

China's Growing Trade Surplus: Causes, Consequences and Policy Implications

Tony Makin
Griffith Asia Institute
Griffith University
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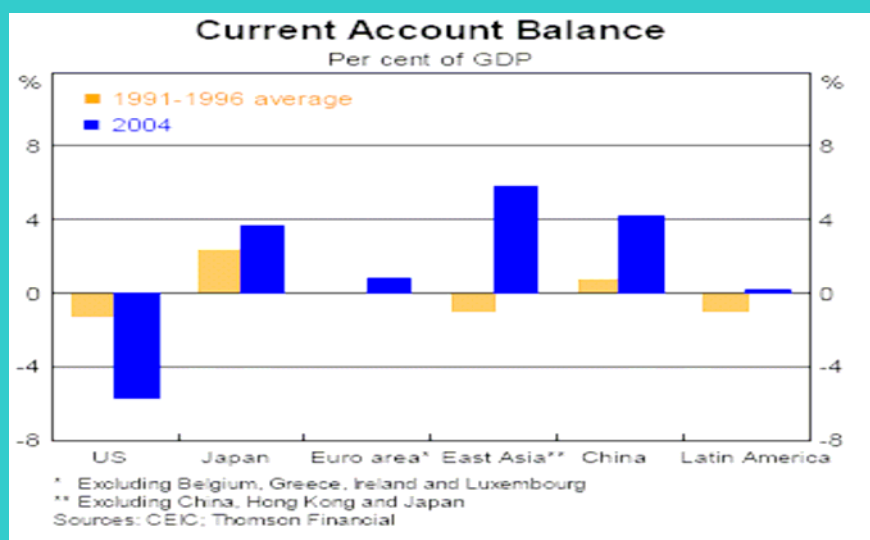
Main Themes

- China's External Surplus
- A Balance of Payments Framework
- Trade Imbalances and the Pegged Yuan
- Exchange Rate and Monetary Policy
- Should the Yuan Be More Flexible?

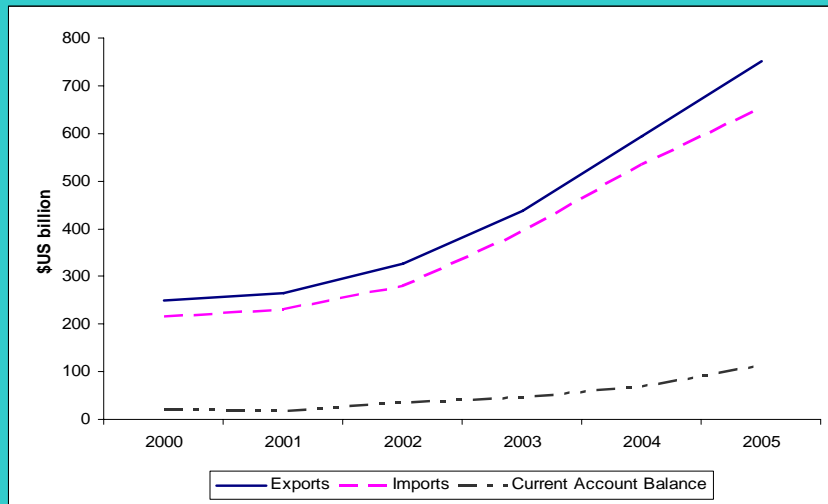
External Account Imbalances: Recent Developments

- Current account imbalances and external liability positions across major trading areas have grown markedly over recent decades
- Major advanced borrower economies currently include the United States, Australia, New Zealand, Spain, Greece, Portugal, Iceland and the United Kingdom whose external deficits are largely funded by East Asia, especially China and Japan, and oil exporters

