Select Committee on Treasury Written Evidence

Memorandum submitted by Dr Gerard Lyons, Chief Economist, Standard Chartered Bank plc

CHINA: NATIONAL, REGIONAL AND GLOBAL IMPLICATIONS

CONTENTS

A. INTRODUCTION: CHINA IS A ROBIN HOOD, GOLDILOCKS AND SUPERMAN ECONOMY

1. This briefing analyses key economic developments in China, the outlook and implications for the global economy. In looking at China it is possible to quote a host of statistics, most of which are impressive, and all of which highlight the economy's potential. Instead of quoting such statistics, in the introduction, let us look at China as a Robin Hood, Goldilocks and Superman economy.

2. Let me explain. China is a Robin Hood economy on account of the huge regional boost it is providing to Asia and Africa. Robin Hood took from the rich and gave to the poor. Because of the common focus on its huge trade surplus with the US, China is often viewed as a competitive threat. However, there is another side. China's trade surplus with the US and EU is matched by its trade deficit with the rest of Asia. Furthermore, increasing trade ties between China and Africa means China has a growing impact on that continent's economy.

3. China is a Goldilocks economy in that its policymakers need to ensure economic growth is neither too hot nor too cold. Not too hot to prevent overheating and a boom-bust cycle. Not too cold that underlying social, regional and unemployment problems come to the fore. The policy needs is to ensure the economic temperature is just right. Just as in the story of Goldilocks where the temperature of the porridge had to be just right.

4. And finally, China is a Superman economy. The Chinese economy's future potential is up, up and away. The trend is up, but as the economy opens up China is likely to experience increased volatility along that upward path. Yet, like Superman, China has a potential problem. For Superman it was kryptonite. For China, it is its huge need for resources. China's present demand is for energy and other raw materials, driving prices of these higher. In the future, it is likely to be China's need to feed its vast population that becomes vital, and in the process that could drive the prices of soft commodities substantially higher.

5. In short, China is a Robin Hood, a Goldilocks and a Superman economy. This briefing covers these issues and the implications for China, Asia and the world by focusing on China in national, regional and global terms. The two appendices look at Chinese monetary and exchange rate policy in more detail and at China's possible impact on global forum.

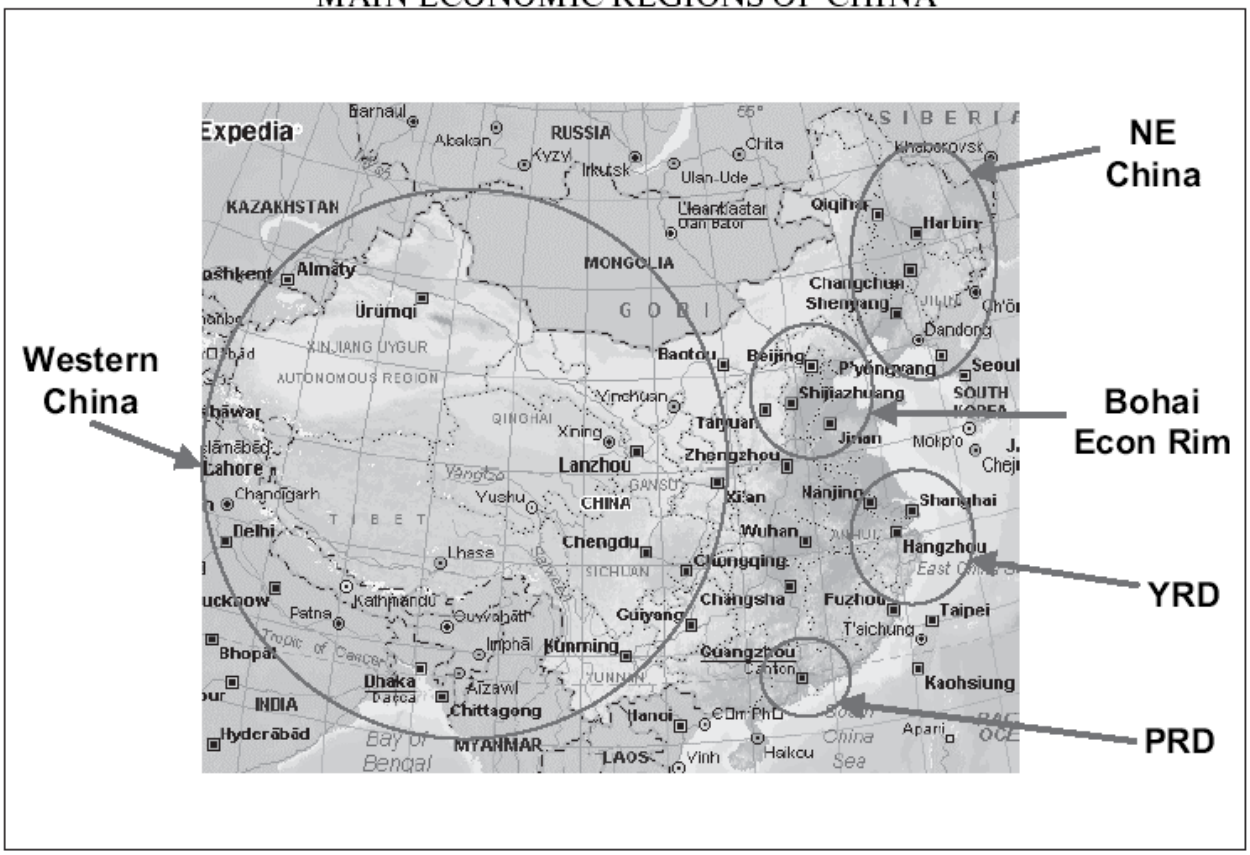
B. NATIONAL ISSUES: AN OVERVIEW OF CHINA'S MACRO-ECONOMIC SITUATION

6. This section examines the main domestic issues in China and the implications for growth and economic policy. During 2004, the emphasis in China shifted from achieving growth at all costs to a focus on the need for sustainable growth, in particular taking into account rural and social issues. The biggest challenges in the year ahead are curbing over investment and controlling inflation. This points to the need for further monetary tightening, including higher interest rates and a gradual currency appreciation.

