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Studying China's International Finance and Policy: A Speech Given at the University of Richmond School of Law

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STUDYING CHINA'S INTERNATIONAL FINANCE AND POLICY
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Chinese international finance may sound to many of you like a daunting subject. It really is not, but I have to admit it's not quite intuitive. International finance is a lot like accounting; you have to learn the rules. And on top of that, in this case we have to add the never intuitive issue of Chinese policy-making. I didn't learn anything about these topics in graduate school but rather in my first job as a CIA economist, over thirty years ago. At that time China published no economic data; it was just sort of a black hole in the world of data. My first assignment was to work with other economists and create an estimate of China's balance of payments accounts using something of a mirror image approach. We could do that because most of the countries that China dealt with did report their transactions with China. Since, for example, U.S. exports to China in theory equal Chinese imports from the United States, we could construct China's accounts using partner data. And if we had most of the partners, we could make a reasonably accurate approximation of their balance of payments. It was kind of a fun puzzle and one that, though complicated, was quite capable of being solved. When China did eventually publish its data, our estimates proved reasonably accurate. Ever since that first job, I have really liked looking at China's balance of payments.

The big news story we hear these days is the huge increase of China's foreign reserves—the dollar, yen, or euro holdings of the People's Bank of China. In fact just this week there is a story out that China is considering selling some of its huge hoard of dollars since the dollar has been weak. Yes, the Chinese central bankers might not be happy with a declining dollar but what happens if they sell their dollars and buy, say euros?

If you are a really big player, like the Chinese bank is, you drive down the price of the thing you are trying to sell and drive up the price of what you are going to buy. So maybe that's not such a good idea. To a degree, then, they are trapped with what they've got. Now, is that a good thing for China or the United States or a bad thing? As most economists will tell you, it usually doesn't make sense in economics to say something is good or bad for a whole country. But what happens does have important implications for different types of people in both countries. There will be winners and losers in both countries if the Chinese take action. So lets take a closer look at this from the perspective of the balance of payments data and the value of RMB, the name of China's currency.

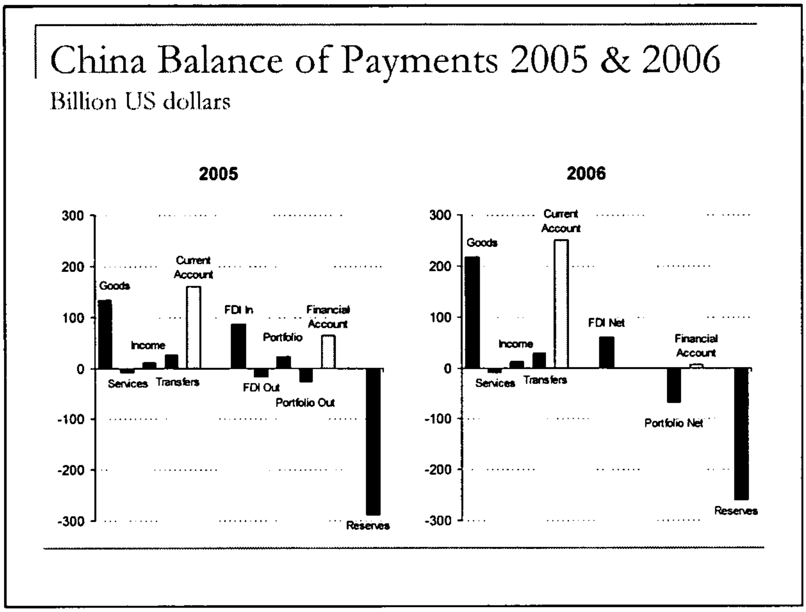

Figure 1: China Balance of Payments

Figure 1 includes China's balance of payments for 2005 and 2006. China now publishes such data on the web so we no longer have to estimate it. What we have in a balance of payments table is a current account side, which is basically an expanded view of the goods and services trade, and a financial account side, which shows the money flows related to the balance of such trade and to investment flows into and out of a country. We all know China has a big goods trade surplus, so they have a positive flow of money coming in on the current account side. Usually, that is in most economies, an inflow on the current side is balanced by an outflow on the finance side as the money earned is sent abroad to earn interest and profits. The foreign exchange reserves figure is the balancing item between the two accounts since any hard currency not sent abroad is captured by the central bank, which uses it to purchase interest-bearing securities of other central banks. In the financial account this is listed as a negative—in other words, the negative shown above on the reserves is really what the central bank is spending in order to purchase reserves. It's not quite intuitive, but just think of the central bank using its cash to buy gold and treasury securities. So the negative is an outflow of money but a buildup of reserves.

