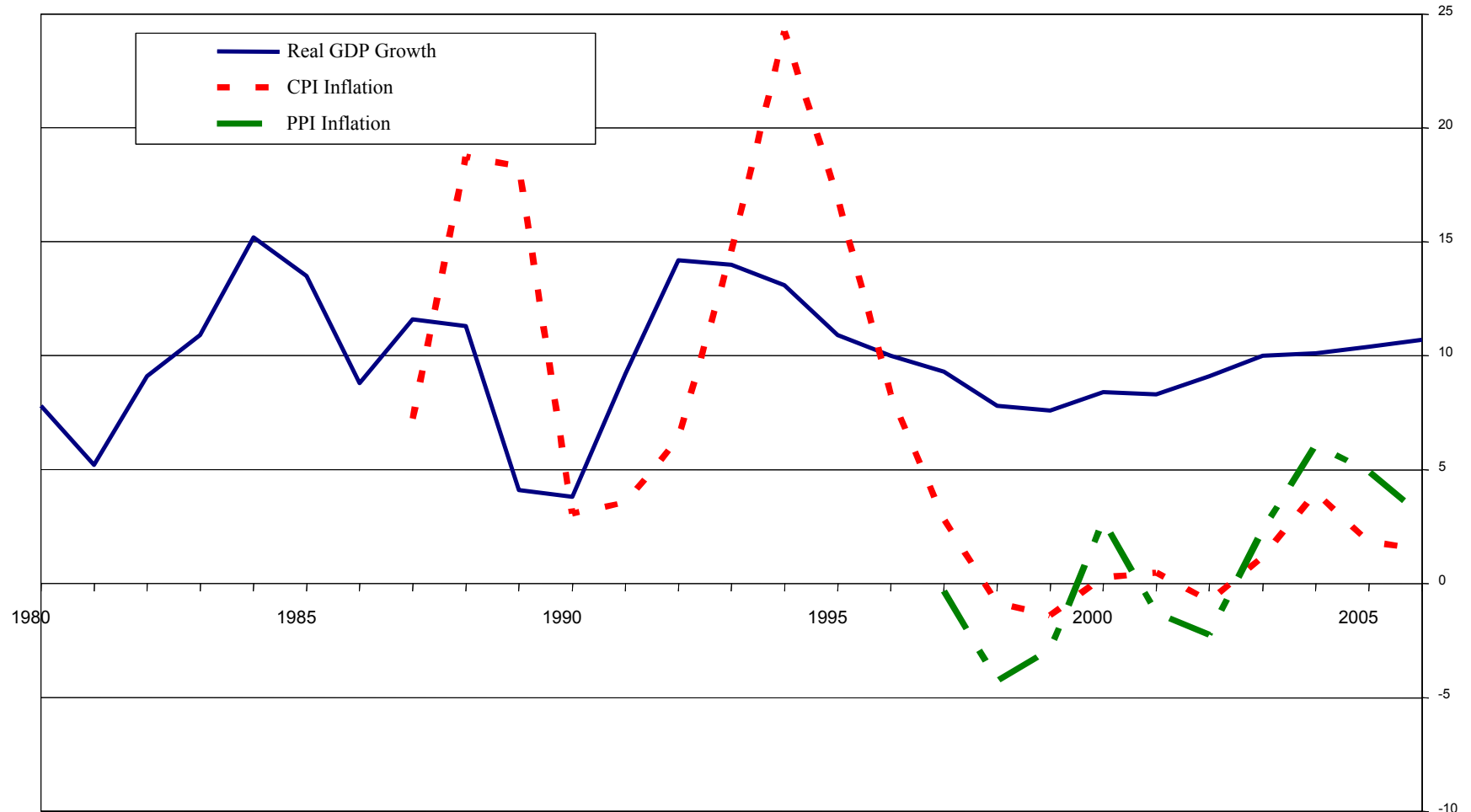

Is the Chinese Growth Miracle Built to Last?