B1. REGIONS OF CHINA

Chart 1:

MAIN ECONOMIC REGIONS OF CHINA



7. In looking at domestic issues, however, it is vital to first grasp the huge economic differences between the regions of China. Although one country, China is comprised of a multitude of economies, with different characteristics. In a developed economy like the UK, there are large disparities between some regions. Similarly in China, such disparities exist, only on a larger scale. I think of China in terms of the following five economic regions, the first three of which are growing strongly:

(a) The Pearl River Delta (PRD), centred on Hong Kong(HK). The PRD is booming and the growing integration between the PRD and HK has helped transform that territory's potential. Since the opening up of China's economy in 1979, the PRD has been the fastest growing region and is now a manufacturing hub accounting for one-third of China's exports. The authorities are trying to build on this, unveiling a Pan Pearl River Delta region in 2004, the so-called 9+2 plan, comprising nine provinces plus Macau and Hong Kong. The aim is to push development inland.

(b) The Yangtze River Delta (YRD), focused on Shanghai. The YRD is also booming, benefiting from huge inward investment, particularly from Taiwan and Japan and increasingly from Europe and the United States. Whereas the PRD has tended to focus on consumer products, the YRD's focus is on capital and industrial goods.

(c) The Bohai Economic Rim, centred on Beijing and Tianjin. Although not booming on the scale of either the PRD or the YRD, this region is growing strongly, with huge potential.

(d) The North East. Back in 1979 this was the strongest region of China's economy, being the industrial centre of the country. Since then this region has underperformed, suffering from the closure of many state-owned enterprises (SOEs). Hence it has many problems, including high levels of unemployment. Yet, despite this, it is seen as having tremendous potential, given a good skills base and growing linkages with both the Bohai region and the Korean peninsular.

(e) Western and Central China. This is a vast region. Sichuan is the fastest growing part of this region, but many other provinces are lagging, held back by low levels of investment, skill outflows to the coastal region and, historically, less favourable government policy. Western China is rich in resources and is witnessing a huge shift away from the land towards urban centres. The "Develop the West" policy, introduced in 1998, has had some effect in terms of developing the infrastructure but foreign direct investment is still low.

8. The huge regional disparities can be illustrated in a number of ways. Urban income per head is roughly twice that of rural incomes. Similarly, incomes in coastal areas greatly exceed those inland. For instance, Gansu province, in central China, had a per capita income of USD 605 in 2002, while the Shenzhen Special Economic Zone in the Pearl River Delta had a per capita income of USD 3,889.

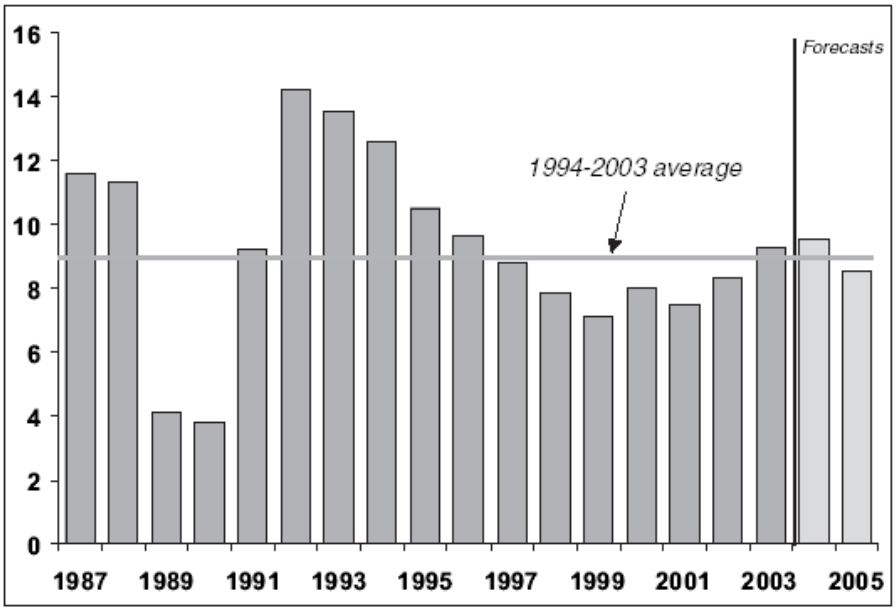
9. There are also huge disparities in foreign direct investment (FDI), the bulk being directed to the coastal regions. This reflects the selective nature of the reform process as well as FDI policies issued by the authorities. Initially concentrated in the east, as more broad based reforms and open door policies for FDI have been adopted, investment has spread to other regions. This will continue. The opening up of western and central China, and the urbanisation programme that this will entail, suggests greater scope for international investors to penetrate all regions of China.

B2. OPENING UP HAS ACHIEVED ECONOMIC SUCCESS

10. Growth rates: China's policymakers have been incredibly successful in ensuring that, despite these huge regional differences, the economy has enjoyed huge success over the last quarter of a century, with particularly strong growth in recent years. Since the beginning of economic reform in 1979, growth averaged 9.4%, but there have been some significant cyclical swings. Trend growth is seen as somewhere around 8%. Growth reached 9.5% last year and we forecast around 8.5% for 2005. There is strong consumer demand for vehicles, housing and better consumer services. Meanwhile, high levels of FDI are supporting continued export growth. In 2004, realised FDI was USD 60.6 billion.

Chart 2:

ANNUAL ECONOMIC GROWTH (GDP, ANNUAL % CHANGE)



11. Deregulation and reform: Deregulation and reform have both proved key features of China's economic success in the last two decades. Both will be critical to China's future success. As a consequence, the non-state sector now accounts for two-thirds of GDP, China has become more integrated into the world economy and its share of world trade has risen steadily. These trends will continue as China transforms itself into a market economy. A dual track approach has been adopted, establishing reforms in parallel with pre-existing tracks of the centrally planned economy. China benefited from the liberalisation of agriculture in the late 1970s. There has been labour migration from agriculture into industry and services.

12. Emerging economies, like China, often benefit from a combination of large labour forces and cheap labour. This can help drive economic growth. But for such growth to be sustainable requires a number of other factors, including sustained productivity growth. The combination of labour force growth and productivity growth would then be a key driver behind total factor productivity. This is hard to measure, but the key to productivity is sustainable investment and continuing reform. In terms of reform, the focus needs to be on restructuring firms and on reforming the banking sector. There is a strong link between structural reform and productivity growth, which is running at about 2.5% a year. Knowledge spillovers from joint ventures (JVs) and from wholly owned foreign firms, for instance, have been crucial.

