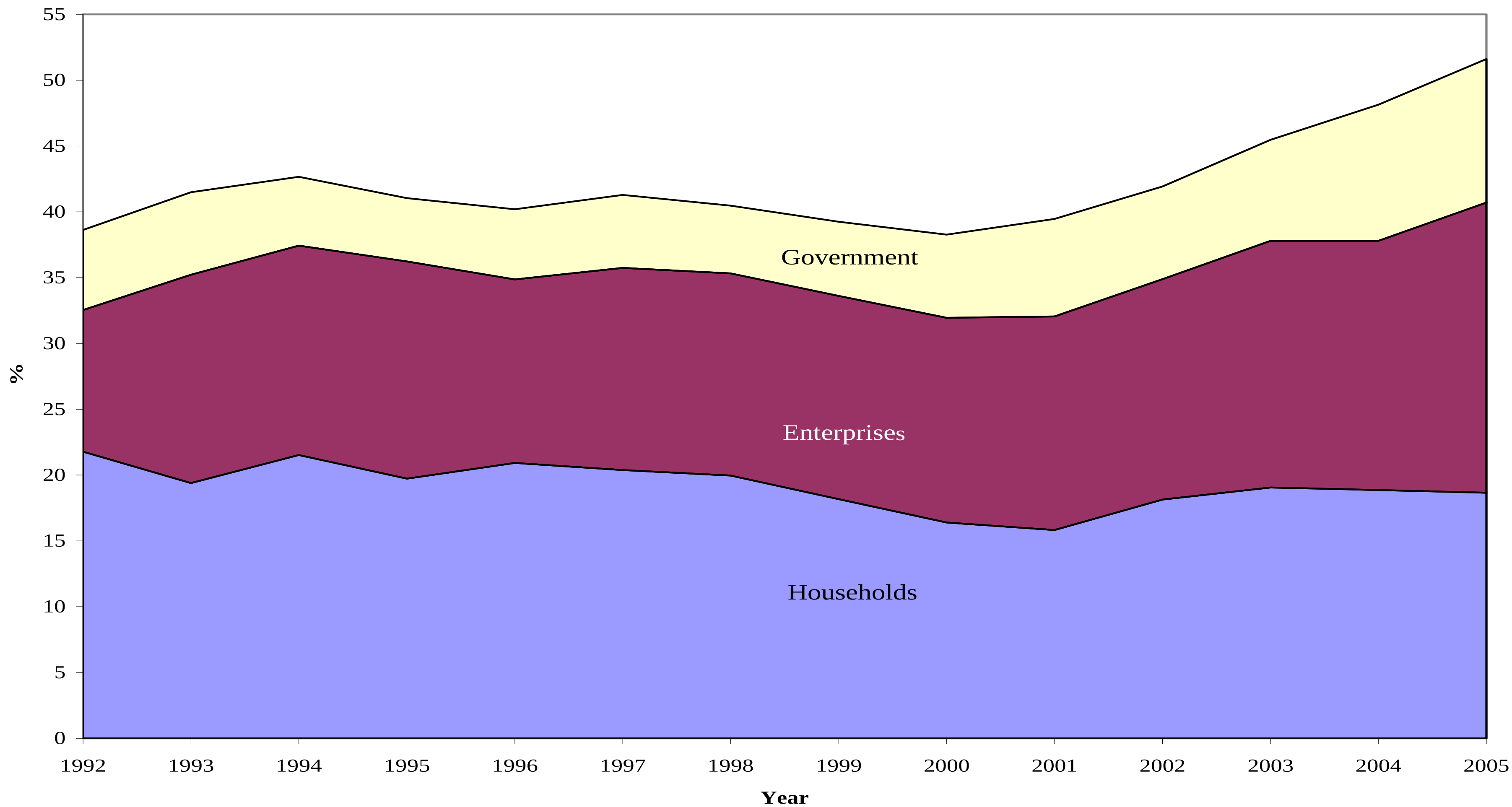
Base and Actual Lending Rates
(1 year, in percent)



Real Lending and Deposit Rates
(1-year rates, in percent)