Eswar S. Prasad
Cornell University

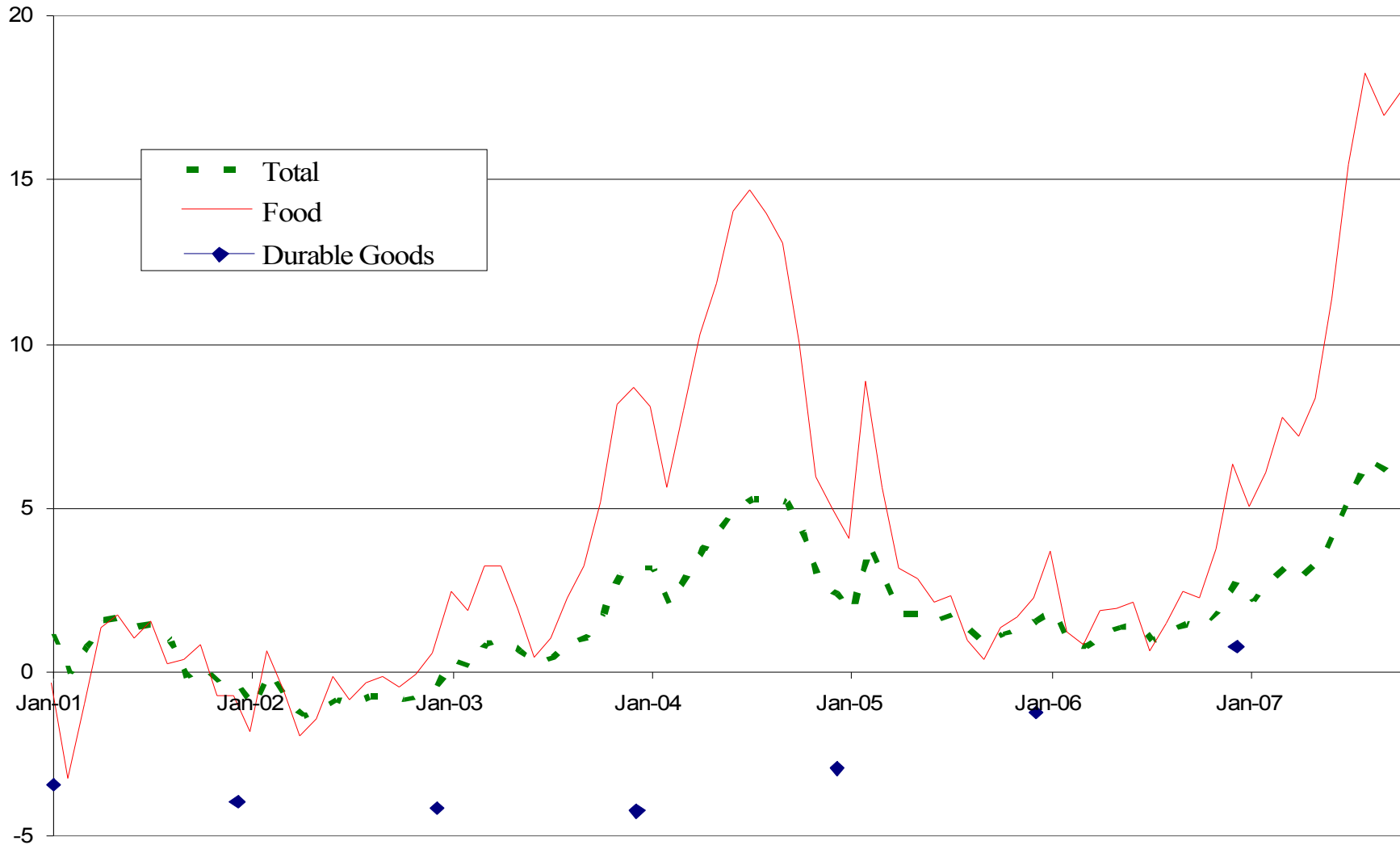
Outline of Talk

- Getting behind the growth story
 - Sustainability versus welfare
 - Reforms in a broader context
 - Risks, possible triggers for growth slowdown
-

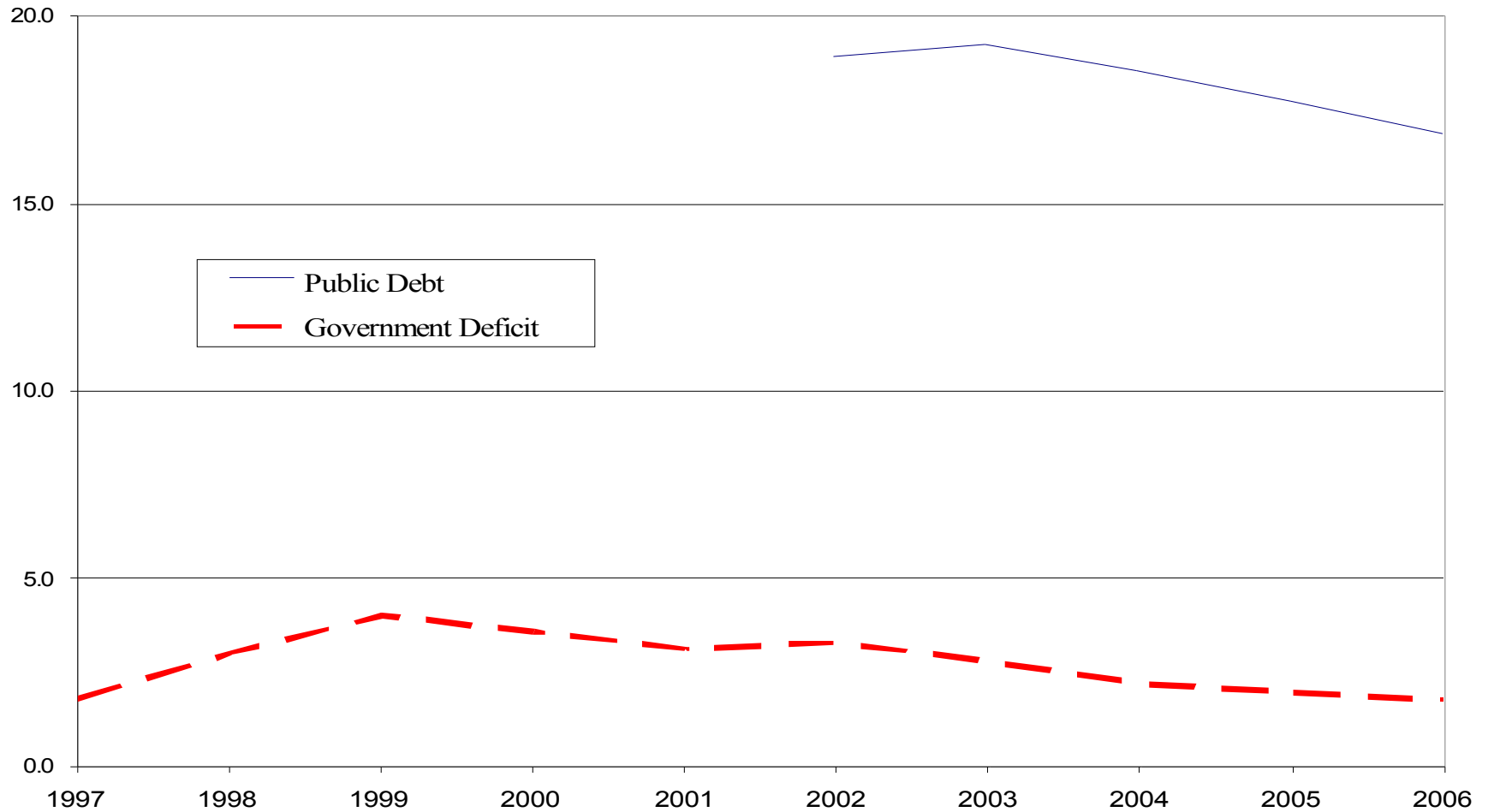
GDP Growth and CPI Inflation



CPI Inflation (year on year)

