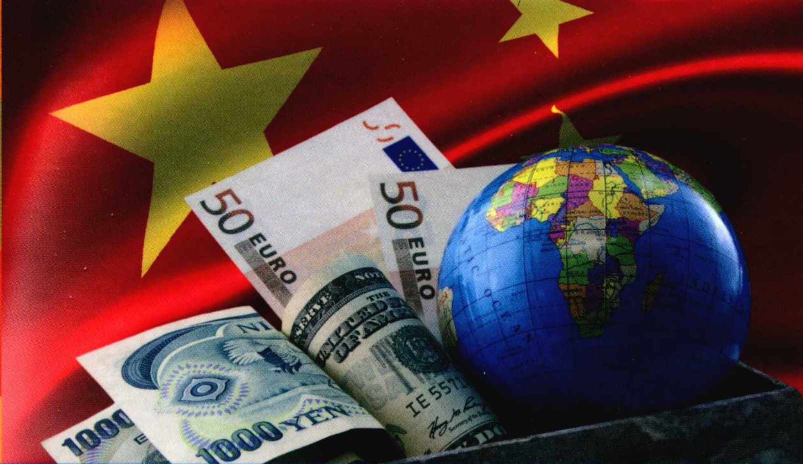

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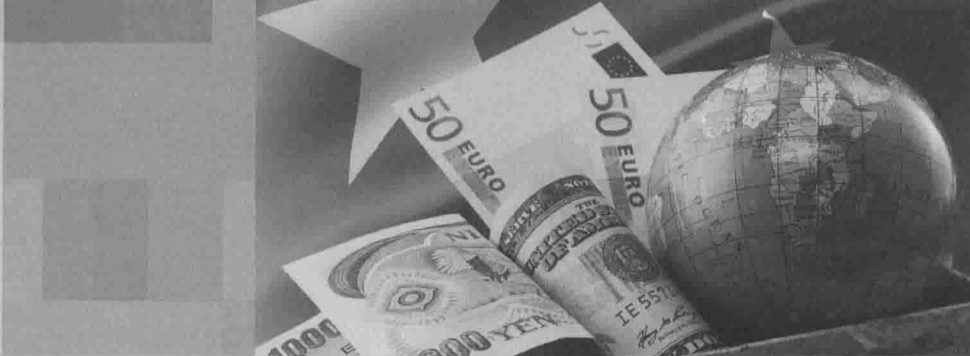
Vol. 2

Editor
John Whalley

CHINA'S TRADE, EXCHANGE RATE AND INDUSTRIAL POLICY STRUCTURE

World Scientific



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Vol. 2 China's Trade, Exchange Rate and Industrial Policy Structure
edited by John Whalley

Vol. 3 International Trade Agreements and Political Economy
edited by Raymond Riezman

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Part I

Overview of Papers and Introduction

Introduction

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Introduction

This volume contains 13 papers dealing with various dimensions of China's economic policies; how they were affected by the 2008 Financial Crisis, and what adjustments in policy directions may follow post crisis. These have all been part of a Young China Scholars Research programme supported by the International Development Research Centre, Ottawa, Canada, and the Centre for International Governance Innovation, Waterloo, Ontario, in which a number of Chinese institutions and individuals have participated. The programme coordinators were Li Shi (Beijing Normal University), Tongsan Wang (Chinese Academy of Social Sciences), Terry Sicular (University of Western Ontario, Canada), and John Whalley (University of Western Ontario, Canada). Papers were presented in draft form to an Annual Policy Forum in May 2011 in Beijing before being revised in light of comment. The papers cover macroeconomic policy making, trade policy, exchange rate policy and reserve management, industrial structure and performance as well as global institutional issues and China's participation in them. The coordinators wish to extend their gratitude to the funding organisations, as well as to the Beijing University of

International Business's School of International Studies for effective organisational and logistical support for the May 2011 forum meeting.

In "How Can the G20 Better Support Global Governance? A Chinese Perspective" Zhang and Tian argue that the G20 will be the most important and the most representative global governance platform both in today's world and for the foreseeable future, and that it should enter a new phase in its institutional development, moving beyond crisis management towards robust governance, including establishing a permanent secretariat in decision-making and setting up rules, more inclusiveness, effective policy coordination and equal and just rights of participation. The recognition of the relevance of civil society and business organisations for global governance is seen by them as a step forward. Their importance in the world economy and the broad representativeness of developing countries both indicates that the developing country E11 group within the G20 has a large space for internal cooperation, and actively promoting the internal cooperation of E11 can create a win-win situation between developed and developing countries and improve global efficiency. In the E11, China is still a new player on the international stage and not the rule maker, but given the risks and problems of the Chinese economy, China needs to adopt a series of macroeconomic measures, including fiscal, monetary, taxation, financial and industrial policies to maintain exchange rate stability, and prevent a inflow of hot money, contain credit binges, curb inflation, expand domestic demand, stabilise external demand, promote economic restructuring and adjust the income distribution. In the next decade, China's basic attitude to global governance will be to minimise the loss from its participation, not to maximise the benefits. How to ponder and understand the relationship between the partial and the overall, the long-term and the short-term international obligations and rights, and what kind of global governance structure is most consistent with China's long-term development targets, are all challenging problems that China faces.

