

# China's Economic Imbalances and the Role of RMB Exchange Rate

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# Main conclusions

- As noted by Olivier Blanchard (2009), economic imbalances can be divided into good part and bad part. Bad part of economic imbalances is result of policy distortions, externalities, and risks.
- Bad part of economic imbalances can be reflected in many ways, external imbalances, internal imbalances, or both.
- We focus on the bad part of economic imbalances. After the global financial crisis, bad part of economic imbalances still remains, which is reflected by internal economic imbalances rather than external imbalances now.
- Flexible RMB exchange rate is important in term of reducing bad part of economic imbalances.

# How to understand the bad part of China's Economic Imbalances?

- In the past decade, favorable policies, such as exchange rate policy, land policy, tax policy, financial policies and many other policies, encourage rapid expansion of tradable sector(industrial sector); over regulation limit expansion of nontradable sector(service sector).
- Those discriminating policies create economic imbalances in many ways: increasing share of secondary industry in GDP, increasing share of net export in GDP, as well as decreasing share of consumption.
- External demand bubbles, which also encourage expansion of tradable sector, complicated the bad part of China's economic imbalances .

# How to understand the bad part of China's Economic Imbalances?

$$Y = Y_T + Y_{NT}; Y = C + I + TB; C = C_T + C_{NT}; I = I_T + I_{NT}$$

$$Y_{NT} = C_{NT} + I_{NT}; \text{ by definition, } Y_{NT} \text{ can not be exported or imported.}$$

$$Y_T = C_T + I_T + TB$$

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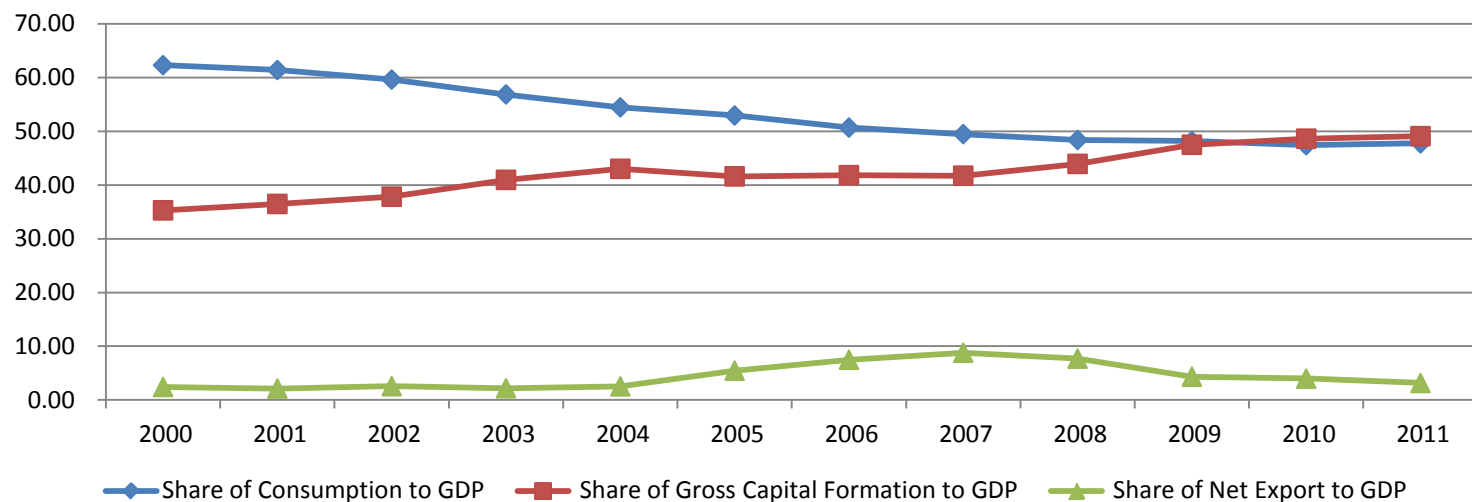
$$\text{saving rate} = (Y - C)/Y = (TB + I_T + I_{NT})/Y$$

$$\text{external imbalance} = TB/Y = (Y_T - C_T - I_T)/Y$$

- Excessive production in tradable goods can be saved in form of net export. Share of tradable in GDP, trade surplus in GDP, as well as saving rate increase at the same time.