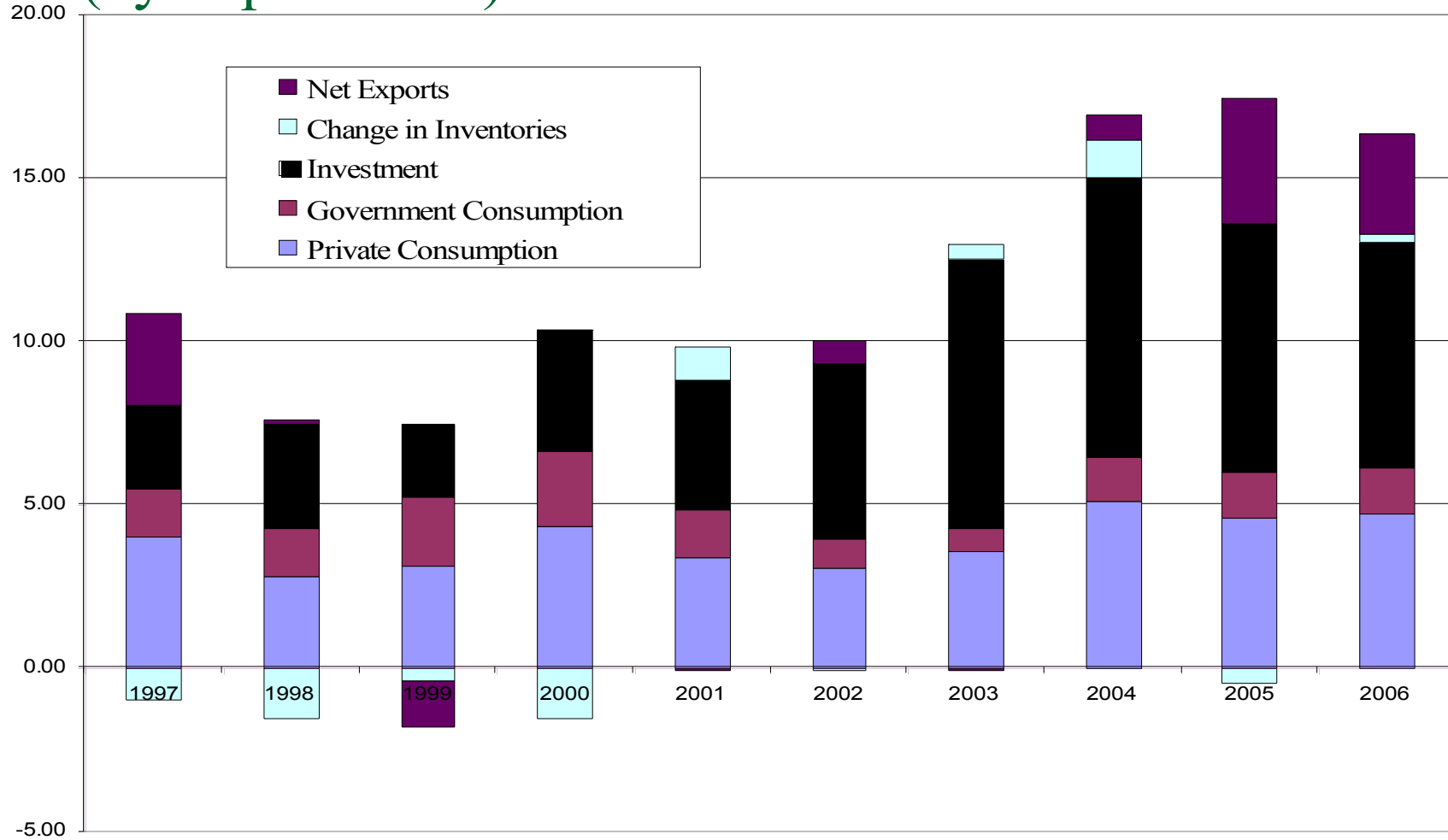


Government Deficit and Public Debt (in percent of GDP)