13. Macro-economic management: It is important to remember that China is a developing economy and, like other emerging markets, it is vulnerable to shocks and to inflation and trade problems. During the early 1990s the economy suffered a boom-bust cycle. Investment rose sharply, and then fell significantly, in turn triggering weaker consumption as well. Now, China faces a similar challenge. In 2005 the government will continue to curb over-investment. The growth rate of investment fell in 2004 but remains high. Whilst the immediate focus is on controlling the upside, it is a delicate balance, as any significant slowdown in growth would expose underlying economic problems as well as wider social and regional issues. Two economic issues on the downside stand out: the risk of higher unemployment, and the danger that the recent downward trend in banks' non-performing loans (NPLs) will be reversed. Lets examine these issues in turn.

14. Too much investment: Investment accounts for over 40% of GDP and has grown strongly in recent years. It is possible to have too much of a good thing, as illustrated by other countries during the 1997 Asian economic crisis. Although China was largely insulated from that crisis, an important lesson from it is valid for China now. Too much investment can create problems. Although there is no ideal level, investment in China now is on a par to that seen in a number of Asian economies prior to 1997. Given the rapid growth rates of investment in recent years any sharp decline in investment would be sufficient to reduce China's growth rate sharply. For instance, with investment at 40% of GDP, a 10% decline in investment would reduce GDP by 4% from around 9% to 5%. Such a growth rate would probably feel like a recession, and would likely be referred to as a growth recession. Excessive policy tightening, or a slowdown in the USA, China's biggest export market, are two potential triggers for such an investment slowdown. The evidence so far indicates that investment growth rates are falling, but not sharply. Another positive indicator is that while money growth peaked at just over 20% in 2003 (above its trend growth of 14-16%), this peak only lasted a few months. It was quickly and effectively controlled. Both the scale and length of this monetary boom was less serious than in the early 1990s. That has tended to lead to the view that any correction in this investment boom will be manageable. This may be so, but the risks clearly lie on the downside.

15. Controlling inflation: Inflation too is a concern. And this is particularly relevant in the consideration of monetary and exchange rate policy covered in the Appendix below. Yet the reality is very complex. Furthermore, inflation differs significantly between sectors. Most consumer goods are falling in price (partly thanks to fast technological development and intense competition in manufacturing). Food prices rose fast in mid-2004, but have since moderated with the good harvest. Inflation in the corporate sector outstrips that in the consumer sector. Consumer price inflation was -0.8% in 2002, rising to 1.2% in 2003 and 3.9% in 2004. Producer prices fell -2.3% in 2002, rose 2.3% in 2003, and likely rose by 6% in 2004. We expect that some of the increase in producer costs will feed through to consumer prices in 2005, particularly as energy prices are liberalised more. As a result there has been a shift in economic policy, with both monetary and fiscal policy being tightened. As discussed in Appendix A below, interest rates are rising. Meanwhile, fiscal policy is no longer being used to stimulate the economy as in the recent past.

16. Sustainable growth: Last year was significant in signalling a shift in policy, away from growth at all costs to an emphasis on the need for sustainable growth. This was articulated at the March 2004 National People's Congress (NPC). At that Congress, "five balances" were highlighted as important. These were:

- the balance between urban and rural;
- the balance between regions;
- the balance between growth and the environment;
- the balance between economic and social development; and

— the need to open up China to international influence.

This shift in emphasis is often referred to as, "scientific development concept." The aim is a comprehensive and coordinated approach to sustained development.

17. The administration of Premier Wen Jiabao has concentrated particular attention on rural areas. The leadership has committed itself to supporting the construction of rural infrastructure, improving agricultural production capabilities, reforming rural taxation and ensuring that rural incomes continue to grow steadily. Last year the rural sector was helped by a good harvest, the first increase in grain output in four years and the biggest rise in rural incomes since 1997. One worry for the leadership is that after food price inflation of over 30% over the past year, farmers will have planted more, meaning that over-supply of food in the next 6-12 months could lead to problems.

18. At the Party's Economic Work Conference in December 2004, the leadership committed itself to "expanding employment, improving social security systems, protecting the interests of the masses, and promoting social fairness." Although inequality in China has risen over the reform period, it appears to have stabilised. The most recent Gini co-efficient (a measure of income inequality where 1 is perfect inequality and 0 is perfect equality) is 0.43 for 2002 having fallen from its peak of 0.45 in 1995. The Party leadership, however, is still focused on the issue.

19. Unemployment: There has been a significant displacement of workers from agriculture into urban areas, and from former state owned enterprises into unemployment and the informal and private sectors. Some 95-120 million migrant workers seek employment in urban areas. In turn this has kept wage costs down. Urban unemployment is officially 4%. However, a more realistic number is 8-10% (and the number, again, suffers from vast variance over the country), and there are some 150 million people idle in the countryside.

20. Financial sector reform: Financial stability is essential for economic stability. This requires modern financial institutions. As part of its commitment to entry into the World Trade Organisation, China is opening up its financial sector. This is a huge task but essential for economic success. Although China was not really impacted by the 1997 Asian economic crisis, there were a number of lessons from that crisis that are particularly relevant for China now. One was the lesson of over-investment mentioned above in paragraph 14. The other lesson is to open up one's financial sector at a speed best suited to the needs of the domestic economy. Gradualism may sometimes be the best policy.

21. Much of the focus on the financial sector tends to be on banks' non-performing loans (NPLs). These are falling. Yet we should focus also on other measures: systems, internal controls and capital adequacy are all important. Shocks to banking sectors can come from a number of sources: vulnerability of the banking sector to an external shock; domestic causes such as weak banking supervision; political interference and inadequate capital; and the system being outmoded and in need of rebuilding. It is important for China to have the political will and determination to push through painful reforms and to the need for autonomy and independence of regulators and courts.

22. China has a high rate of domestic savings, and has saved an average of 37% of GDP over the reform period. It is important for China to channel a larger share of its savings to the more dynamic non-state sector. This is now happening. A stronger banking sector and further financial disintermediation should ensure it continues. Financial disintermediation has been largely bank denominated. Equity and bond markets have been small, implying that in the past savings were not allocated to the most productive areas of the economy, but to the most politically sensitive. Creditworthy entrepreneurs and future productive sectors were thus starved of finance. This is now changing. And this is important as small and medium sized enterprises are important for China's future success and need access to funds. In terms of banks, there has been much progress. Non-performing loans are down and modernisation is occurring across the banking sector. This is most evident amongst the biggest four banks which are being prepared for stock market listing. To assist that move, at the start of last year, USD 45 billion of foreign exchange reserves were transferred between Bank of China and China Construction Bank to boost their capital base. Within this modernisation, it is important to appreciate the vital role that foreign banks can play in China, particularly in bringing best practice, whether it be risk management, technical transfer or human resources.