In "The Chinese Savings Rate: Causes and Implications for Imbalances" Cai and Wang analyse the underlying causes of China's high national savings rate and argue that the high savings rate is an inevitable and reasonable result of a dualistic economic structure, institutional distortions, China's current development stage and its demographic structure. The high Chinese savings rate, along with overconsumption by the United States, is the root reason for global imbalances. Unilaterally appreciating the RMB would not bring radical change to the global imbalance, given China's huge surplus of savings. However, the Chinese aging process is changing the fundamental conditions for China's high savings rate. Deepening reforms will tend to decrease the savings rate in China. What China should be concerned about is not the current high savings rate and trade surplus, but possible insufficient savings for domestic investment in the future. Actions should be taken to adjust the investment structure in the next 10 years. The priority for investment should turn to welfare accumulation, specifically expanding the capacity of infrastructure in transportation, communication, electricity and elsewhere.

In "Labour Market Reform, Income Inequality and Economic Growth in China" Lu and Gao argue that after opening up in 1978, China has followed a development strategy that has led to internal and external economic imbalances, especially following its labour market reform in the mid-1990s and the resulting surge in rural-to-urban migration. Low labour costs emerged as its main comparative advantage, but its over-reliance on exports for growth was exposed by the global economic crisis of 2008. This, coupled with widening income disparities could jeopardise the sustainability of China's growth unless it adjusts its reform and development strategies to promote income equality and domestic consumption. They suggest that the Employment Contract Law in force since 2008 could signal institutional change in the right direction.

In "Institutional Constraints, Identity and Household Consumption Heterogeneity in China" Chen, Lu and Zhong study the effect of the *Hukou* system on household consumption in China based on a dataset from the Chinese Household Income Project Survey (CHIPS). They find migrants' marginal propensity to consume is lower than urban residents by 0.146. This consumption heterogeneity cannot be explained by life cycle characteristics, culture, social norms or habits. Precautionary saving is the most likely channel through which the *Hukou* system affects household consumption, as migrant households face higher labour income risk and are less likely to be covered by an insurance program. Further studies on the compositions of household consumption show the gaps in marginal propensity to consume are largest over such areas as education and culture, durable goods and health. This is consistent with the precautionary saving explanation.

In "What Accounts for China's Export Market Performance During the Financial Crisis?" Tao and Lin begin by noting that the reduction in external demand brought about by the financial crisis in 2008 has not decreased the export market share of China to the world and its trade partners. On the contrary, the export market share of China actually improved slightly. The paper studies the relationship between export share performance and external shocks, as well as its determinants. Some theoretical and policy arguments can help explain the steady export performance of China during the crisis. On one hand, the paper uses a reduced-form econometric model to test the effects of the determinants on the export share and provides some implications of the model. On the other hand, the central government instituted many policies to increase export volume, including repeatedly raising the export tax rebate rate, increasing the export credit insured sum and financing facilitation, expanding fiscal support for the export enterprises. All these measures have played a practical role during and after the financial crisis such that the export performance of China has rebounded and returned to its pre-crisis level.

In "The Global Financial Crisis and China's Trade in Services: Impacts and Trade Policy Responses" by Fan, the impact of the global financial crisis on China's services trade is analysed and the policy responses taken by Chinese government discussed. It also offers some policy suggestions. The main findings of the paper are as follows: Although the global economic and financial crisis has spawned a synchronised recession leading to a contraction in China's services trade, it has had a small effect on China's trade in services owning to the lower internationalisation degree of services. China's trade surplus in goods decreased and its trade deficit is services increased post crisis. Structural reforms are needed to help support the recovery of output and trade. A possible solution is to reduce the balance of trade (trade surplus in goods and trade deficit in services) by expanding trade in services. The openness degree of services is lower than that of goods in China. Continued policy and regulatory reform in favour of services trade will be vital to supporting economic recovery. Further liberalisation in services trade is the appropriate policy choice for the Chinese government.

In "How Much Did China's Exports Drop During the 2008–2009 Financial Crisis?" Jing notes that China's exports were badly hit during the 2008 financial crisis. This paper attempts to measure the extent to which China's exports contracted during the recession and investigates the patterns of collapse. China's product-country monthly exports data are utilised. It is found that exports contracted mainly on intensive margins — the average export value per product to each country. The number of destination countries and the average number of products in each market hardly decrease. This result implies that China's exports can easily emerge from recession once general economic conditions improve. It is also found that GDP growth rates of importing countries play an important role in explaining the size of the contraction. Exports of capital and intermediate goods fall more severely than consumption goods. Last, in line with previous literature, industries with high shares of processing trade prior to the crisis survive the recession well.