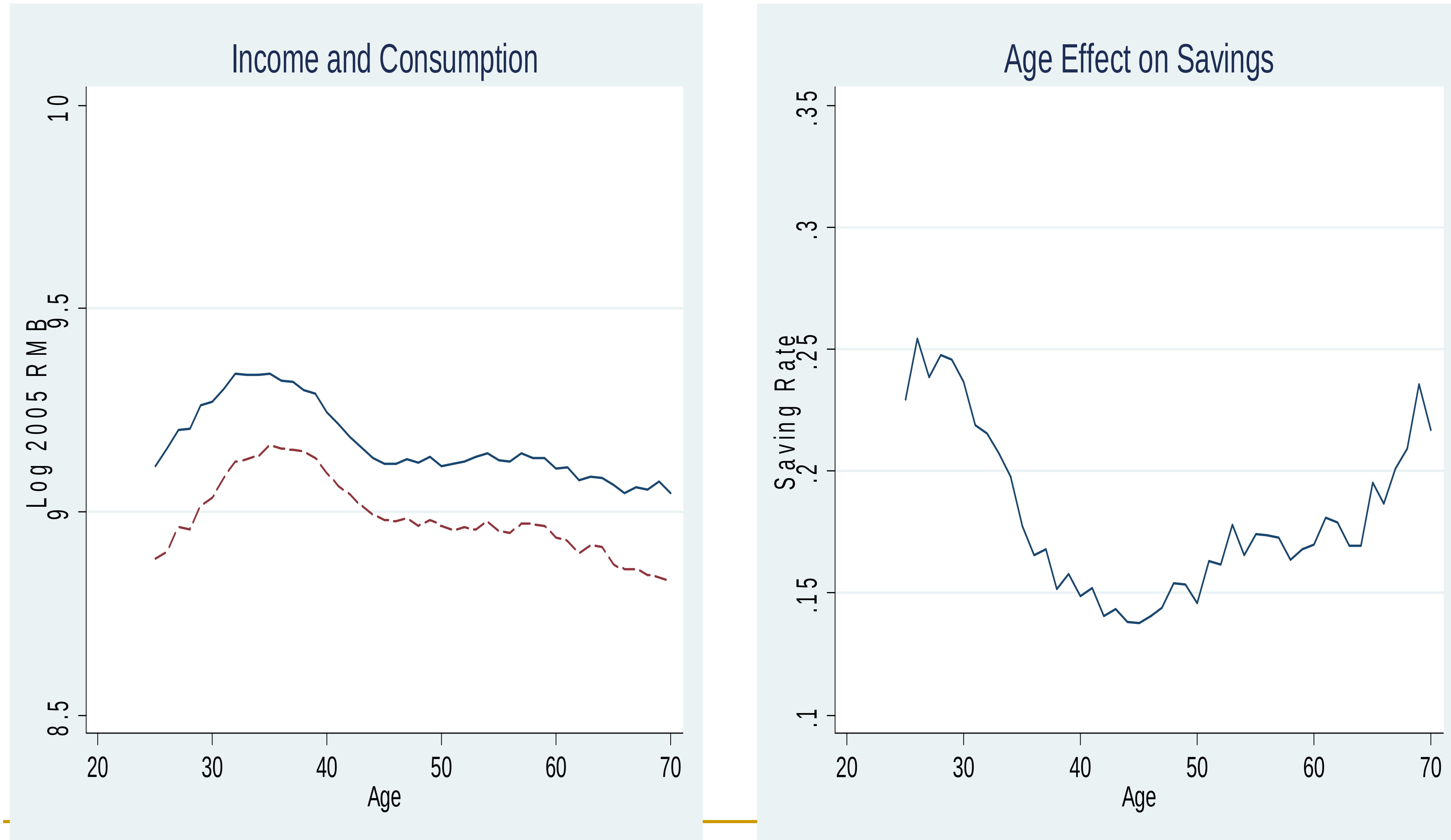


Contributions to Gross Domestic Savings as a Percentage of GDP

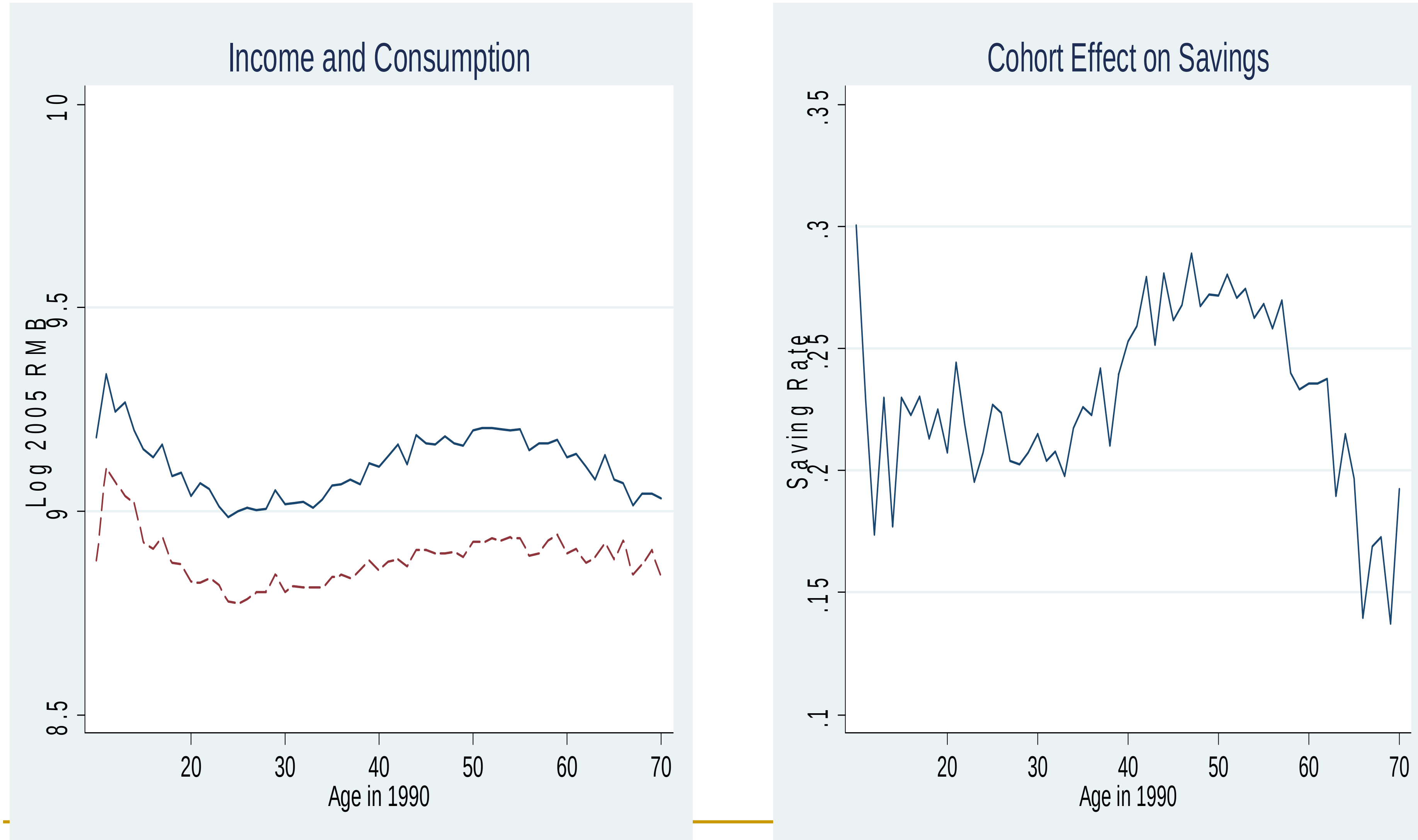


Average Saving Rates by Age of Household Head

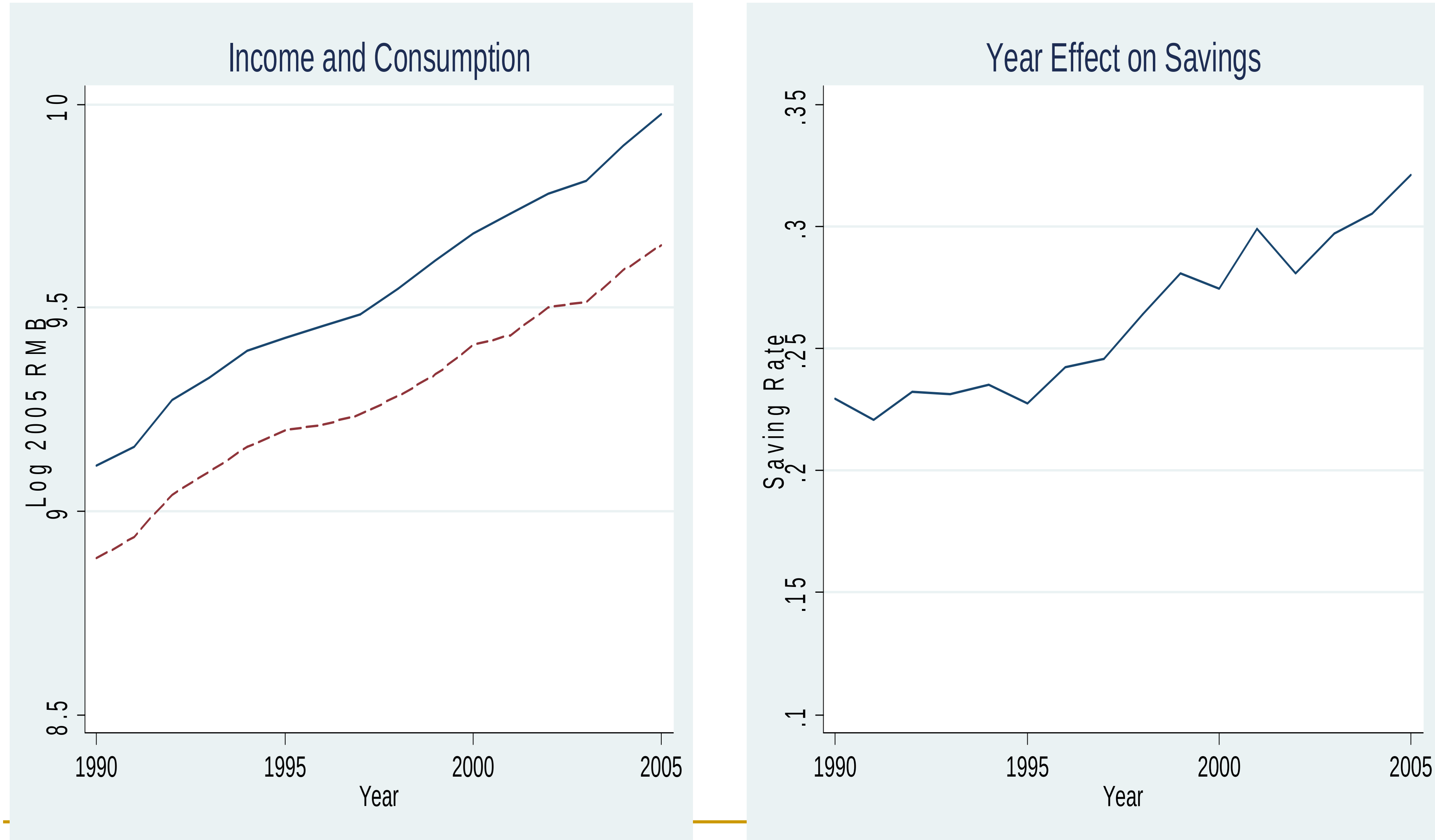
Age Effects on Income, Consumption, and Saving Rates