C. REGIONAL: CHINA'S GROWING REGIONAL ROLE

23. It is evident that China is becoming important for a number of different regions around the world, particularly Asia and Africa. Also, through its demand for energy, China's future importance to the Middle East cannot be overlooked. Trade deals between China and Latin America and the rest of Asia are proliferating. Consider here the importance of China to Asia and Africa.

24. China and the rest of Asia: In a remarkably short space of time attitudes towards China across Asia have changed. Whereas only a few years ago China was seen by many Asian countries as a competitive threat, now it is widely regarded as a growth opportunity—a market to sell into. Trade links between China and other Asian countries have grown. And, in our view, this trend is set to continue. Trade between other Asian countries and China has soared, growing at three times the pace of world trade. Exports from Asian economies to China have risen sharply. In 2003, half of the exports from Asia to China were re-exported, half were used to meet domestic demand. This not only emphasises the potential of the Chinese market for the rest of Asia, it also highlights the growing importance of the Asian supply chain. And, as a result of this, there appears to be a shift in the product mix across Asia. Many Asian economies are becoming increasingly specialised. For example, Taiwan has been the biggest maker of laptops, but more and more assembly steps are outsourced to plants in China. This leaves Taiwan with the role of making the upstream products, such as the microchips and the LCD screens, as well as being increasingly innovative with branding and design.

25. Although the US is still the dominant export market for Asian countries, China's importance is growing. For instance, for many south-east Asian countries, exports to China account for around 6% to 7% of their total. Whilst small, the same figures only a few years ago were around 2%. An important implication of this is that any downturn in China would now have significant repercussions across the region. Moreover, trade deals between China and other Asian countries suggest increased future linkages. The group of economies that appear most exposed to China are Hong Kong, Taiwan, Singapore and South Korea.

26. Although trade is the most recognisable link between China and the rest of Asia, tourism has also become important. For instance, in the first half of 2004, mainland China accounted for 59.8% of the increase in Hong Kong tourists, 11.1% of the increase in tourists to Singapore and 7.9% for Thailand. This trend is likely to rise as Asian destinations are made more accessible to Chinese visitors. Foreign direct investment from China has yet to benefit Asia in any meaningful way, but Hong Kong is the exception. The region could benefit more as Chinese capital will be seeking opportunities in the region in coming years, as the authorities are relaxing the outflow of capital. According to the United Nations Conference on Trade and Development's (UNCTAD's) World Investment Report, Hong Kong received USD4.1 billion inward investment from China between 1979-2002, the whole of Asia USD9.3 billion.

27. Sino-African links: China's importance to Africa is often overlooked. Trade between Asia and Africa is rising significantly. There is huge demand from Asia, and in particular China, for a range of commodities exported from Africa. And this increasing trade flow is two-way, with Africa importing manufactured goods from Asia. Traditionally, western Europe was the major trade partner for Africa. This is changing. And given Asia's future potential growth this could be very important in helping Africa reverse its recent declining share of world trade: Africa's share of world trade was 3% in 1990, falling to 2.1% by 2003. As African economies diversify their trade links, China and Asia are already becoming more important.

28. In 2003, total trade between China and Africa reached USD17.2 billion, of which USD9.2 billion were exports from China. The total figure is over 10 times that recorded in 1991. Asia, led by China, is now the biggest importer of Nigerian oil. In fact, in 2003, 18% of China's oil imports came from Africa. China has also become the principle destination for tropical timber from Africa for the past five years and has now replaced France as the primary export market for Gabonese wood. And, China's demand for commodities points to it being a key future driver in Asian-African trade.

29. China's impact on India: China's emergence may have also been a contributory factor in encouraging India to open up and deregulate at a faster pace. Whilst this Briefing is focused on China, it is important to appreciate the likely growing importance of India. Whilst the present consensus may be to view China as a manufacturing hub and India as a service sector hub, the reality is likely to be far more complex. There are three aspects to India worth stressing. First, like China, it will become a future growth opportunity, a huge market for British firms to sell into. Second, India is intending to move up the value curve into higher value added services. Third, with a huge young population, it is very likely that in order to boost employment that India will have to shift into large scale manufacturing as well.

D. GLOBAL ISSUES

D1. Implications of China's growth for the world economy

30. China's impact on global demand now: It is important for the world economy that China continues to grow at a sustainable pace. In China the current worry for policymakers is that the economy is growing too strongly. The worry for the rest of the world is that the present upswing is soon followed by a hard landing, providing a demand shock to the world economy. Whereas the world economy has been resilient in recent years to a combination of economic, financial and terrorist shocks, now it appears more vulnerable. This vulnerability stems from the present imbalances in the world economy, being overly dependent upon growth in the US and China. As a result, the outlook depends crucially on policymakers in both the US and China avoiding major policy mistakes. In recent years the US has enjoyed its biggest pre-election boom since World War II. And although the US economy has present momentum, it is likely that the pre-election boom will be followed by a post-election slowdown. In previous cycles when the US slowed, Europe and/or Japan picked up the slack. Not this time. One of the major dangers for the world economy is a synchronised downturn in the US and China, possibly triggered by policy tightening as central banks try to remove excess liquidity from the global economy.

31. China's importance for future global growth: Beyond these near-term issues, the key for the global economy is the need to return to balanced growth. This requires a combination of factors, including the US avoiding downside risks and seeing a rise in savings, and whilst this happens Asia needs to become a counterbalance in the way that Europe and Japan used to. This would involve stronger domestic demand across Asia. This requires Asian economies, including China, translating high domestic savings into increased domestic investment and consumption. It also implies a shift from today's current account surpluses across Asia to current account deficits. China will play an important role both in ensuring the absence of any demand shocks now and a move to steady sustainable balance in the world economy.

32. Asia holds the key to global currencies: A decade ago, Asian central banks held one-third of global currency reserves. Now they hold two-thirds, the bulk in dollars. The accumulation of reserves across Asia has been fully justified. The dollar's prospects will be heavily influenced by the behaviour of Asian central banks. One of the many influences on currency policy across Asia has been the desire to retain competitiveness. And, in this context, the behaviour of Chinese currency policy will have a big bearing on what happens across the region. Appendix one below looks at Chinese monetary and exchange rate policy in more detail, highlighting that China is likely to adopt a gradualist approach to currency reform. In turn this may contribute to a gradual appreciation of most Asian currencies against the dollar.