China is not a usual country; however, as we can see, especially in 2005, it ran large surpluses on both the current and financial account sides, followed in 2006 with an even larger current account surplus and a small financial account surplus. So in addition to earning a lot from exports, China was borrowing a lot for investment purposes, and was a huge recipient of foreign direct investment. This then nets out to an incredible excess of foreign exchange, which flows from Chinese firms and agencies into the central bank, which promptly spends it to purchase foreign securities, thus raising its level of reserves. This is the number that everybody throws around as a very scary thing—about $300 billion in each year. For two reasons I'll get to below, I'm not so worried about these numbers but there is no doubt they are very large.

First let's compare the U.S. and Chinese balance of payments tables for 2006 as shown in Figure Two, importantly on the same scale. We can see here that the US runs a huge deficit on its current account and that is offset by a huge surplus on the financial account, so the impact on reserves is not so great. In effect, foreigners are lending us the money to pay for our imports and in doing so are helping keep our interest rates low and our economy growing strongly. Imports are helping to keep inflation down and our standard of living high. China is quite the opposite in this respect, but the levels as compared to the US are still quite low.

Second, lets look at the cumulative impact of these balance of payment *flows*. These are shown in Figure 3 as China's *stock* of assets and liabilities for 2005 and 2006.

You can see that China has about $1.3-1.6 trillion in assets and about $1.0 trillion in liabilities with a net of between $300 billion and $600 billion, growing at about $300 billion a year as can be seen from the balance of payments table. The liabilities shown are foreign investments in China and are dominated by foreign direct investment—lets say IBM and Motorola factories in China. The assets, in contrast, are completely dominated by central bank reserves. The point I'd like to make is the relative absence of private or non-central bank foreign assets. China's government still maintains extensive capital controls that prevent its citizens and many of its institutions from engaging in international finance, hence all foreign exchange earnings that are not spent on imports are captured by the central bank. These then are used to purchase foreign government securities. If you were to look at similar data for an OECD country like the U.S. that does not limit its citizen's foreign activities, you would find much larger amounts of foreign assets owned by private citizens and private institutions, such as insurance companies, and much less foreign exchange owned by the

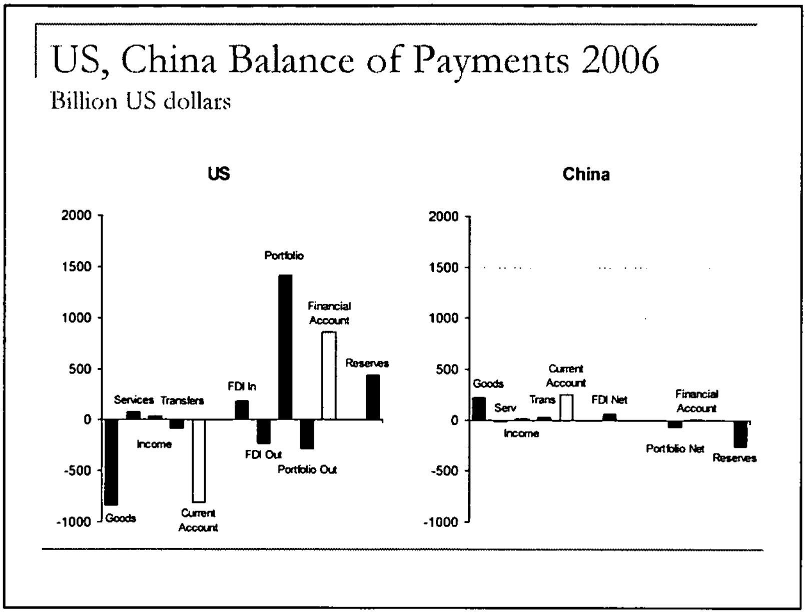

Figure 2: US/China Balance of Payments 2006

central bank. So the bottom line is clear; China's central bank foreign exchange reserves are large but such reserves for the country as a whole are not.