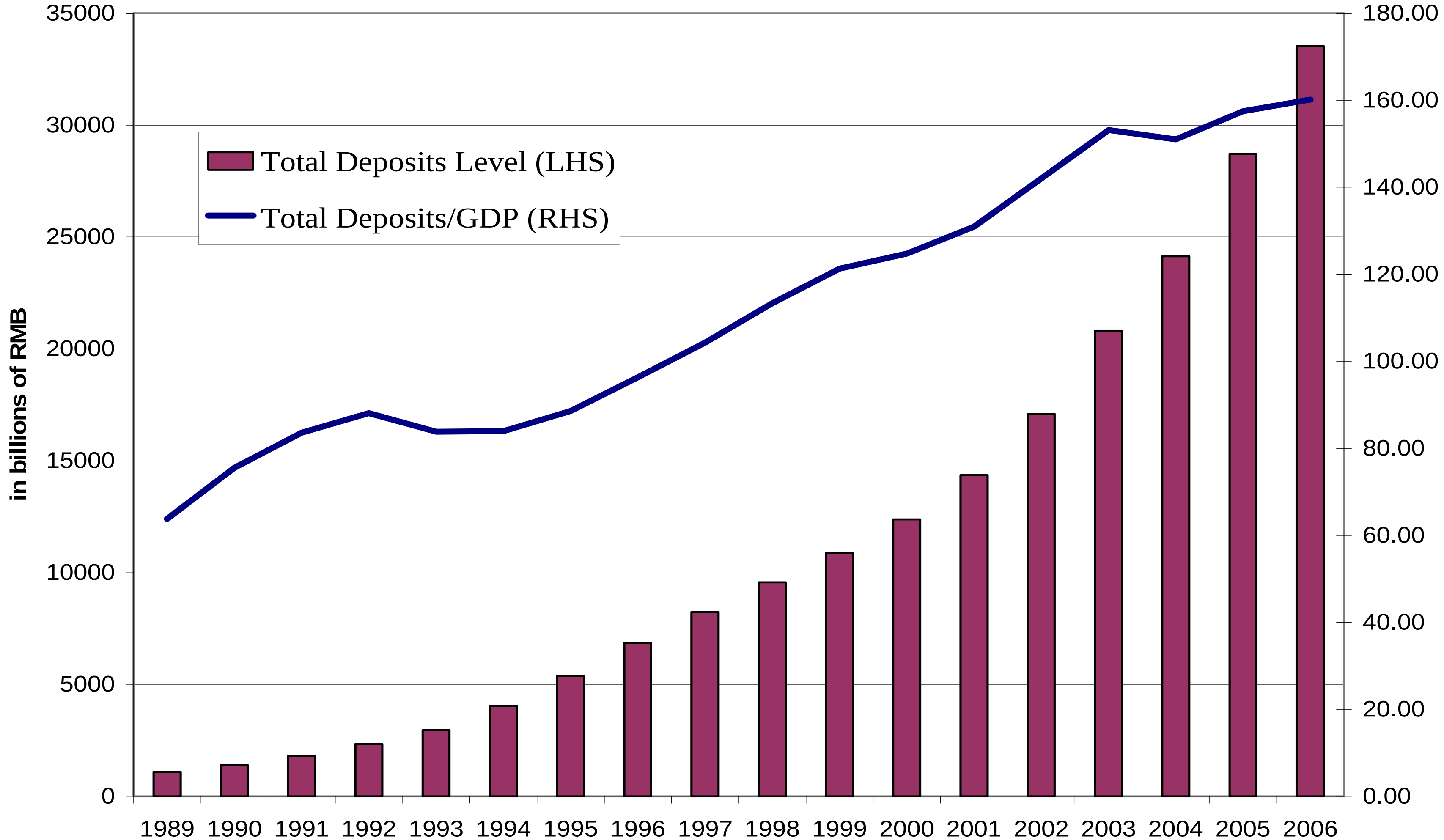
Cohort Effects on Income, Consumption, and Saving Rates