33. China and commodity prices: China is having a huge impact on global inflation. The impact is not uniform. In commodity markets, China's demand has led to a huge increase in prices through higher demand. This is a hard one to predict. The longer-term trend for commodity prices—in real terms—is down. Could China, and in turn India, on account of sheer size of future demand change this? Supply clearly plays a role. If so, this applies to both soft as well as hard commodity prices and energy. China's demand for raw materials and energy is huge. China accounts for around one-fifth to one-quarter of global demand for a host of hard commodities. For instance, in 2003, China accounted for 20% of global demand for copper, 19% of aluminium, 24% of tin and 21% of zinc. And whilst its demand for oil was 8%, China is reported to have accounted for about one-third of the increase in global oil demand in 2003. The last year has shown China's huge impact on commodity prices.

34. Supply-chain optimisation and disinflation: Increased competition from China is contributing to low inflation. Initially this is seen in terms of its production of cheaper manufacturing goods. This is a direct effect. But there are also two indirect effects likely to become evident in coming years, and both potentially as significant. One is optimisation in the supply chain. Across Asia, the emergence of China has seen intra-regional trade rise significantly and as a result supply chains have become interlinked. With production costs having

already been squeezed, largely on account of China, the next phase of global competitive pressure may very well involve attempts by firms to squeeze costs lower in the supply chain—to optimise it. This is a big competitive challenge. The second indirect is that China's emergence has been a factor driving the opening up of India. This will add to competitive pressures, and not only in low value added services but both in higher value added services and in manufacturing.

35. The need for global forum to change: There is a clear need for global forum to change. This is considered in more detail in Appendix two below.

D2. Implications of China's growth for the UK economy

36. China creates both immediate challenges and lasting opportunities for the UK: China's economic emergence is adding to pressures on the UK in a number of areas:

— need to compete;

— need to think global and see China as an opportunity;

— need to seek China's support for the UK's G7 agenda; and

— recognise and do not underestimate the importance of Hong Kong.

37. Need to compete: Across the globe, both companies and countries are repositioning themselves to become more competitive and to be able to compete with China and India. For some counties there may be the ability to compete on cost, but the reality for most is that competition will have to be based on a range of factors. Specialisation is likely to increase across economies. Firms may need to spend more on research, design and development. The Treasury's recent report highlighted the need for the UK to become flexible, innovative and entrepreneurial. Clearly, the UK cannot compete on cost. Chinese workers in the manufacturing sector earn a fraction of the wage of their UK counterparts (around 4%). Employment in already-developed economies increasingly needs to be skills based and high in terms of added value. With worker productivity 15% below the G7 average, and average educational attainment levels below that of most developed and many developing countries, the UK faces a number of immediate dangers. It is hard to measure competitiveness across countries. One measure, that of the World Economic Forum, suggests the UK has fallen from the 4th to 11th most competitive economy between 1998 and 2004. And there are widespread reports that businesses fear the full impact of further regulations and higher taxes. Certainly the UK's competitive position appears to be under threat. According to the Treasury's own forecasts, the tax to GDP ratio will rise from 36% currently to 38.5% in 2008, the highest it has been since 1984, ahead of the Thatcher Government's tax reforms. This will further set back the UK's competitive position in terms of generating domestic investment and attracting foreign investment. It is not just the direct competition from China that is important it is also the indirect competition from elsewhere, as other countries adjust to compete with China. Of course, one could argue that by default, rather than by design, the UK is less at risk than many other countries because so much of its manufacturing base has already been hollowed out. And this, plus the very open nature of the economy, has already led to a high degree of specialization in areas such as pharmaceuticals and the financial sector. An additional challenge in years to come will be as India moves "up the value curve" into higher quality services. I would agree with a number of points that the Treasury made in its recent report on long-term challenges, when it talked about entrenching macro-economic stability, promoting a flexible, enterprising and innovative business sector and increasing and optimising the skills mix in the labour market, while maximizing flexibility.

38. Need to think global: The UK needs to think global. Whereas the US and Europe are clearly important, the focus needs to be global. In this context there is a need to see China as an opportunity, not a threat: UK firms need to see China and India as opportunities, not just threats. China and India are attractive markets to sell into, given their vast populations, in sharp contrast to Europe's ageing population. The UK is the 14th biggest exporter to China, behind the likes of France (12th) and Germany (4th). Perhaps the present position is not a complete surprise, given the capital goods export mix of other countries like Germany, but it does highlight that we need to position ourselves better in the future. Although we fare better in terms of exports to India, where we rank 4th, on a par with Germany, there is still more potential to realise.

39. Need to seek China's support for the UK's G7 agenda: Given Britain's presidency of the G7 and European Union, the UK could seek China's support in pursuing an agenda geared to helping Africa and to solving environmental issues. In both these areas, Africa and the environment, China's future role will be crucial.

40. Recognise and do not underestimate the importance of Hong Kong. It is important for the UK authorities to recognise the important role played by Hong Kong. There appears to be a danger that attention is focused on Shanghai and Beijing. Clearly these are very important, but so to is Hong Kong. And this is not just from a historical perspective, given the trade and business relations between Hong Kong, Britain and China. But it is very important from a future perspective, given Hong Kong's important role within the Peal River Delta and its position as a premier international financial centre.

APPENDIX 1: CHINA'S MONETARY AND EXCHANGE RATE POLICY

MONETARY POLICY

41. One size does not fit all in China: This appendix focuses in more detail on the key issues for Chinese monetary and exchange rate policy. For the rest of the world the focus is on China's exchange rate policy. Yet this is not the dominant issue within China, where monetary policy needs to support the aim of sustainable growth. To appreciate the difficulties Chinese policy makers face in monetary policy, it may be useful to think first of the single European currency zone. Europe has a one size fits all monetary policy—that is, one monetary policy for all the countries in Europe. There is a similar problem for China, as one monetary policy has to fit a country with even greater economic differences than Europe. The challenge is to calm fast rates of investment growth and to cope with a fixed exchange rate regime that is coming under considerable pressure.

42. Gradual and targeted tightening since summer 2003: Since the summer of 2003 the Chinese authorities have focused on gradual and targeted tightening to slow the pace of economic growth. This has involved a combination of factors:

— administrative measures aimed at slowing bank lending to sectors that appeared to be overheating such as cement, steel, aluminium and real estate;

— administrative measures to stop investment projects and land development, particularly in coastal areas;

— raising reserve requirements, aimed at curbing bank lending, particularly to the property sector. On September 21 2003, the required reserve ratio was raised from 6% to 7%, and on April 25, 2004 it was hiked further to 7.5%. This had an immediate effect of withdrawing some CNY200 billion from the system, and it would have also had an effect on the money multiplier, the ratio that links base money with broad money (M2).