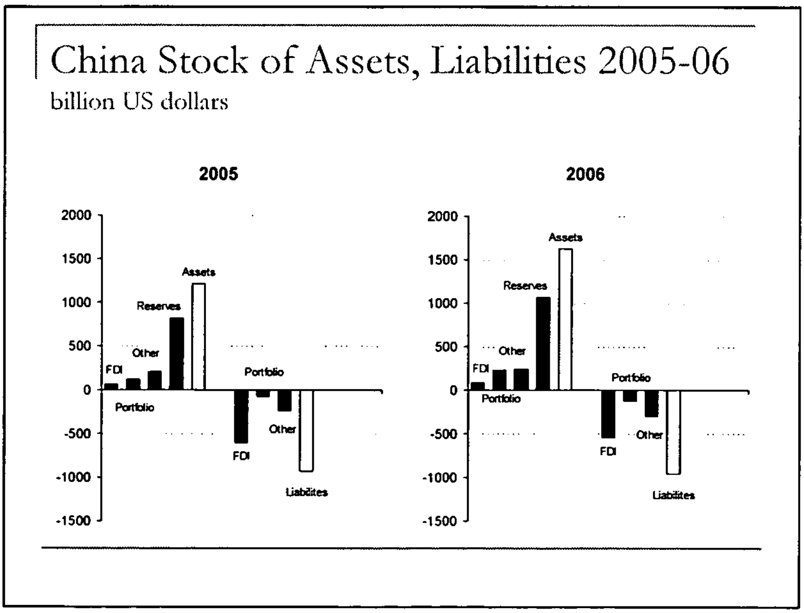

Figure 3: China Stock of Assets, Liabilities, 2005-06

With a better understanding of these facts let's return to this week's news story that China is going to sell its dollars since it is unhappy with the return it is getting. What this would mean is that the central bank would sell some of its huge stock of treasury securities and use the money to a) import something or b) buy Euro or Japanese securities. If you were China you would have the same feeling. When the Chinese government buys U.S. treasuries, it gets a return of four percent or five percent per year even as the dollar's value slips about that much each year. Meanwhile, the return on capital in China is probably ten or twenty percent per year, so, if the funds were invested in China, they would be doing much better. How can the central bank afford to do this, borrow at ten to twenty percent and lend at four percent? The truth is they don't allow Chinese savers to earn as much as they could on an open market. The Chinese people save a huge amount of their relatively small incomes and those savings flow into the central bank, which then controls all investment. Largely as an outgrowth of their Communist system, the government does not want private savers to be able to channel investment into the most profitable areas, so they control all investment quite tightly. The result is the whole system generates very little return on investment and far too much money ends up with the central bank. Maybe it's a bit intentional, given the Communist ideology that still frowns somewhat on high returns on capital; but the problem is they can't have it both ways—they can't have a market economy for goods, services and labor and a controlled economy for capital.

Let me give you an example of a kind of problem that is developing in this mixed system. On Monday, you may have read the story in the Wall Street Journal where PetroChina (China's biggest oil company - mostly owned by the state) launched an IPO in Shanghai, selling to any Chinese person shares that already were on sale in Hong Kong to international investors. The price in Hong Kong had been about $2.50 a share. The price started at about the Hong Kong price but by the end of the day the price had gone up four times. I've forgotten the actual dollar price, but it went up to something like ten dollars per share. The funny thing is the Hong Kong shares didn't go up, so you have the same share priced four times more in Shanghai (for Chinese people) than in Hong Kong (for everyone else). This gap tells you there are a lot of restraints on such trades. At that ten dollars per share rate, this company was valued at more than Exxon Mobile and was by far the biggest company in the world as measured by stock prices times stock outstanding. There are some significant oil fields in China to be sure but compared with Exxon-Mobile you have to wonder.

The reason for such overvaluation and low returns in China is that, in its highly compartmented system, Chinese savers don't have much of an outlet for their savings. They can either put savings in the monopolized bank system and earn a low or even negative real interest rate, or they buy speculative stocks that seem to go up and up. So, bank savings start flowing into the stock market, and that just pushes up the price at an incredibly fast rate. I have no doubt China now has built up a big financial bubble, with a stock market that has doubled in the past three or four months. I think they are staring in the face a real crisis in their capital markets looking at the way stock prices have shot up. An early sign of this is inflation—the inflation rate is rising rapidly and shot up to six percent in September.