Year Effects on Income, Consumption, and Saving Rates



Deposits in the Chinese Banking System
Total Deposits in Financial Institutions



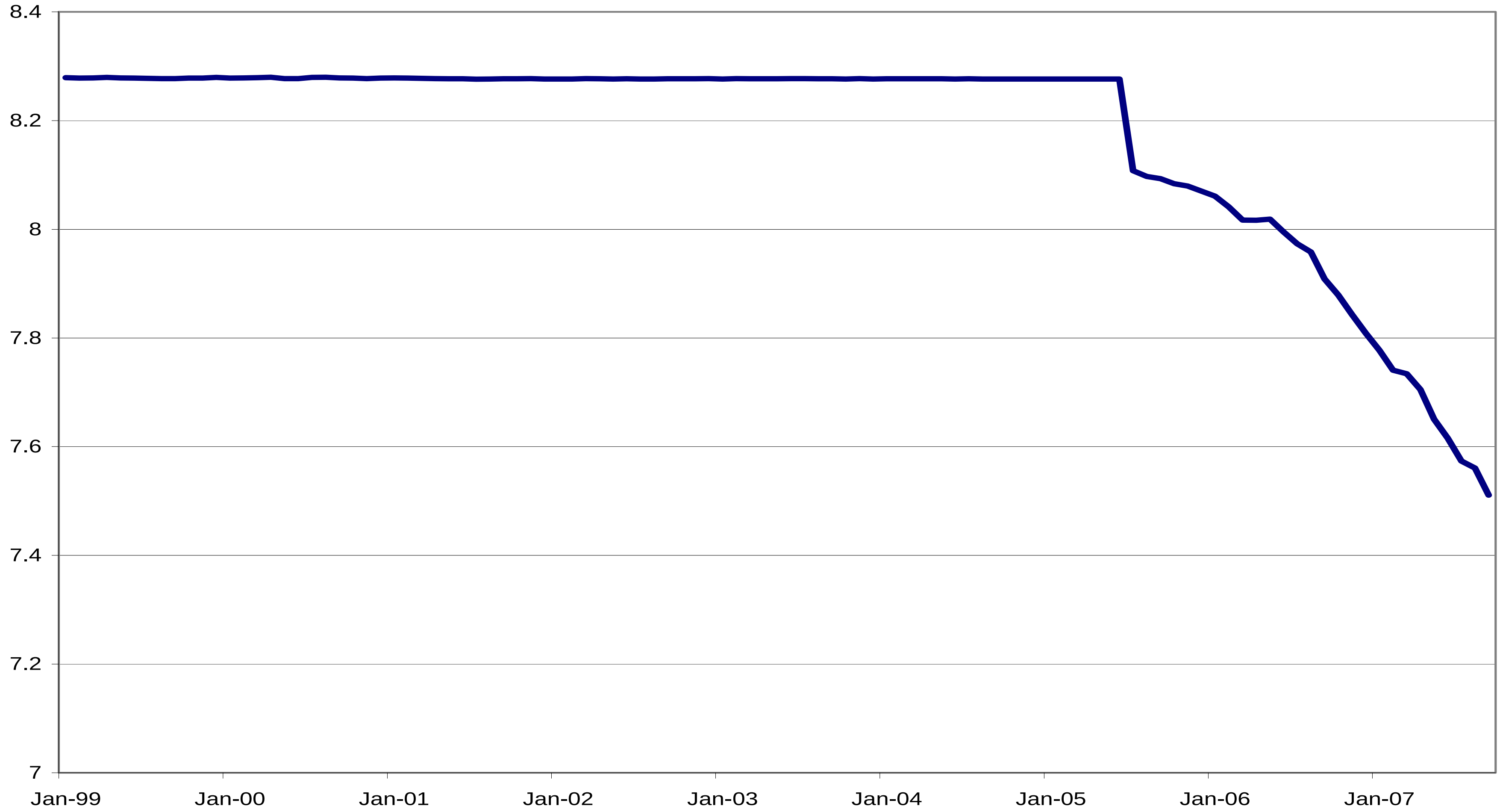
Macro Policy Distortions

- Lack of fx flexibility
- Capital controls
- Financial repression

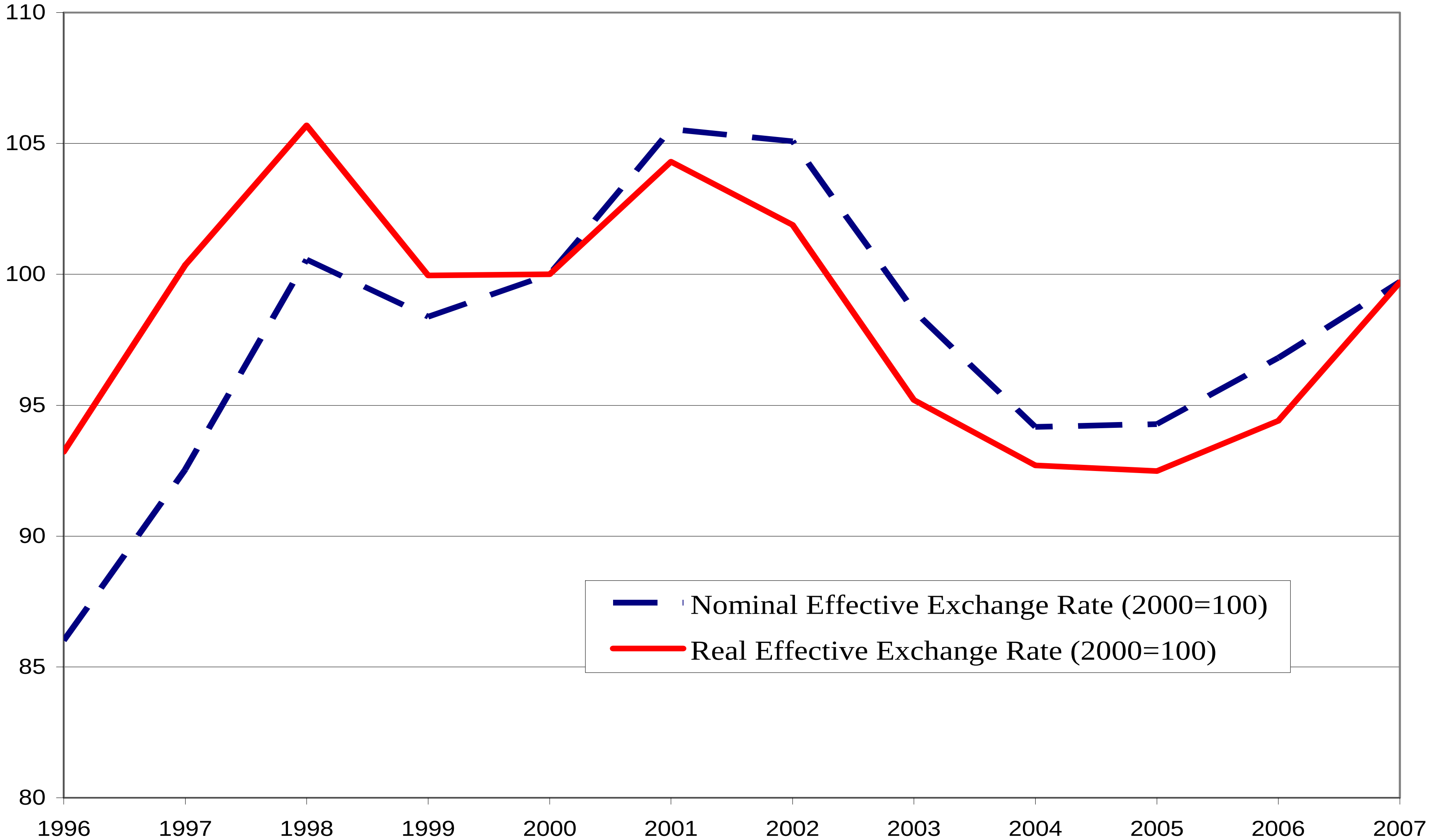
Exchange Rate Flexibility: Not!

- Renminbi tied to U.S. dollar since 1995
- 2.1% revaluation on July 21, 2005
- About 10% bilateral appreciation to date
- Much smaller in nominal/real effective terms

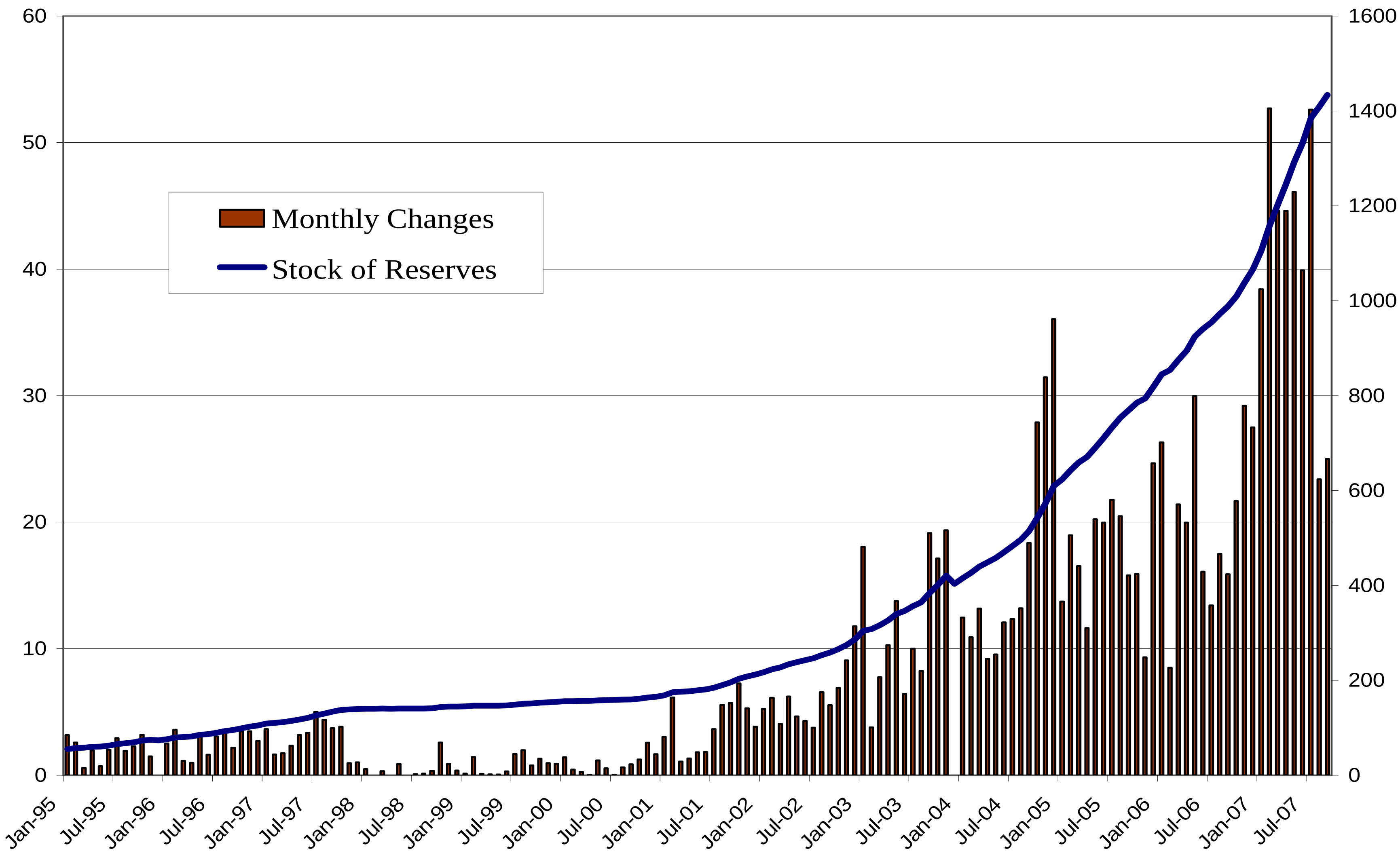
RMB-USD Exchange Rate
(1999 – present)