43. Although successful, such measures are not sustainable: Administrative measures proved successful, restraining investment and preventing inflation whilst still allowing strong growth. However, with growth of 9.5% and fixed investment assets rising 26% last year, it is clear such administrative measures by themselves are not enough for a government that remains committed to its policies to cool the economy. Indeed, such administrative measures are not sustainable if growth is to slow to, and remain around, its trend rate of 8%. Also, these measures may have had some unforeseen consequences, including making it increasingly difficult for private firms to access working capital loans. Furthermore, their limitations were evident when inflationary pressures began to reemerge towards the end of 2004. This was evident in a number of ways. Producer price inflation started to rise by an annual rate of 8%. Large rises in property prices were evident in a number of areas. And with the economy growing above trend it was vulnerable to rising oil and commodity prices. Thus it proved necessary to tighten monetary policy further. Official GDP growth in 2004 was 9.5%, and fixed investment asset grew 26%, suggesting only the mildest of slowdowns. The government remains committed to its cooling policies.

44. Broad based tightening as interest rates rise: In October 2004, it proved necessary to move to more broad-based measures to slow the economy. The central bank, the People's Bank of China (PBOC), had long been arguing for such a shift. In late October 2004, interest rates were hiked for the first time in nine years. The one-year deposit base rate for financial institutions was raised by 0.27% to 2.25%. The one-year lending rate was increased 0.27% to 5.58%. Although the hike of 27 basis points was small, it was hugely significant. It signalled that interest rates were to be used as a tool for macroeconomic adjustment. Higher interest rates should also help make investment decisions more rationale. The PBOC's reasoning for the move at the time, was to, "Make progress in resolving inflationary pressures, prevent an investment rebound, prevent enterprises over-borrowing funds, gradually sort out cash flow problems at some enterprises, and to decrease the amount of money circulated informally."

45. Upper band on lending rates eliminated: Although the rate hike was important, it was not the only significant factor. The PBOC also eliminated the upper band on lending rates for banks and for urban credit co-operatives. Previously the limit was 1.7 times the base rate, having been raised from 1.3 times at the start of 2004. Banks can now lend at any rate above the base rate that they wish. This has important implications:

— banks will now be able to charge for risk, allowing them to lend to small and medium-sized firms more freely;

— there is more freedom for banks to compete on price;

— it is a further sign of development in monetary policy, with the PBOC using open market operations, interest rates and other market based tools to manage liquidity and the demand for funds.

46. Further interest rate hikes likely: Reflecting the inflationary pressures highlighted above, it is likely that there will be further interest rate hikes, particularly in lending rates. The PBOC will also continue to attempt to reduce liquidity in the banking system in order to make banks and their customers more sensitive to the PBOC's core discount rate.

47. Key focus is exchange rate policy: In common with other countries across Asia, China has intervened aggressively in the currency market in recent years. For China the aim has been to maintain its peg against the US dollar. Currently at 8.28 CNY to the dollar, the present rate has existed since 1994, when China devalued. Although this intervention has been successful in maintaining exchange rate stability, it has created additional problems, largely because of the scale of the intervention that is taking place.

48. Huge build up in reserves: During 2004, China's foreign exchange reserves rose by USD 206.6 billion, reaching USD 610 billion in December 2004. A number of factors contributed to this. Strong year-end trade figures; record foreign direct investment (FDI) inflows and hot money flows, all leading to intervention by the authorities to prevent the CNY appreciating. For instance, take the FDI flows. During 2003, the gross FDI into China was USD 53.1 billion. Gross FDI rose to USD 60.6 billion, with the net inflows into China being offset by USD 2.5 billion of FDI outflows into Africa, Asia and Latin America.

49. Need to sterilise this reserve build up: When any country builds up its reserves this boosts domestic monetary growth. In buying dollars from Chinese exporters, CNY is being injected directly into the domestic financial system. This is potentially inflationary. The way in which this boost to monetary growth is prevented is "sterilisation", through sales of domestic debt. Monetary growth in China, as measured by M2, trended around 13% to 14% for many years before accelerating sharply in 2003 and 2004, as currency intervention took place on a large scale. As a result there was significant sterilisation. The PBOC uses two main instruments to sterilise foreign exchange inflows and to take money out of the domestic monetary system. These are central bank bills and repo actions. In late 2002 a new instrument was created, central bank bills (CBBs). Issued by the PBOC into the inter-bank market these bills have maturities of 3, 6 and 12 months. The first auction of these new bills took place in April 2003. And in April 2004, the PBOC began weekly treasury-bond-based repo operations.

50. Central bank's balance sheet has been restructured: Last year, we calculate that just under one-third of new foreign exchange reserves were sterilised. Sterilisation efforts have resulted in a restructuring of the PBOC's balance sheet. We look at this using data available up to October 2004. Table 1 shows the liability side and table 2 the asset side of the PBOC's balance sheet in October 2004. While bonds only accounted for 4% of its liabilities in October 2002, they rose to 12% by October 2004 as a result of bond issuance. Reserve money fell from 83% of liabilities to 73% over this period. Between October 2002 to October 2004, net foreign assets (FX reserves) have risen significantly (up 8 percentage points as a proportion of the total). Claims on deposit banks and other financial institutions have fallen.

Table 1

THE LIABILITY SIDE OF THE PBOC'S BALANCE SHEET, OCTOBER 2004

Reserve money	*73*
Bonds	12
Government deposits	13
Foreign liabilities	1
Other	1

Table 2

THE ASSET SIDE OF THE PBOC's BALANCE SHEET, OCTOBER 2004

Net foreign assets	*56*
Claims on financial institutions	14
Claims on deposit banks	13
Other assets	13
Claims on government	4