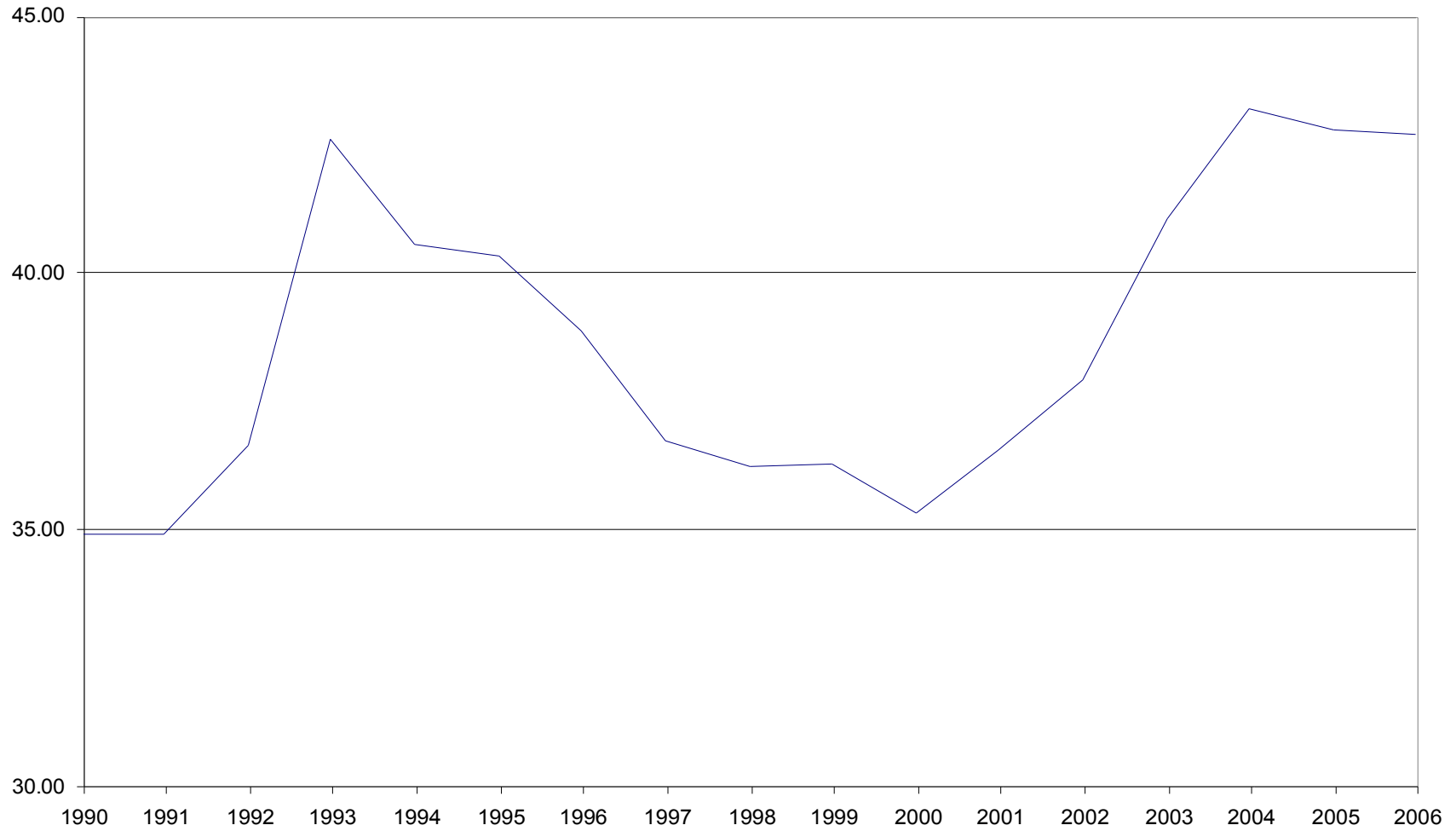


Contributions of GDP Components

(by expenditure) to China's Nominal GDP Growth



Capital Formation



The Sectoral Composition of GDP Growth

Year	GDP Growth	Sectoral Shares in GDP			Sectoral Contributions to Aggregate GDP Growth		
	Total	Primary	Secondary	Tertiary	Primary	Secondary	Tertiary
1991	9.2	17.5	52.6	29.9	0.4	6.4	2.4
1995	10.9	12.3	60.6	27.1	0.6	7.8	2.6
2000	8.4	9.5	62.8	27.7	0.2	5.6	2.6
2001	8.3	9.0	62.8	28.2	0.3	5.2	2.8
2002	9.1	8.4	63.1	28.5	0.3	6.0	2.9
2003	10.0	7.8	64.1	28.1	0.2	7.3	2.5
2004	10.1	7.5	64.5	28.0	0.5	6.9	2.7
2005	10.4	7.1	65.1	27.8	0.4	7.4	2.7
2006	10.7	6.7	65.6	27.7	0.3	7.5	2.8

The Structure of Employment

Year	Total Emp.	Sectoral Employment Shares			Employment Level	Emp. Growth: Sec. + Tertiary
		Primary	Secondary	Tertiary	Primary	
1991	655	59.7	21.4	18.9	391	2.2
1995	681	52.2	23.0	24.8	355	5.5
2000	721	50.0	22.5	27.5	360	1.2
2001	730	50.0	22.3	27.7	365	1.3
2002	737	50.0	21.4	28.6	369	1.0
2003	744	49.1	21.6	29.3	365	2.8
2004	752	46.9	22.5	30.6	353	5.4
2005	758	44.8	23.8	31.3	340	4.8
2006	764	42.7	25.1	32.2	326	4.6