Global External Imbalances

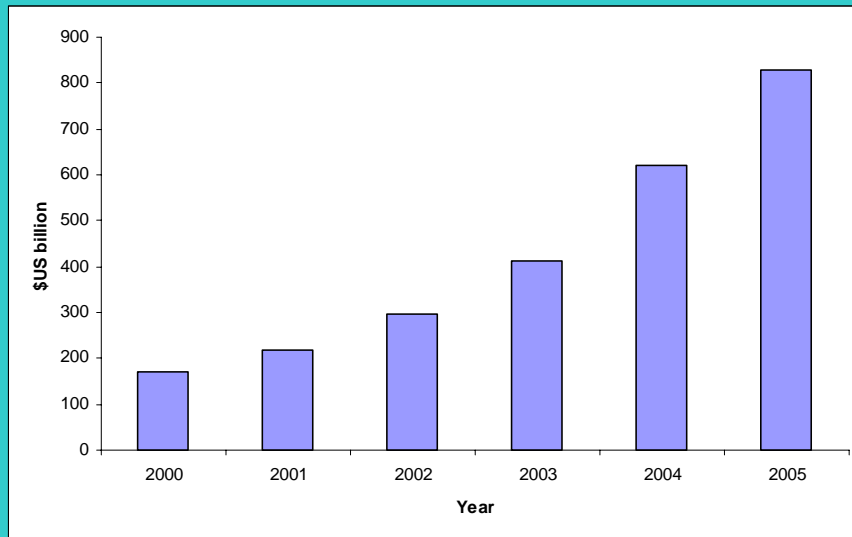


China's Exports, Imports and Current Account Surplus



- export-led growth has been crucial to China's development strategy
- but large trade surpluses matched by deficits of trading partners especially the US and Europe
- what role has a pegged yuan played?
- FX reserves at record level entailing risk

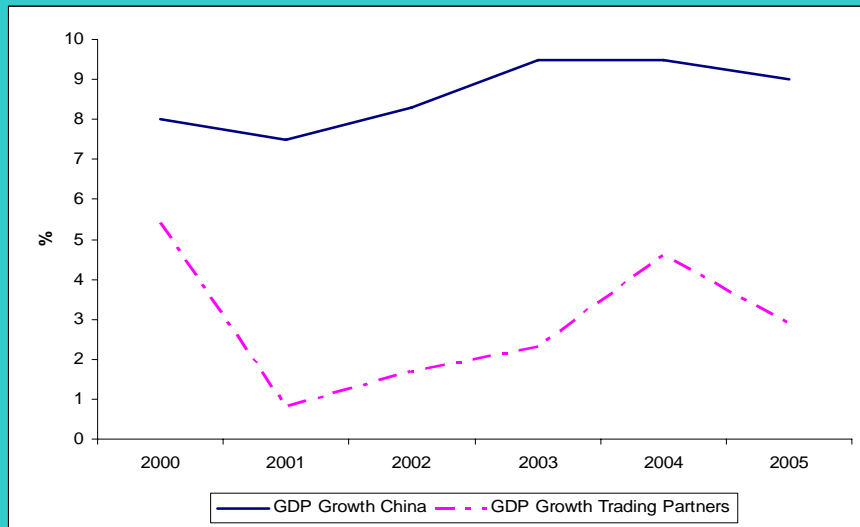
Gross International Reserves



Key Determinants of China's External Surplus

- a quarter century of at 8-9% growth, substantially faster than trading partners
- average annual export growth of 13%
- highly open economy relative to advanced economies $(X+M)/GDP$ around 75%
- third largest exporter after the US and Germany
- world's largest exporter by 2010?

Economic Growth of China and Its Trading Partners



Reasons for China's High Growth

- high saving and better investment climate
- privatisation and reform of state-owned enterprises
- high public infrastructure spending
- enhanced labour mobility and better educated workforce
- emergence of entrepreneurial class
- *exchange rate management*

An Analytical Framework

- exports, imports and exchange rates:

The export functions of China and its main trading partners can be specified as

$$X = f(e; L^+, K^+, A^+) \quad (1a)$$

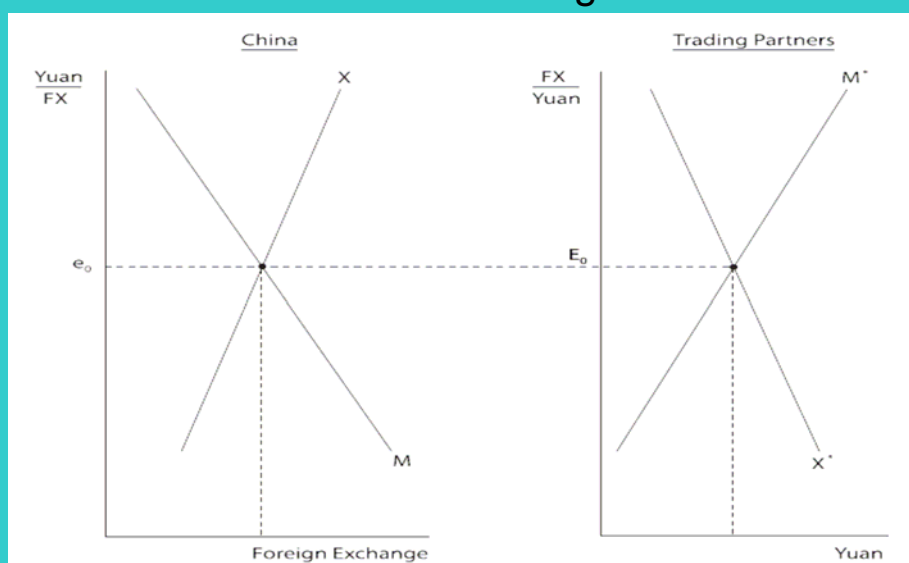
$$X^* = g(\bar{E}; \bar{L}^+, \bar{K}^+, \bar{A}^+) \quad (1b)$$