Real and Nominal Effective Exchange Rates



Foreign Exchange Reserves: Flows and Stocks



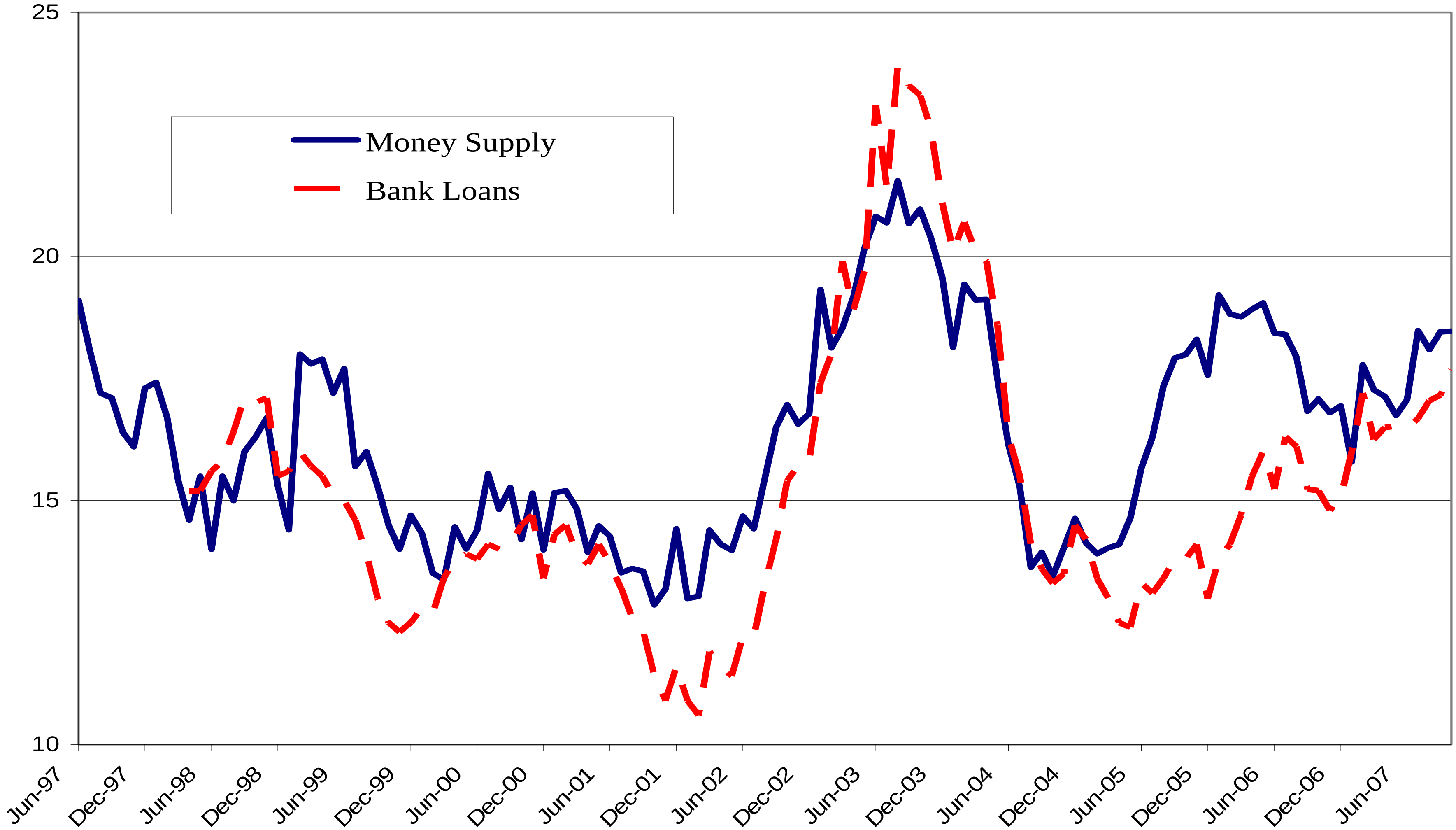
The Balance of Payments

	2000	2004	2006	2007 H1
Gross international reserves	168.9	618.6	1072.6	1338.7
(in percent of GDP)	*14.1*	*32.0*	*40.8*	
Change in international reserves	10.5	206.3	247.0	266.1
A. Current account balance	20.5	68.7	249.9	162.9
(in percent of GDP)	*1.7*	*3.6*	*9.5*	
Merchandise trade balance	34.5	59.0	217.7	135.7
(in percent of GDP)	*2.9*	*3.1*	*8.3*	
B. Capital account balance	2.0	110.7	10.0	90.2
FDI, net	37.5	53.1	60.3	51.0
C. Errors and omissions, net	-11.9	27.0	-12.9	13.1
Memorandum Items:				
Non-FDI capital account balance (including errors and omissions)	-47.4	84.6	-63.2	52.3
Nominal GDP	1198	1932	2626	

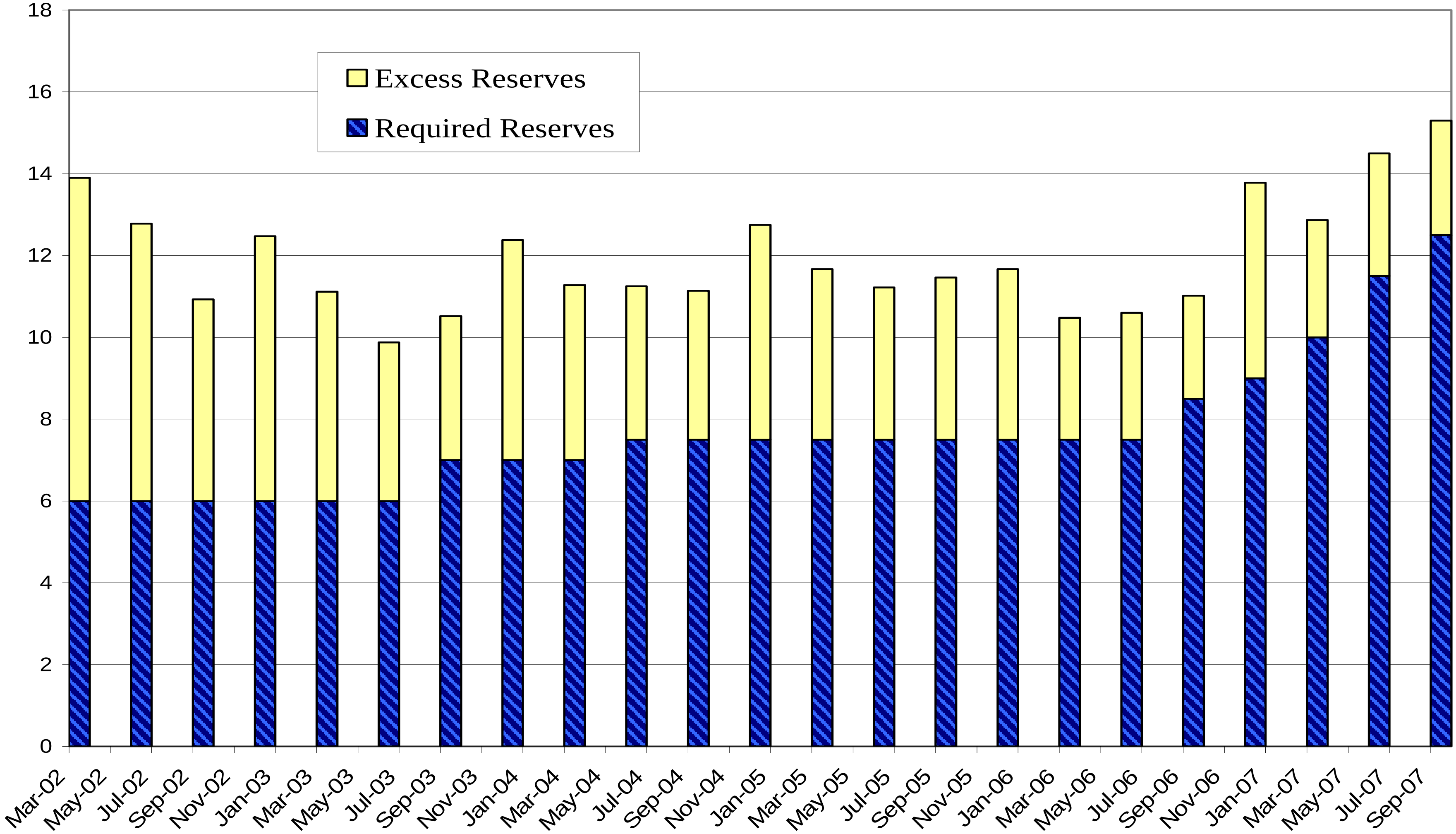
Decomposition of the Recent Reserve Buildup

	Annual averages			Changes	
	1998-2000	2001-04	2005-06	2001-04 - 1998-00	2005-06 - 2001-04
	(1)	(2)	(3)	(2) - (1)	(3) - (2)
Increase in foreign reserves	8.5	112.4	227.0	**103.9**	**114.6**
Current account balance	24.4	41.9	205.4	**17.5**	**163.5**
Capital account balance	0.3	57.7	36.5	57.4	-21.2
FDI, net	38.5	46.1	64.1	**7.6**	**17.9**
Errors and omissions, net	-16.1	12.1	-14.9	28.2	-26.9
Non-FDI capital account balance (including errors and omissions)	-54.4	23.6	-42.4	**78.0**	**-66.0**