Weak Employment Growth

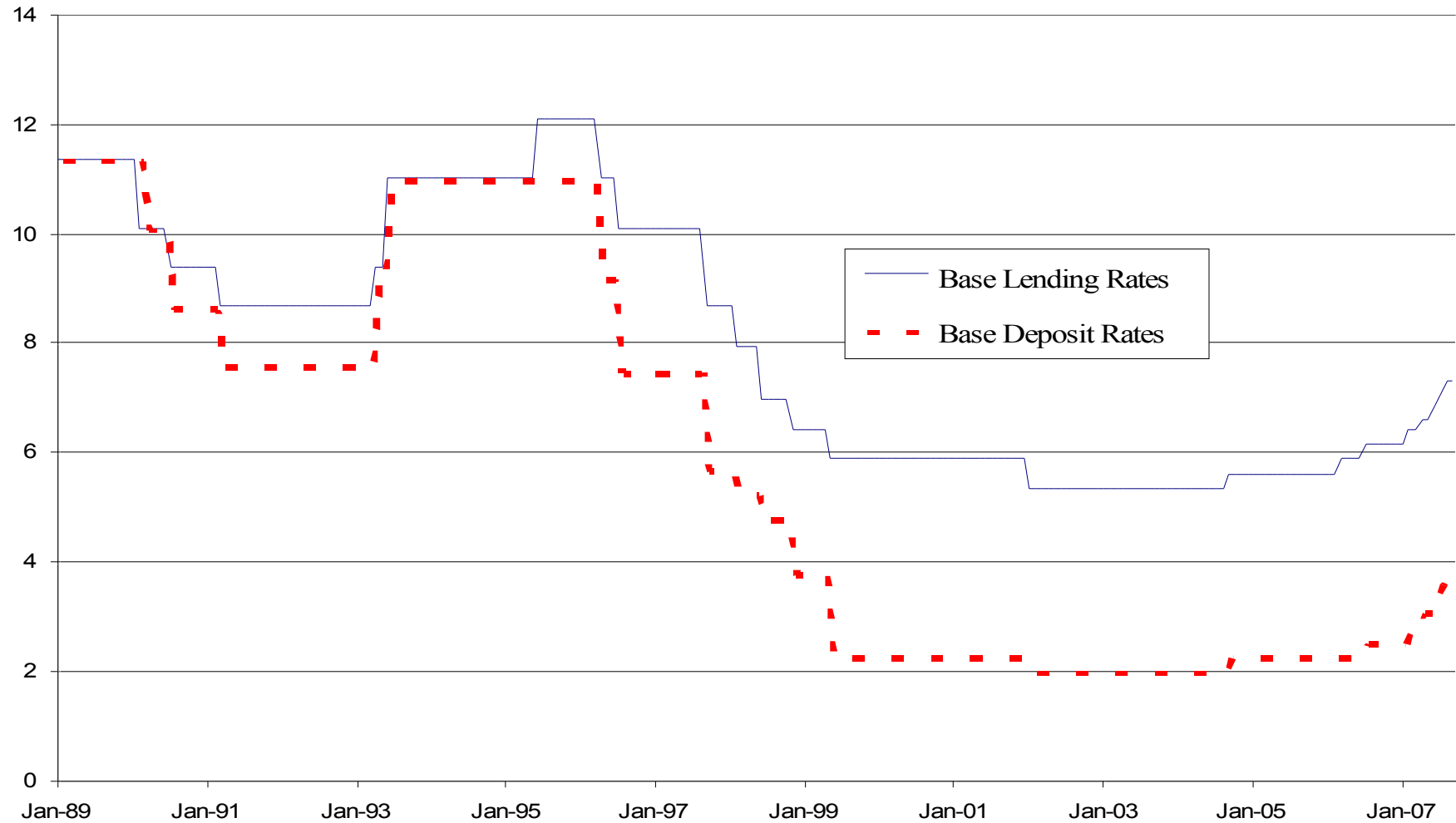
Average
2000-06

GDP growth	9.6
Employment growth	1.0
Industry: output growth	10.8
Industry: employment growth	2.3

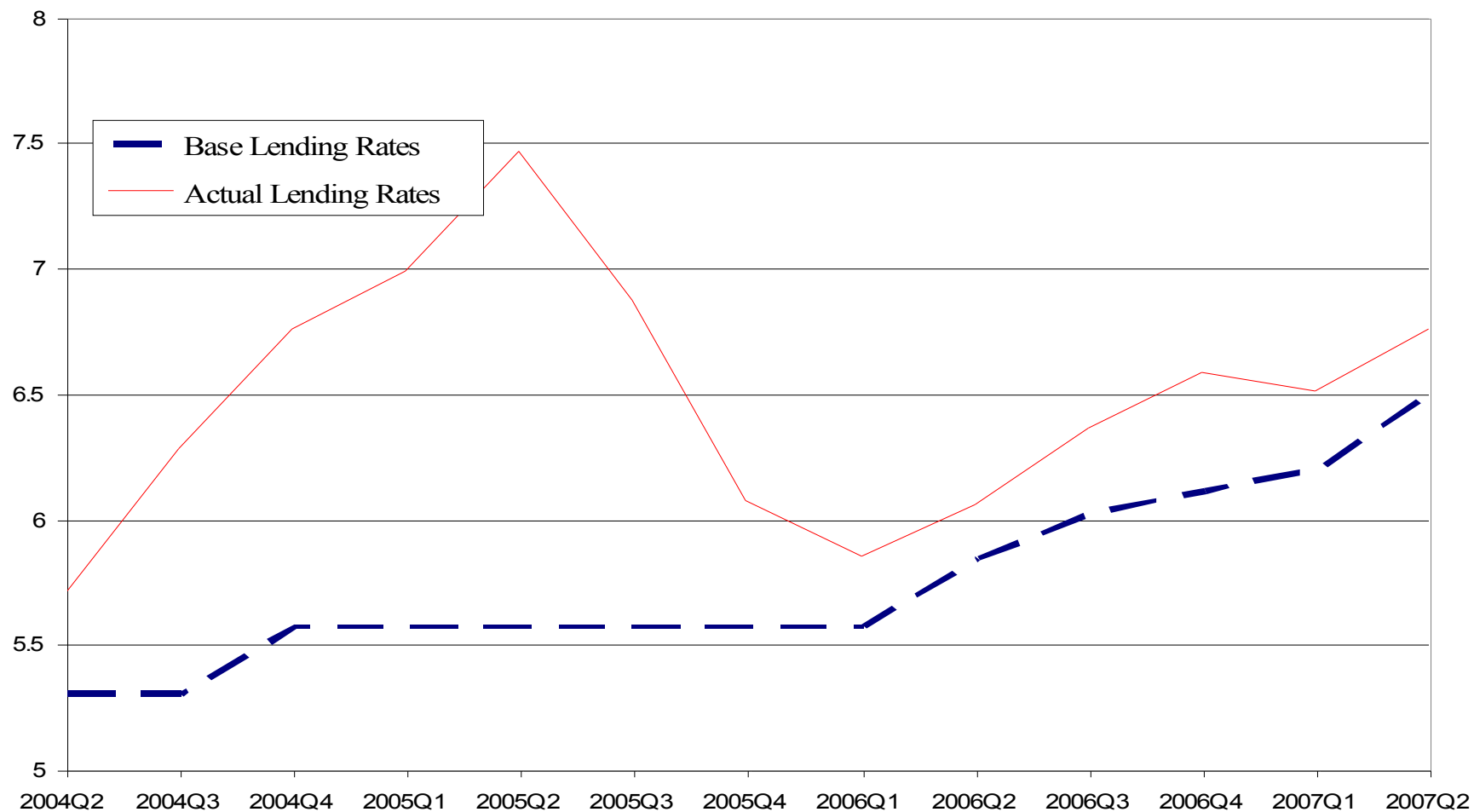
Savings-Investment Balance

- High level of investment financed by cheap credit, retained earnings
 - High household and corporate savings
 - So still large current account surpluses
-