What's the impact of all this for China and for us? As I see it, there are two different ways they can go. A high inflation, high growth policy spurred on by this over-investment boom economy, led by a weak currency and low interest rates. Inflation ultimately will raise their RMB costs to the point that the exchange rate will be about right—it will make their exports more expensive and imports relatively cheaper and thus will rebalance their current account. I think most economists would argue they can fix the problem in a better way by raising interest rates even though it might pop the investment bubble. The problem is they should have done this a while back. The longer they wait, the more likely this bubble is to keep expanding, as it has been expanding rapidly even in the last week, and the bigger the pop.

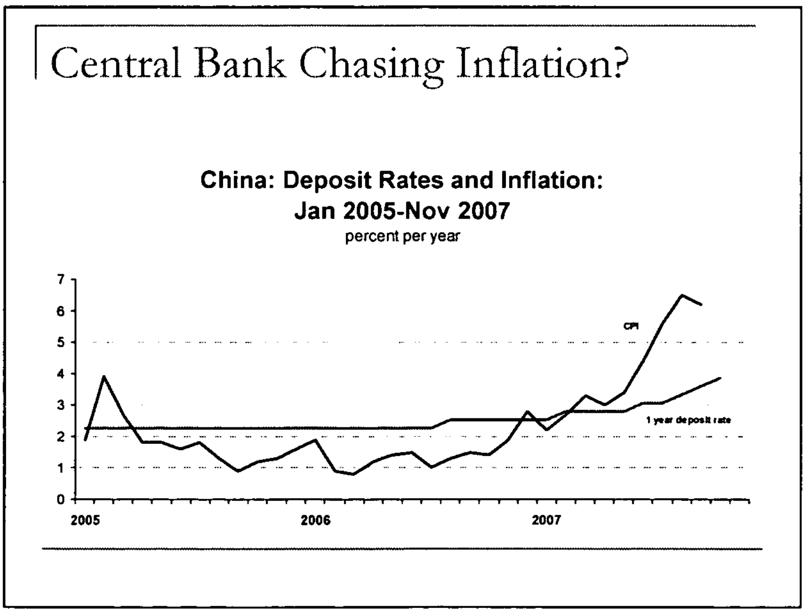

Figure 4: China's Deposit Rates and Inflation, Jan. 2005-Nov. 2007

I do think they've waited too long to liberalize their capital markets and allow domestic interest rates to find their right level. I