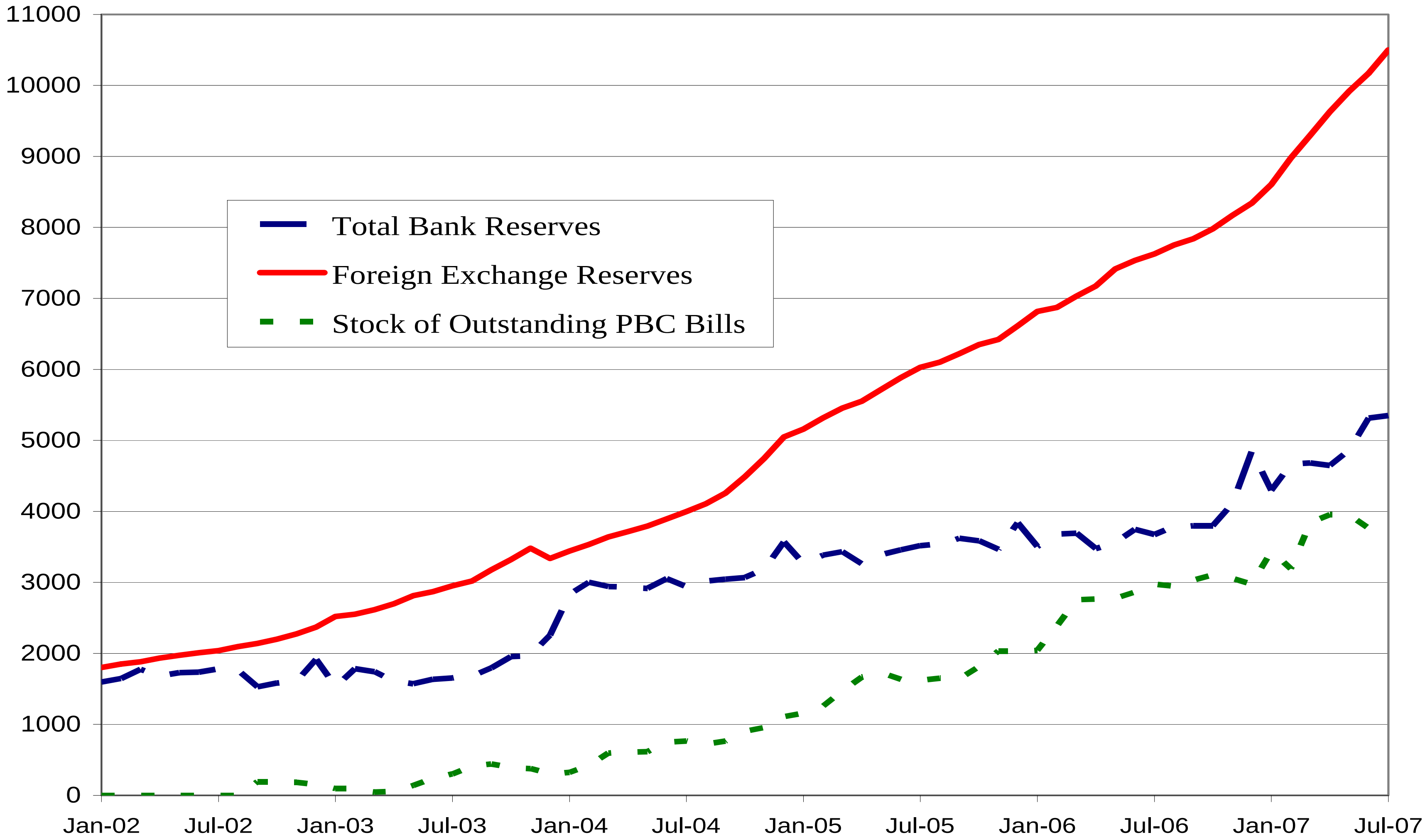
Money and Credit Growth
(year on year, in percent)



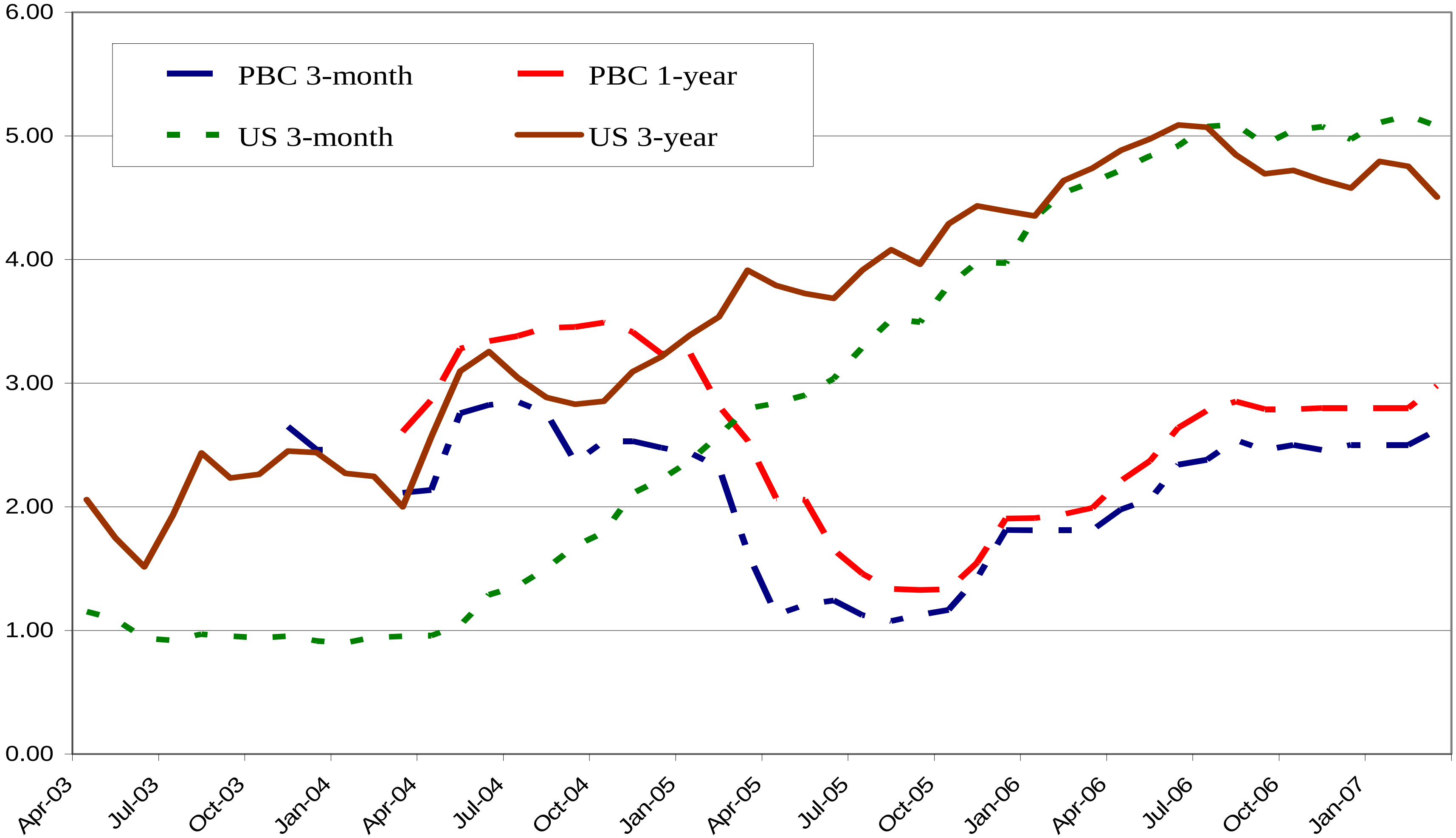
Required Reserves and Excess Reserves Ratio (in percent of total deposits)