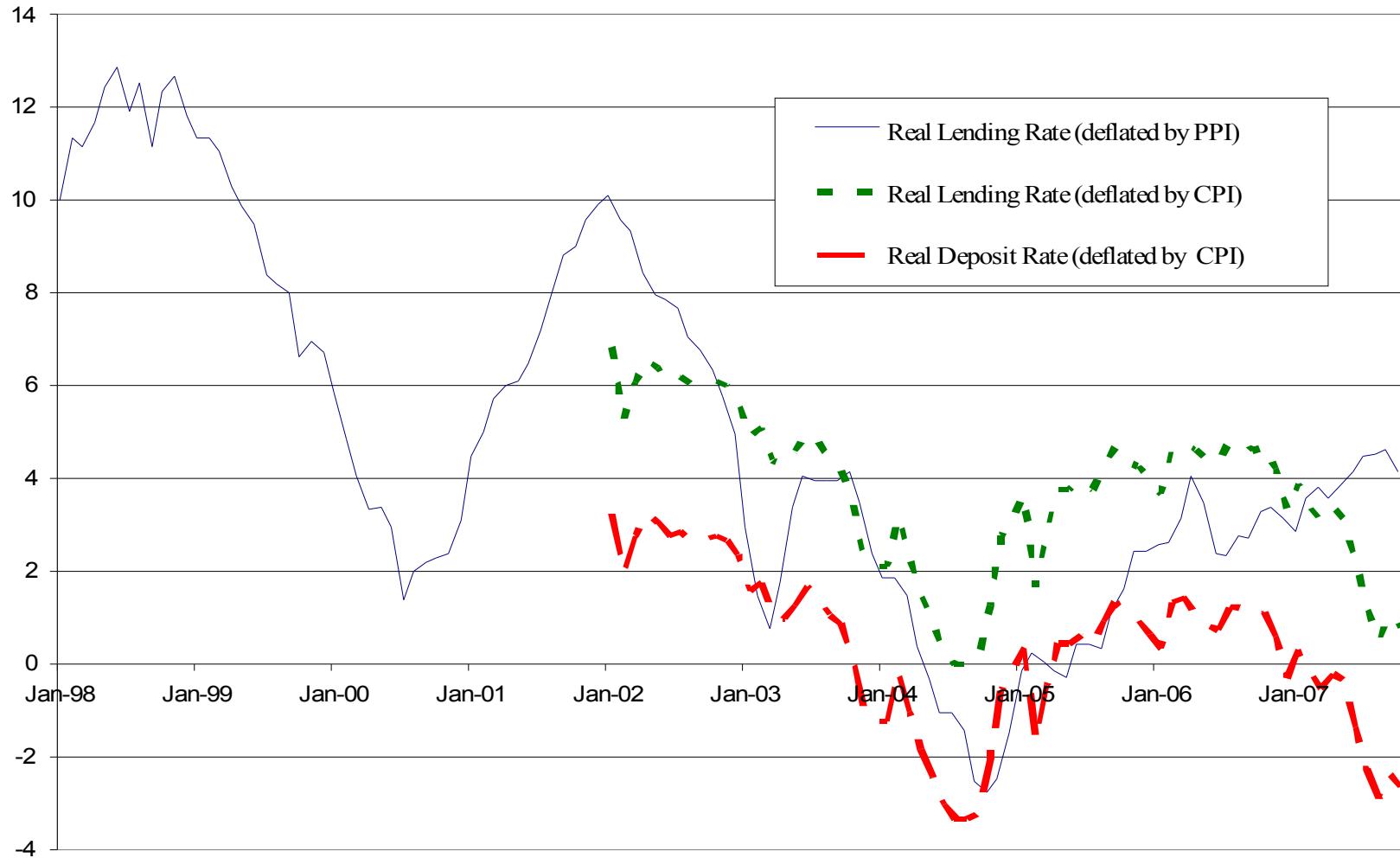
Base Lending and Deposit Rates (1-year rates, in percent)