The Chinese and trading partners' import functions are:

$$M = f(\bar{e}; \bar{P}^*/\bar{P}, \varepsilon(\bar{i}, \bar{\phi}, \bar{G})) \quad (2a)$$

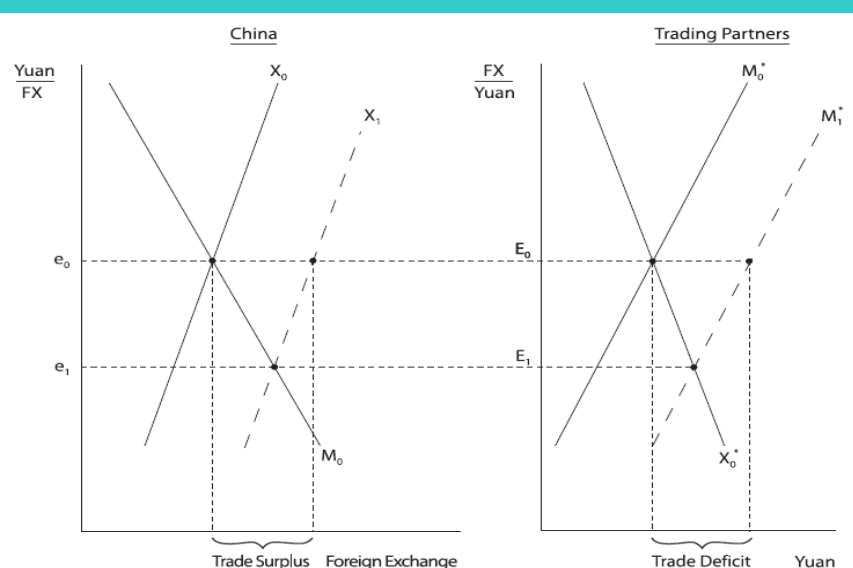
$$M^* = g(\bar{E}; \bar{P}^*/\bar{P}, \varepsilon^*(\bar{i}^*, \bar{\phi}^*, \bar{G}^*)) \quad (2b)$$

Exchange Rates and Trade Flows: China and Its Trading Partners



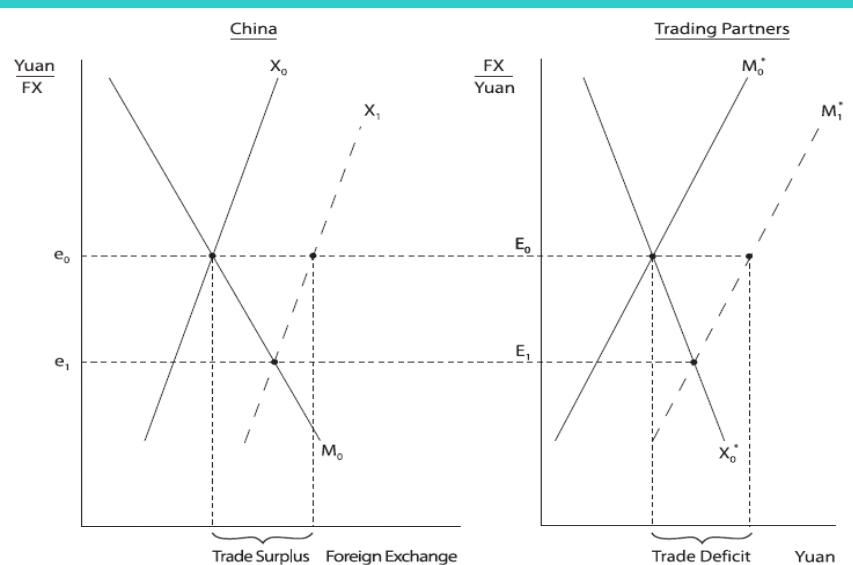
- next consider the effects of relatively faster output growth in China and changing relative prices for tradables
- China's export growth must be matched by trading partners' import growth