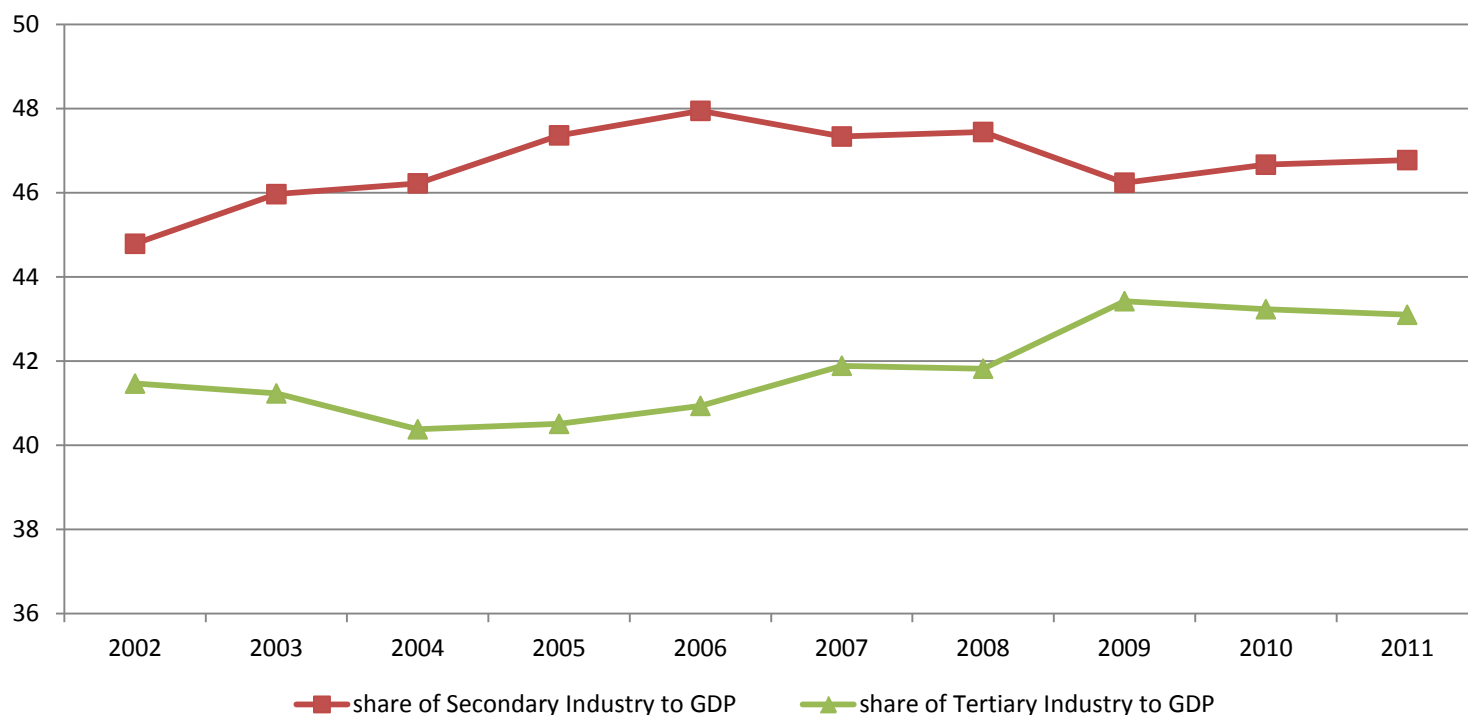
# Recent Development of China's Economic Imbalances

- After the global financial crisis
  - share of net export in GDP decreased significantly
  - share of investment in GDP increased further, and
  - share of consumption in GDP stop falling.



# Recent Development of China's Economic Imbalances

- After the global financial crisis,
  - share secondary industry (mainly tradable) in GDP remain increased slightly
  - share of tertiary industry (mainly nontradable) in GDP decreased slightly.



# How to understand recent changes?

- Weak external demand and compensating investment demand from the stimulus package explain the share changes in the demand side.
- Weak external demand, which mainly impose negative impact on the tradable production (reduce  $TB$  and  $Y_T$ ), should decrease the share of industry to GDP too. But stimulus package, which mainly increase demand for heavy industrial products and commodities (increase  $I_T$ ), kept the share of industry in GDP at high level.

# Did China go over its economic imbalances?

- Before the global financial turmoil, imbalance was contributed by both domestic policy distortions and external demand bubble.
- After the global financial turmoil, imbalance was lessened by burst of external demand bubble, but at the same time was enhanced by internal demand bubble for industrial sectors. (TB was replaced by  $I_T$ , saving rate kept constant)
- In general, policy distortions remain. The bad part of China's economic imbalance reflected by internal imbalance rather than external imbalance now.



# Prospects of China's Economic Imbalance

- Demographic changes can not reduce the bad part of China's economic imbalance, even though it may reduce the overall imbalances.
- Financial reforms, which are thought to be the key measure for transforming savings into investment and redressing the imbalances (by IMF and most economists), is important. But it may not be the key measure.

# What's the role of RMB exchange rate for rebalancing?

- Three fundamental policies for making rebalances.
  - Fair competition. Reduction of policy subsidies toward tradable sectors and deregulations in service sectors.
  - A flexible exchange rate (relative price effect; improve monetary policy autonomy and leave rooms for financial market liberalization, which help better resources allocation; ).
  - A higher share of public goods in fiscal expenditures.
- All those measures are aimed at fair competition for resources between industry and service sectors.

# How to prompt further RMB exchange rate reform?

- Increasing daily volatility does not make too much sense, unless daily exchange rate movement is continuous.
- Make transparent rule for FX market intervention.
- Keep control over capital account, and be cautious on RMB internationalization measures which is by large extent releasing control over capital flows.
- Be cooperative and active in pushing forward global monetary and financial reforms.