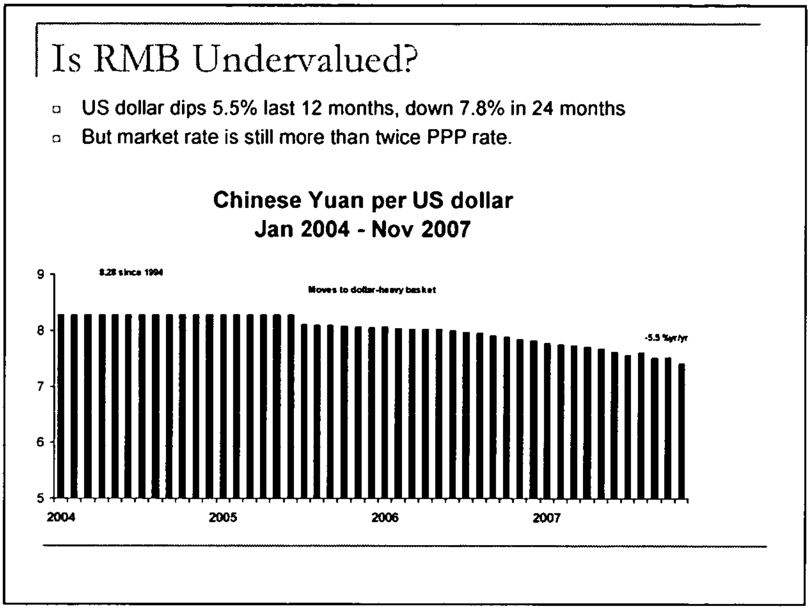

Figure 5: Chinest Yuan per U.S. dollar

argue they are doing the right things, but they're doing them too slowly and are inviting a big financial crisis. If we look at Figures 4 and 5 we can see that they are raising interest rates—though they are not keeping up with inflation—and they are allowing the dollar to fall in value against RMB. I'm not necessarily predicting a crisis, but they really need to speed up interest rate increases and RMB appreciation. Allowing the currency to appreciate lowers import prices and reduces exports, so that helps with inflation. Raising interest rates gives savers more income and prevents too much investment spending that inevitably will reduce profits and lead to an investment bust. Ultimately, I'm pretty confident that, ten years from now, instead of this 7.4 yuan per dollar rate we see now, it will be three or four yuan per dollar and we'll all be saying, "boy, I wish I had bought Chinese money then when it was so cheap." That is what is happened in Japan in the 1950s and 1960s and it seems to me the same thing is happening in China. In the mean time, China may have to live through a big financial crisis much like occurred in Japan and later, in South Korea.

The implications of this on U.S. industry, of course, are important also, and I've listed some of these in Figure 6. The cheap yuan pushes a lot of investment into China and is helping it build an incredible manufacturing industry that is going to affect the world for a long time. Again, we needn't think this is necessarily good or bad; there are a lot of positive things for us. As China becomes more export oriented, as happened in Japan, they start becoming more import oriented as well. Today, U.S. trade data just came out for the first three quarters;

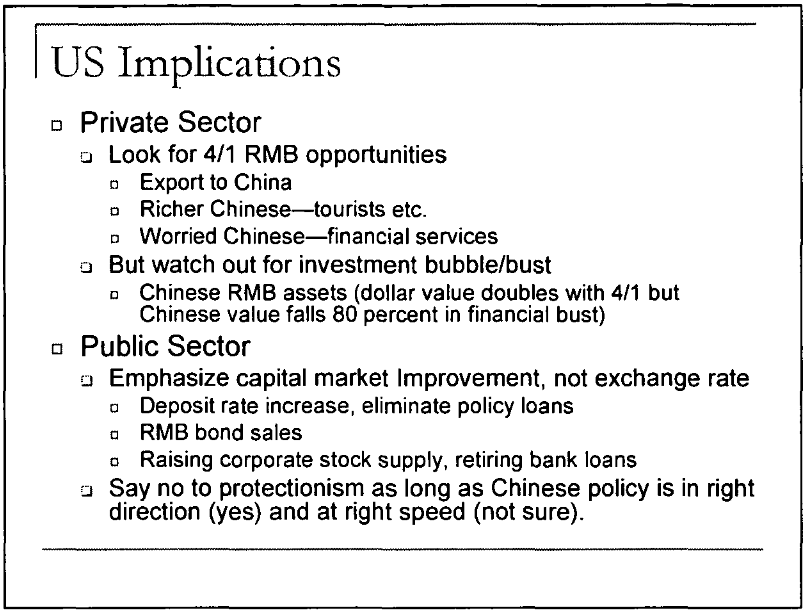

Figure 6: U.S. Implications

I looked at it on the way down. U.S. exports to China are up a strong twenty percent in the last year. As China creates this booming export oriented economy, they're going to start sucking in goods and services. As inflation kicks in they will need more imports to dampen price increases and improve productivity. Firms that are ready to take advantage of that are going to make a lot of money in the next twenty years' time - but they will need to have a lot of guts as they will have to weather a financial crisis in the middle of this. Maybe I should stop there and take some questions. My bottom line is that this is a really interesting but difficult and complicated issue, but it's well worth your paying attention to. Select some aspects of the issue and start studying it and before long you will be an expert.

Question: Do you think if they raise interest rates they will still keep their currency valued at what it is - 7.8 to the dollar, or whatever it is right now?
Answer: I don't think so. One thing, it's not pegged right now; they are allowing it to increase, although relatively slowly. They use a basket approach with the dollar as a very heavy weight in the basket. So if the dollar declines against the Euro, yuan also declines against Euro. And the whole basket can rise or fall against yuan, although only very slightly any given day. They need to raise interest rates just to keep up with their inflation. Allowing appreciation also would help them fight inflation. If they don't raise interest rates, inflation will almost surely kick up to a faster rate.