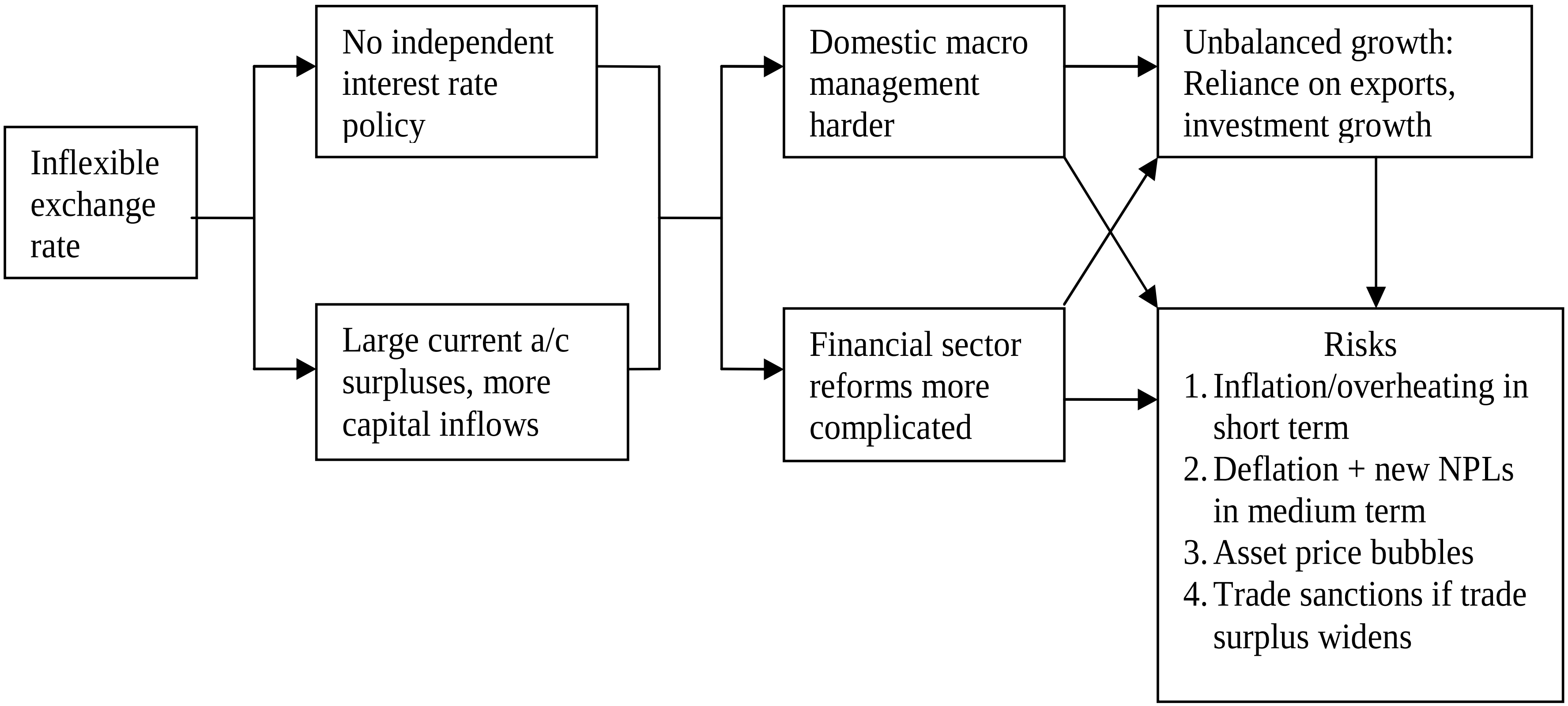
Stocks of Reserves and Central Bank Bills
(in billion of RMB)



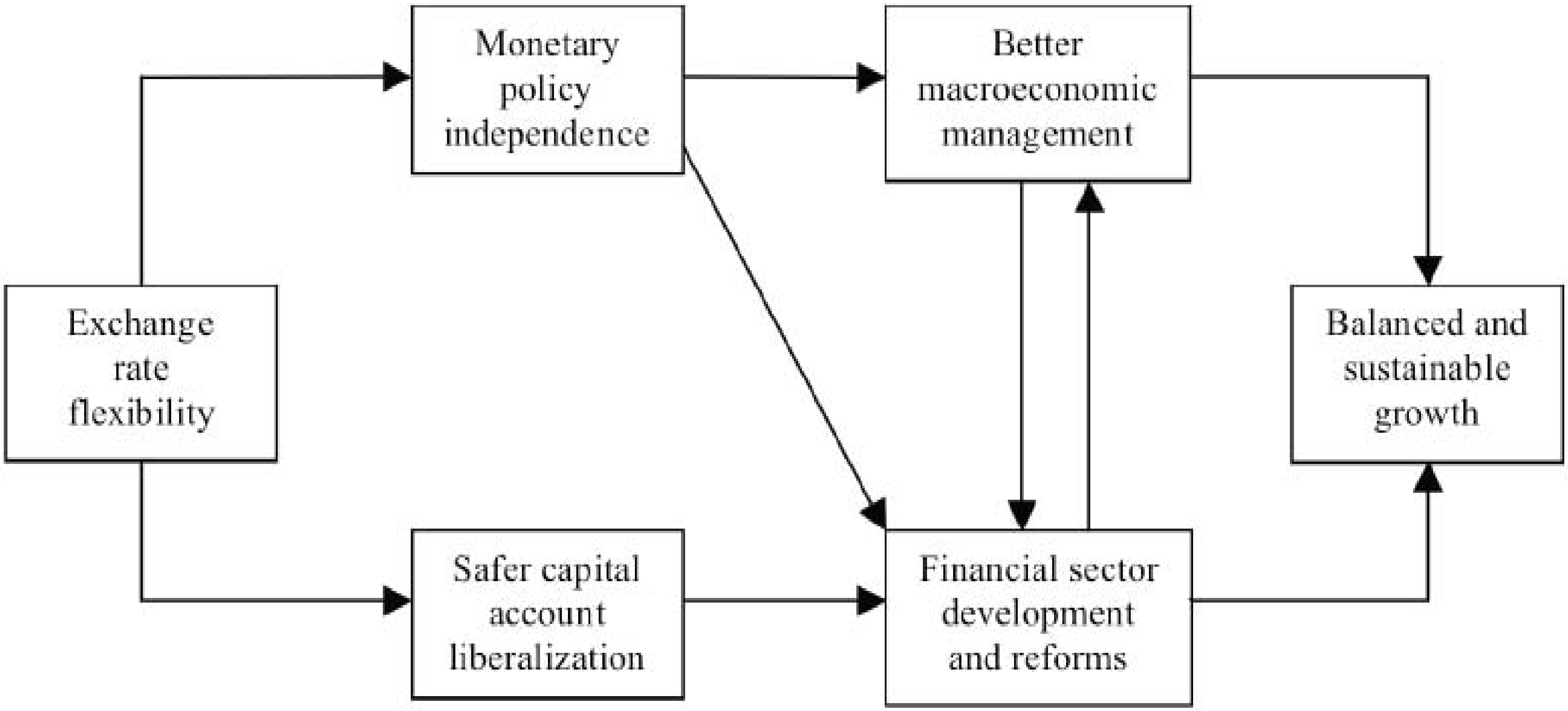
PBC Bill Rates vs. U.S. Treasury Yields
(in percent, annualized)



Lack of Exchange Rage Flexibility Complicates Macro Policy and Reforms



Making the Right Connections



A Framework for Independent Monetary Policy

- A long-run low inflation objective
- Macro and financial stability
- Fx flexibility would evolve naturally
- Would assist in financial sector reforms
- Good time to put new framework in place

Independent Monetary Policy

- Flexibility, not revaluation
- Flexibility, not free float
- Capital account liberalization not solution in itself

The Reform Process

- Incremental approach not easy
- Controlled experiments harder
- Reforms are connected
- Need a framework for reforms

Risks:
External and Internal Shocks

- Sudden stop/reversal of capital inflows

China’s International Investment Position

	2004	2005	2006
Net Position	**293**	**423**	**662**
A. Assets	**930**	**1223**	**1627**
Reserve assets	**619**	**826**	**1073**
Other	**311**	**397**	**554**
B. Liabilities	**637**	**800**	**965**
FDI	**369**	**472**	**544**
Other	**268**	**329**	**420**

Risks

- Sudden stop/reversal of capital inflows
- Plunge in value of US dollar
- Collapse of external demand
- U.S. trade sanctions

China-U.S. Relations

- The exchange rate issue
- Opening up of the financial services sector
- Common interests not often emphasized
- Strategic Economic Dialogue needs benchmarks
- Risks of the legislative process
- Legislation in motion in Senate, House