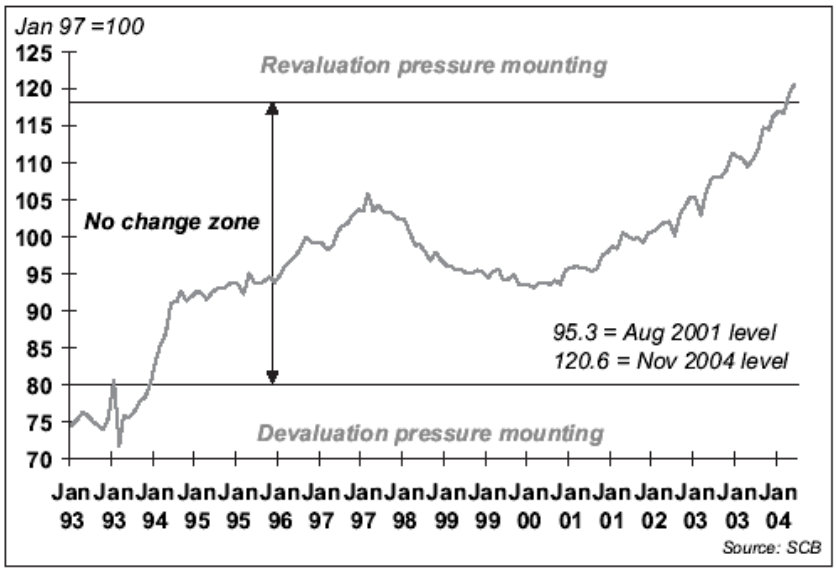
Source: Standard Chartered using CEIC Database

51. Higher rates increase the cost of sterilisation: The main challenge of any sterilisation strategy is coping with rising interest rates. As the central bank increases its issuance of paper, market participants demand higher interest rates, increasing the cost to the government as well as having a macro-economic side-effect. So far, however, the PBOC has not yet had to raise the rates on its paper. This is partly because of the limited scale of Central Bank Bill issuance and partly because of the large amounts of liquidity in the system. However, given the recent acceleration in reserves in October—December 2004, this might not be sustainable. If interest rates across the board rose, then of course, there would be a cost in terms of the price at which new debt is issued, both for the central bank and for the Ministry of Finance (MoF).

52. Strong case for currency revaluation: Instead of relying on sterilisation, however, we believe that the economic case for a revaluation of the CNY is strong. In order to measure the pressures on the CNY over time, Standard Chartered introduced a CNY Barometer. This is shown in Chart 3. The higher the reading the stronger the pressure for a change in the CNY. The Barometer takes into account a number of factors, including sustainability, competitiveness and overall economic performance. In 2004, there was widespread speculation of a CNY revaluation. We did not share in these calls for a CNY revaluation and our Barometer suggested there was no imminent need to change. In fact, many of those called for a CNY revaluation last year were amongst those demanding a depreciation in 2001. How times change! In recent years China's trade competitiveness has been further enhanced by the weakening trend of the dollar. And it is this USD decline that makes a CNY revaluation more likely. Indeed, because of these recent gains in trade competitiveness, a modest appreciation of the CNY against the USD, and by implication on a trade-weighted basis, would not harm exporters from China. Although the Chinese will not be forced into change by speculators, latest official comments suggest some officials see present CNY policy as a potential problem. Currency reform, however modest, would help relations with the US and serve as an important signal of China's commitment to market reforms.

Chart 3:

STANDARD CHARTERED'S CNY BAROMETER



53. China's three stages to revaluation: The ideal situation would be for China to have a freely floating exchange rate, able to move in response to economic and financial market conditions. This, of course, will not be possible until there is capital account convertibility and that is some way off. There is much to be said in support of the present peg against the dollar. It is clear, open and transparent. For an economy still trying to establish credibility in monetary policy, this is important. Yet, as the UK lesson from Europe showed, pegging against another currency only makes sense if economic conditions in both countries are the same. Moreover, even if there is a peg, it is important to have some flexibility, with frequent realignments in response to changing economic conditions. The Chinese could still defer or postpone exchange rate reforms. The current exchange rate regime has served the country very well. External shocks like a sharp fall in global growth rates could make the authorities reluctant to move. Internal shocks like the possibility of a hard landing could also have the same effect. In the absence of such shocks however, we see three main stages to the revaluation of the CNY.

54. Stage 1-the widening of the currency band: Although China's currency is often viewed as being pegged, the reality is that it is a managed float. And in terms of the present policy, it is possible for the CNY to appreciate by 0.3% a day, equivalent to a 1.5% appreciation over a week. So China does not really need to alter policy if it wants a stronger CNY. The first step the Chinese may consider is the widening of the currency band, allowing the CNY to move within a plus and minus 3% band against the US dollar. We see this happening in the next twelve months. A gradual move would be in line with the official desire to perfect the exchange rate mechanism. The trouble is, such a widening may encourage the financial markets to expect further appreciation of the CNY. A hurdle to any widening of the current band is that market participants, especially local financial institutions, would need practical experience with handling variable exchange rates.

55. Before China widens the band, two important prerequisites will need to be satisfied. First, the introduction of an onshore forward market in order to make it easier for China to accommodate a wider CNY trading band. Some steps have already been taken. The China Foreign Exchange Trade System and the Chicago Mercantile Exchange have already signed a memorandum agreeing to develop an onshore CNY forward market. Second, the level of speculation will need to ease. The Chinese have made it clear on several occasions that changes to the CNY exchange rate cannot be implemented in an environment of intense speculation.

56. Stage 2-trade-weighted targeting: Beyond 2005, it is most likely that there will be further gradual widening of the band. This will be consistent with a snake-like appreciation. And it will then be followed by a trade-weighted targeting of the CNY, against a basket of currencies. This could be similar to India's system of targeting the real effective exchange rate or Singapore's nominal effective exchange rate target.

57. The move towards this is likely to be measured. Singapore and India both operate successful currency policies based on managing their pegs against a basket of currencies with which they trade. Thus, as an interim step towards an eventual float, pegging the CNY against a basket of currencies could be an option. Given the growing diversification of China's exports, a more varied exchange rate peg has increased benefits. It is, however, harder to implement and such a policy is not so transparent. If China was to make a shift to a trade-weighted basket, it would make sense to move to a basket that is not only reflective of trade now but is indicative of likely Chinese trade in the future. That is, as it would be such a dramatic change to move to a trade-weighted basket, it makes sense to move to a basket that can be retained for

a number of years.

58. On this basis, the Chinese might not include currencies such as sterling, the Australian or Canadian dollars or even the Russian rouble, which could be validly included in a basket now, but instead, focus on the dollar, euro and the currencies of Asian regional currencies. In this respect, it would likely include the countries that China is increasingly trading with in Asia. Effectively, the basket should include the emerging Asian trading bloc. If one excluded the small countries this would leave a group of Indonesia, Malaysia, Philippines, Singapore, Thailand, Vietnam, South Korea and Japan. And to this would be added the US and Europe to provide a basket of 10 currencies. And in time one would expect India to be included. The weights of such a group could not simply be based on present trade flows. It would need to evolve, as trade flows changed. The lesson is that pegged systems need to be flexible. The exchange rate must act as the shock absorber.