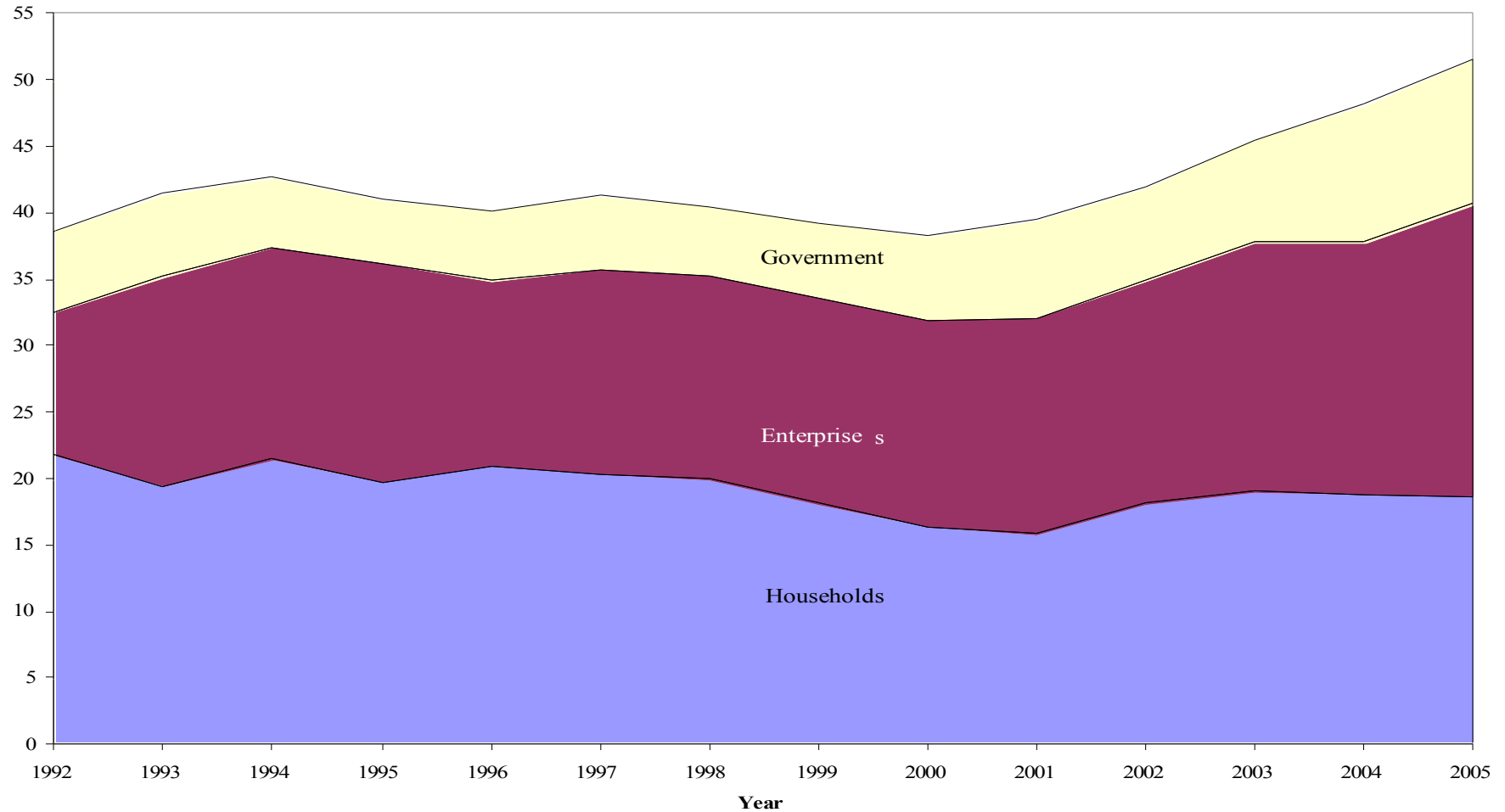
Base and Actual Lending Rates (1 year, in percent)



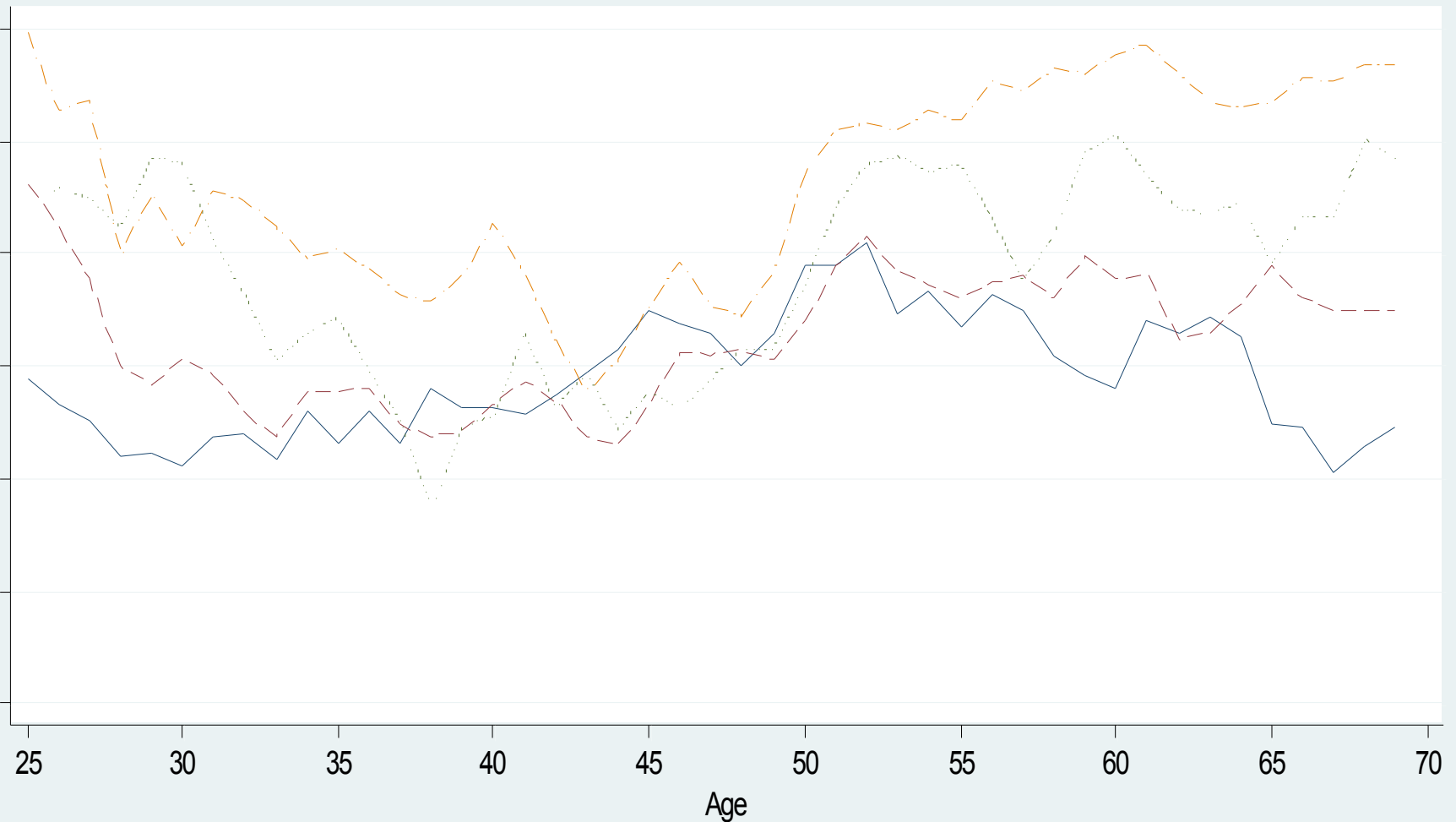
Real Lending and Deposit Rates (1-year rates, in percent)