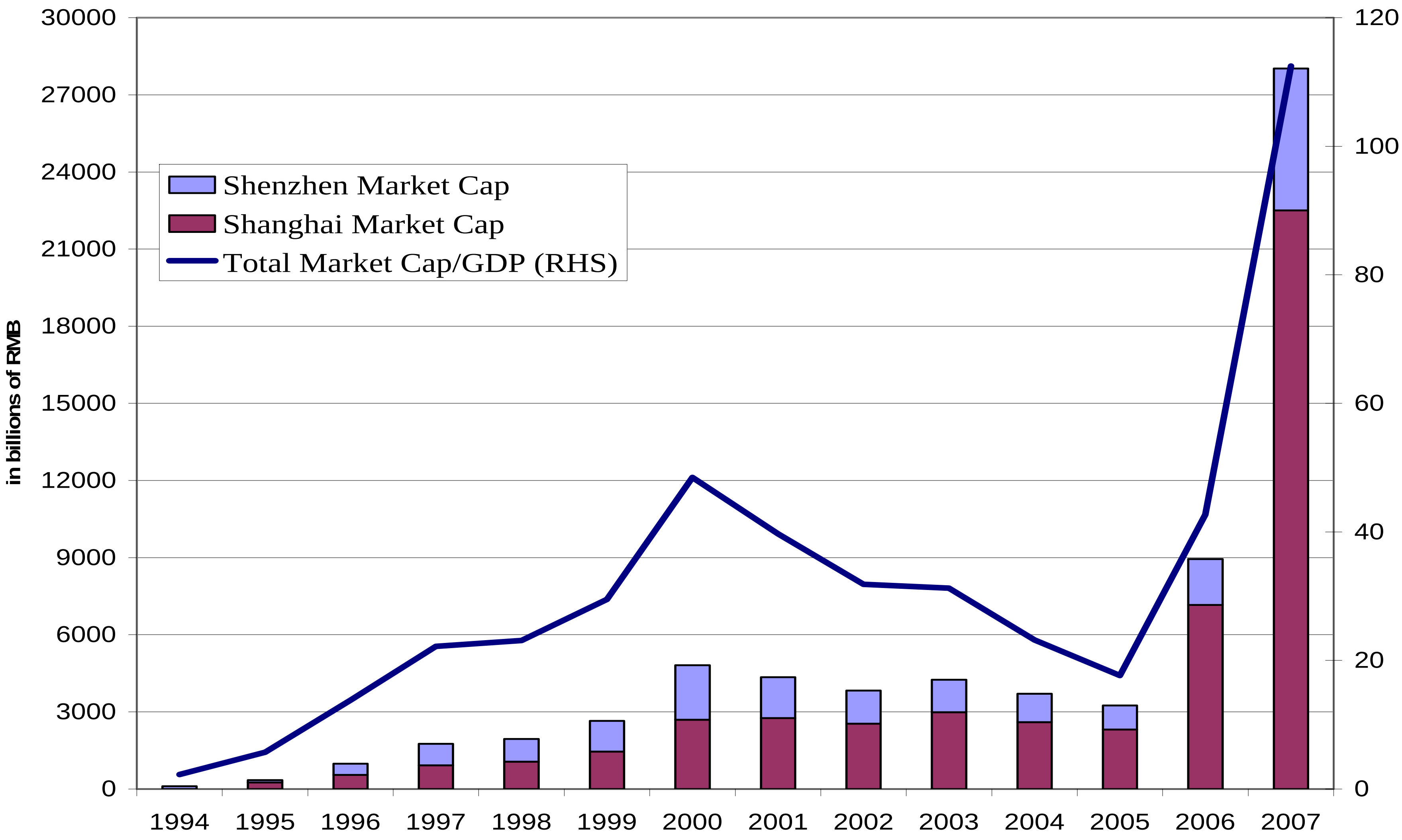
Risks

- Sudden stop/reversal of capital inflows
- Plunge in value of US dollar
- Collapse of external demand
- U.S. trade sanctions
- Loss of confidence in banking system

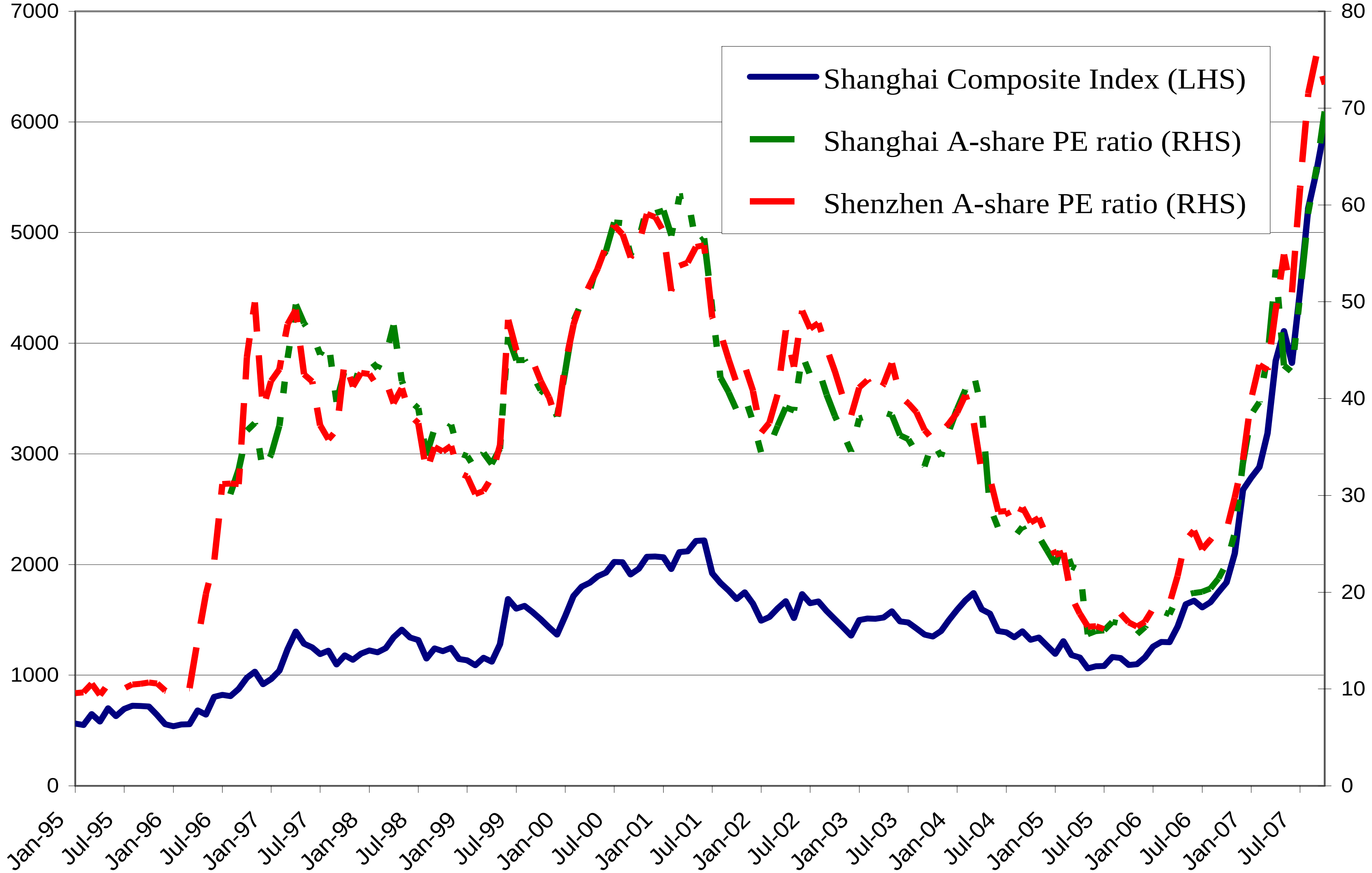
Risks

- Sudden stop/reversal of capital inflows
- Plunge in value of US dollar
- Collapse of external demand
- U.S. trade sanctions
- Loss of confidence in banking system
- Asset price busts

Stock Market Capitalization



Stock Market Valuations



Risks

- Sudden stop/reversal of capital inflows
- Plunge in value of US dollar
- Collapse of external demand
- U.S. trade sanctions
- Loss of confidence in banking system
- Asset price busts
- Social instability

Looking Ahead

- Economy has many fundamental strengths

- System rigid; some shocks could trigger growth slowdown (but meltdown unlikely)

- External pressure could help, if done right