59. Stage 3-floating the CNY: The third and final step is floating the CNY. This is still some time off. The banking sector in China, despite all the positive reforms that are underway, still lacks the sophistication and the maturity to deal with a floating currency and an open capital account. Once again, gradualism will be key. Our projection is that it would take five to 10 years and it that would require a number of conditions to be met, not least a strong financial sector, resolution of the problems in state-owned enterprises and the opening of the capital account.

60. So gradualism is key: The dollar's recent decline, which looks set to continue, will add to pressure for China and other Asian currencies to bear more of the burden of dollar adjustment. Beyond 2005, it is most likely that there will be further gradual widening of the band—to around +/-3% of the current peg. The currency would likely appreciate to the top of this band. This will then be followed by a trade weighted targeting of the CNY, against a basket of currencies. This could be similar to India's system of targeting the real effective exchange rate or Singapore's nominal effective exchange rate target. The move towards this is likely to be gradual.

APPENDIX 2: THE NEED FOR GLOBAL POLICY FORUM TO REFORM

61. Reform means empowering these forum: Paragraph 35 above stated that there was a clear need for global forum to reform. This appendix explains why. The issue is whether this reform should take place through existing forum changing, or new forum emerging. This issue can be seen from a political as well as an economic perspective. The Iraq War, for example, raised questions at that time about the legitimacy of the United Nations Security Council. But whether one confronts this issue from a political or economic perspective, successful reform has to mean empowering forum, or global institutions, so that they can find solutions to problems. It has to be more than just achieving a balance between different interests that ends up effectively paralysing the various forum. The political reality is that it may be difficult for countries to leave present groupings to make way for new members. Thus, existing groupings are more likely to become larger or new ones emerge.

62. Independence versus interdependence: The importance of this subject can, perhaps, be seen in the context of independence versus interdependence. As Bryan Sanderson (see further reading section below) highlighted in a speech in Beijing last March, "These words may sound similar but the concepts are dramatically different. Independence is the ability to act along. To act without acknowledging the consequences of our actions for others, or of our responsibility for those consequences. And to acknowledge the right of others to do the same, without regard to the consequences for ourselves. Interdependence is the opposite. It is acceptance that we need to act together. It is the acknowledgement that everything we do will have its effect on others. And that we are exposed and vulnerable to the actions of others. And that we have a collective responsibility for the system in which we operate."

63. Economic case for change: From an economic perspective, I believe there is a clear need for global policy forum to change in order to remain relevant. China's economic emergence is just one factor behind this. The future emergence of India and the growing importance of Asia will reinforce the need for change. Western economies face ageing populations, pointing to slower future trend rates of growth. Young, emerging economies across Asia are likely to grow at a rapid pace. A brave way to proceed would be rather than taking existing forum and thinking of how they should change, consider what forums would be set up now if we were starting from scratch.

64. Membership must be appropriate: International forum need to serve a purpose if they are to succeed. This not only means that each forum is able to address key, common issues but that it has to contain the appropriate membership that can solve these issues. For instance, it is hard for the present Group of Seven (G7) to attempt to solve currency issues by itself, when its present membership only includes one of the top ten countries with the largest holding of global foreign exchange reserves That country is Japan, which has the largest

reserves (not counting the eurozone as one country, Germany is in 16th place). This does not mean that all top ten holders of currency reserves should be in an expanded G7, but it demonstrates that forum must have the right membership to act.

65. Identify the global issues to be addressed: What are the global issues that policy forum need to take into account? And are these issues being addressed at present? The answer is that many issues are being addressed. For instance, the International Monetary Fund and World Bank meetings focus on world poverty. The World Trade Organisation focuses on opening up world trade. And the Group of Seven (G7) addresses global growth, amongst other issues. But some issues could probably be better addressed. For instance, it is important that Africa as a region is not marginalised and is allowed the opportunity to speak with one voice and have this voice heard at international forum. Whilst it is not possible to identify all the challenges that the world economy will need to cope with, we can already identify many of them.

66. Many issues can be best addressed regionally, not globally: Clearly there are many common challenges that can be addressed by global forum. But it is also likely that many issues may best be addressed in a regional, rather than a global context. Take the 1997 Asian economic crisis as an example. Regional contagion was evident in that crisis. Yet, as has been argued since, such regional contagion may have been avoided if Asia had strong domestic financial systems and active communication lines between countries had been in place. That crisis, and the response to it, highlighted the limitations of relying on global forum to address regional problems. At that time, the International Monetary Fund failed to gauge the root cause of the problem and the potential severity of the downturn and thus proposed a response not suited to the region. Perhaps a regional Asian IMF may have been better placed, perhaps to help avert the crisis and to respond appropriately.

67. Regional forum are becoming stronger: Regional cooperation can achieve more. Regionalism reflects the fact that countries in the same region face similar challenges and opportunities. Why face these alone? A country whispering alone can be ignored. A group of countries shouting with one voice must be heard. Regional strength empowers all nations to play a role on the global stage. Regional issues are becoming more dominant. In terms of trade deals, political actions and progress. This is particularly evident in Europe. But is also common across Asia. For instance, ASEAN + 3 has become more prominent; ASEAN is the Association of South East Asian Nations plus the three countries of Japan, South Korea and China. Also, the Group of 20, a collection of emerging economies, has become more important, helped by China's membership

68. The G7 should include future economic superpowers: The G7 is perhaps the most interesting forum to consider. Even if this group did not change it would still be important given its membership. Yet, it would make more sense for G7 to evolve by including emerging future economic superpowers, such as China now and possibly India in the future. The G7 with China now would be able to address key issues such as global growth and currency issues. Also, G7 is perhaps best placed if there is any international forum that can address financial issues. Global financial systems have become more important in the transmission mechanism It is important to reduce cross border shocks that could emanate from financial markets. Many countries have strong domestic regulators. It is hard to impose rules across countries, so perhaps the way to proceed is to ensure more openness and transparency. Many of the key global issues have been highlighted, by for instance, the Bank for International Settlements and the Bank of England's Financial Stability Review. So at the very least there is the need for more openness and transparency, the need for countries to have strong domestic institutions and the need for global forum to reform to take into account the growing interdependence in the global economy.

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