The Trade Balance Effects of a Pegged Yuan



- without foreign exchange intervention by the PBC, the yuan would appreciate and trading partner currencies depreciate
- yet, pegging the yuan ensures a trade surplus and reserve build-up for China
- purchase of G8 securities also sustains lower world interest rates

The Trade Balance Effects of a Pegged Yuan

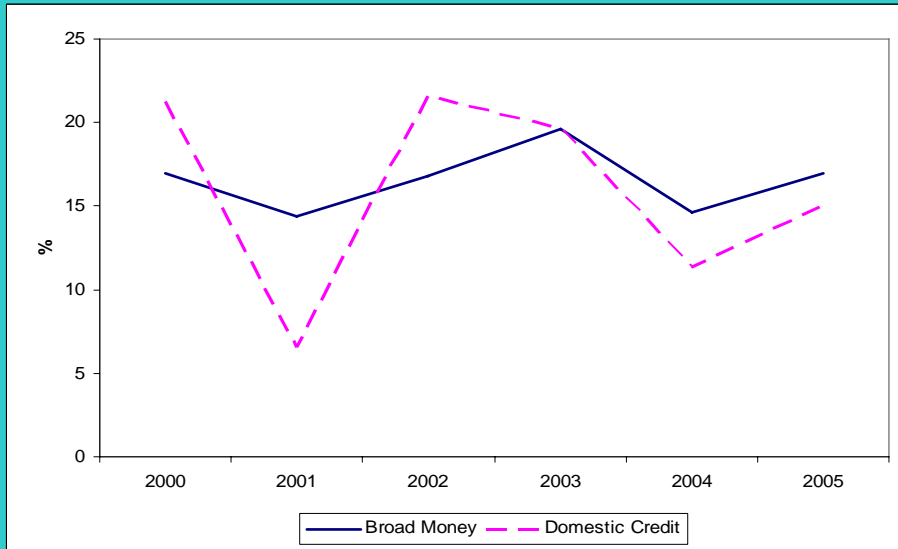


-and a collective trade deficit for trading partners
- a corollary is that the higher China's trade surplus, the more undervalued is the yuan

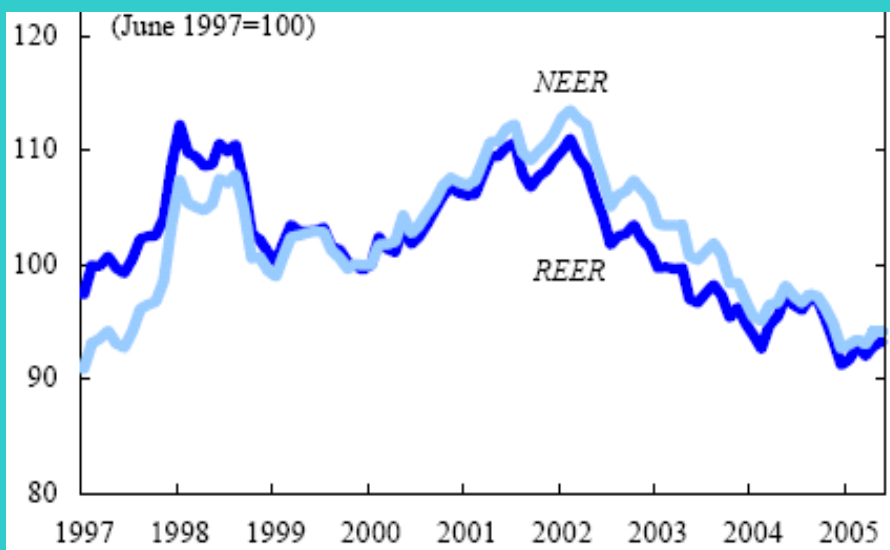
Why Isn't External Adjustment Automatic?

- in theory, the real exchange rate should depreciate via higher inflation at home or deflation abroad
- ...but much FX intervention by PBC is sterilised
- in any case, if money growth matches money demand arising from high output growth, inflation will be checked
- however, is this sustainable?
- inflation and interest rates should eventually rise

Money and Credit Growth



Nominal and Real Effective Exchange Rates



A more flexible yuan would

- alleviate international trade tensions
- better insulate China from higher oil and other commodity prices
- allow monetary policy to focus explicitly on inflation control

THE END