In "Employment versus Wage Adjustment and Revaluation of RMB" Mao analyses both the channels for and magnitudes of impacts of RMB revaluation on the Chinese labour market from several aspects. The statistical analysis and empirical evidence reported indicate that, first, real wage rates and employment are responsive to real exchange rate movements in Chinese manufacturing industries. A 10% revaluation of RMB exchange rate in one step will cause the wage rate to drop about 4% and cost over 2.6 million jobs in the long run. Second, the impact of RMB exchange rate change on labour market is closely associated with trade openness, competitive structure and ownership characteristics of Chinese manufacturing industries.

In "China's Sovereign Wealth Fund as Foreign Reserve Manager: Pre- and Post-Crisis" Fei and Xu begin noting that with the rapid accumulation of foreign reserves in specific countries, Sovereign Wealth Funds (SWFs) are playing a larger role in the world economy. The recent financial crisis did not only bring SWFs heavy losses and pressure to improve their image and governance structure, but also an opportunity for a better external environment by easing the nerves of recipient country governments. Taking China's Sovereign Wealth Fund, China Investment Corporation, as the example, this paper finds that after the crisis SWFs continuely worked to better their governance and managing mechanisms. Unlike in the pre-crisis period, investment strategies will be more positive, diversified and complementary to their own real economy.

The paper "On Industrial Performance During the Global Recession" by Gao and Su studies the trade collapse for China during the Global Recession, mainly focusing on the reasons for Chinese industries' different performance during the Global Recession. They emphasise supply-side factors, especially comparative advantage which is neglected by most literature. They employ parametric and semi-parametric estimation techniques, and measure variables which show which sectors had smaller declines or bigger rises in exports with the improvement of comparative advantage. Decisions by policymakers make a difference and they give some suggestions for China's postcrisis policy regime.

In "Post-Crisis Infrastructure Investment and Economic Growth in China" by Huang, Shi and Zhou, they note that though China may have been mildly affected by the global financial crisis compared to the United States and other developed countries, the crisis has nevertheless caused substantial change to China's economic growth pattern. To offset the negative impact of this crisis, the Chinese government launched an economic stimulus plan, i.e., a two-year investment plan with additional funding totalling 4 trillion RMB. Over half of this investment was to be directed in infrastructure, including railroad, highway, airport, water conservancy construction, upgrading of urban and rural power grids, etc. In addition, the local governments were to increase their infrastructure investment. According to the National Bureau of Statistics of China, the total investment in infrastructure in 2009 was 6.18 trillion RMBs, while this number rose to about 7.2 trillion RMBs, higher than those in previous years.

A similar strategy was adopted in 1998 as a response to the Asian financial crisis which aimed to improve the domestic demand in China. In hindsight, the "soft-landing" in 1998 worked generally well, yet whether this strategy could work this time remains a question. Also given the extraordinary size of funding this time, it seems useful to take fiscal risk into account. Currently the two-year stimulus plan has come to an end.

They empirically investigate the optimal ratio of infrastructure to production capital at the provincial level in China, which can be used to evaluate if the current large-scale infrastructure investment is economically efficient. They also estimate the dynamic responses of production capital and output to evaluate local governments' fiscal risks caused by the debt issued for this large-scale infrastructure investment.

In "The Effects of China's Stimulus Policies and Their Transmission Channels" Tao and Wenfu note that after the Subprime Loan crisis in 2008, some of the larger countries used fiscal policies to address the crisis through macroeconomic policies of management of effective demand. They present some stylised facts concerning the macroeconomic effects of fiscal policies of China in the Subprime Loan crisis, and try to explain them. They find that output and consumption responses to government spending are positive, but output and consumption responses to interest rate policies are negative. Real Business Cycle models in a pure competition environment can not explain these empirical facts and the paper builds a Dynamic New Keynesian model with monopolistic market features, introducing price stickiness, liquidity restriction and positive externalities of government spending in a Dynamic Stochastic General Equilibrium structure. They use this to simulate the Chinese economy and find that liquidity restrictions and positive externalities of government spending play an important role in the transmission of fiscal policy effects. Price stickiness does not play a significant role in the transmission mechanism. Such conclusions imply that China's government should maybe consider imperfect competition effects when it implements fiscal policies.

These papers represent a positive contribution to debate on China as to how best respond to the 2008 Financial Crisis. They evaluate macro, trade, exchange rate, and reserve management policies, together with industrial policies from the view point of their individual contributions to a desirable post Crisis policy mix. Their role in advancing the continued development in scholarship of Young China Scholars is significant.