Question: They have a controlled economy so is it easier for them to raise interest rates or the exchange rate?
Answer: A good question, but it's not clear to me that it's easier for them to do one or the other. What I'm thinking is that their interest rates need to be above the rate of inflation. Especially their bank deposit rates so that savers earn a positive real return. Certainly, the rule of thumb is that the interest rates should be above the regular inflation. Their inflation right now is about six percent so that would be moving the interest rates from about two percent to seven percent. Wow, that would be a huge shock to their system. I don't know if their banks could handle that. I think I would argue that they need to be moving towards a floating exchange rate, in tandem with raising interest rates. Raising interest rates protects them from an outflow account.

Another issue is whether their currency really is overvalued. I'm two-sided about it. Considering what they pay for labor, on what goods cost, on anything you buy in China, RMB or yuan looks very undervalued; it looks way too cheap. But with respect to what Chinese can earn on the money, it looks very expensive. Doesn't buy very much PetroChina stock, for example. So, when the Chinese say, "no, we don't want to float the currency," they are worried about an outflow of funds on the financial account; for instance a lot of Chinese making portfolio investments abroad. So there is a two-sided aspect to this they have to try to balance. I guess my answer, though, is just doing one without the other won't work, they have to work on both at the same time.

Question: I just thought capital controls could prevent the loss that. . .
Answer: The interesting thing about capital controls is they work if you are a very strong government, you can prevent arbitrage between internal rates and foreign rates but the incentives to cheat the system are huge and corruption easily can become rampant. I'm pretty sure somebody is able to buy, for instance, those PetroChina shares in Hong Kong for $2.50 and sell them in Shanghai for $10.00, and earn a million dollars in a day. Whoever controls that. . . well, there is a lot of corruption in China because of that. Corruption is like punching holes in this wall of capital controls and I think there are so many holes in this wall right now that the controls sooner or later will completely fall apart.

Question: Is it possible for a foreigner to collect property in China?
Answer: Not directly, but obviously Chinese own things, so you can work with Chinese; maybe work out a deal with the Chinese. This is where the wall is springing all these holes. US banks are buying into Chinese banks in a big way. US companies are able to buy into Chinese companies more and more; this is why the FDI inflow is so large and is partly why PetroChina soared—I expect there is some US

money in it. Still you, as a U.S. citizen, cannot go in and buy property in China, but you can get a lease, and may get a really long-term lease, which is just about as good. Certainly you can buy Chinese shares in Hong Kong. I'm thinking right now that PetroChina is a good buy in Hong Kong and a bad buy in Shanghai. The bottom line is that with this volatility, there are lots of opportunities and risks.

Question: You mentioned the ideology of the Chinese government versus these capital controls - do you see the capital controls as letting them lead to the collapse of this Communist ideology over there more so than in the past?
Answer: The ideology, I think, has already collapsed. I say that because I gave a similar briefing with a group of Chinese officials at the Commerce Department a couple of years ago, telling them I though they should raise interest rates, etc. and said I understood the difficulty that the Communist Party had in raising interest rates since that, as Marx said, might make the rich richer and the poor poorer. A gentleman came up after my presentation, a Chinese official, and gave me his calling card, "Chairman of the Communist Party" of some large city. He said "Mr. Brown, you don't understand, we are not Communists anymore, at least Communists in the way you describe it." Communism is really only the party's name. It is easy to forget, however, that the state still owns most of the land and real property. Again, I think this is a really big opportunity. I would guess one of the biggest opportunities for those of you in the law field in China would be helping them work with securities laws and helping them privatize public property. Their state enterprises and banks are in bad financial shape with huge bad loans. They are illiquid but probably are not insolvent since they own lots of real estate they can't sell. What they really need is a huge shift in property in China from the public sector to the private sector. They know that, but it is a legal minefield doing that.

I don't want to blame them because I think they have made such progress over twenty-five years moving in the right direction without creating another revolution, and we should commend them for that. Again, my main issue is whether or not they going fast enough with liberalizing their capital markets. That's where pressure needs to be. We should keep pressure on them to be fixing these capital markets, stock markets, bond markets, and cleaning up bad loans so that they can open up their capital markets to international competition. That would be good for Chinese savers and good for American producers. In those circumstances I think both their and our balance of payments will become more "balanced."