Contributions to Gross Domestic Savings as a Percentage of GDP

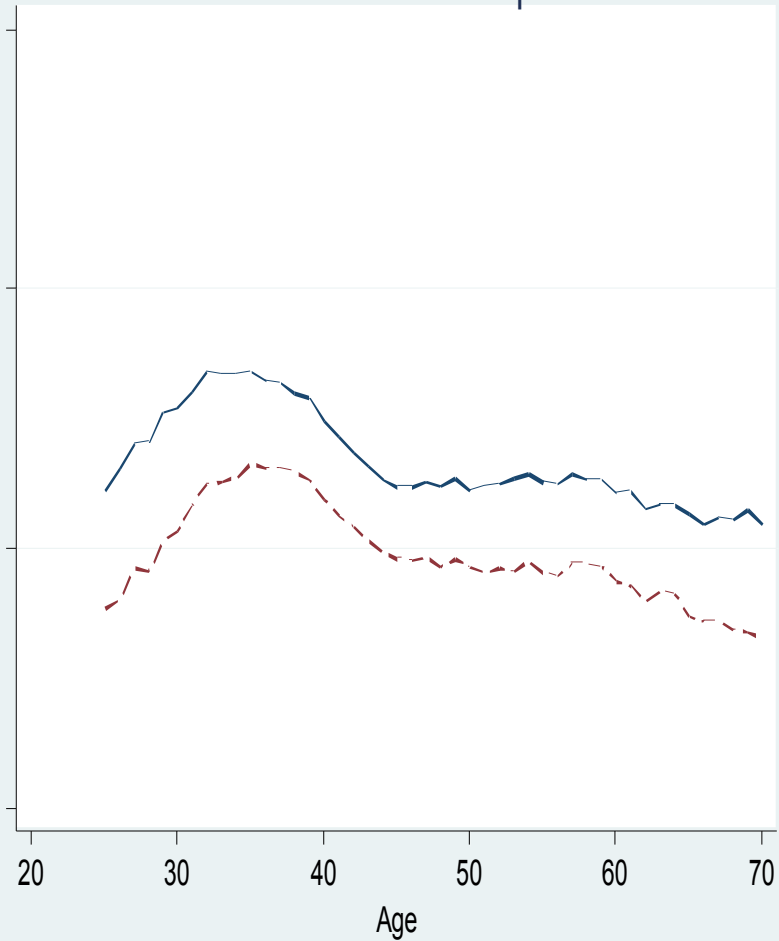


Average Saving Rates by Age of Household Head



Age Effects on Income, Consumption, and Saving Rates

Income and Consumption

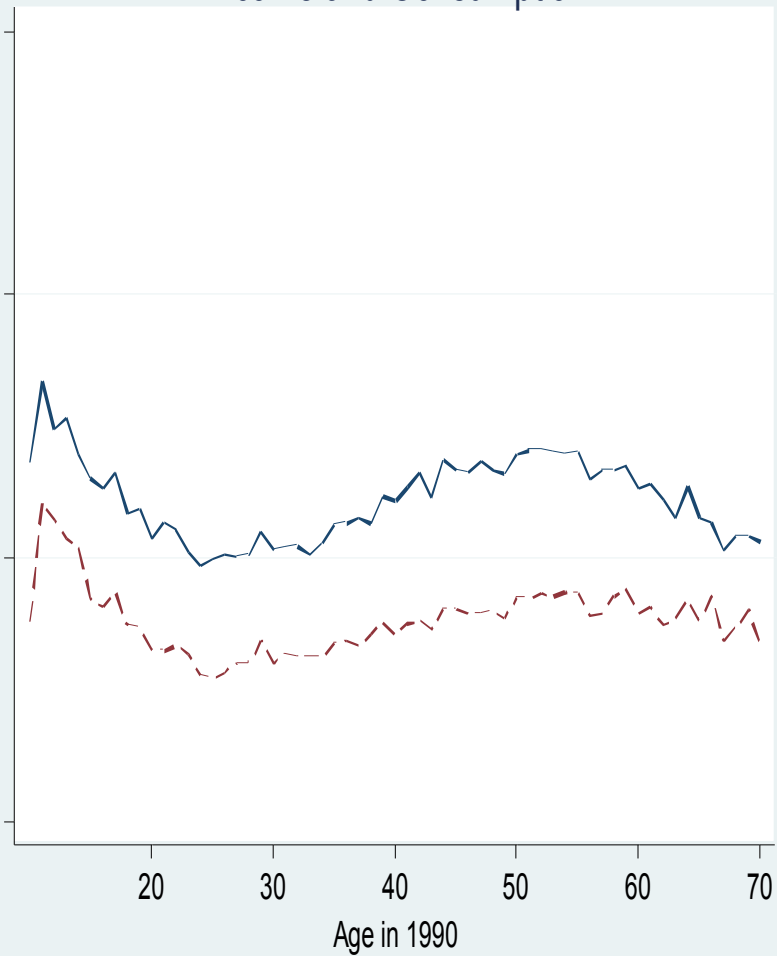


Age Effect on Savings

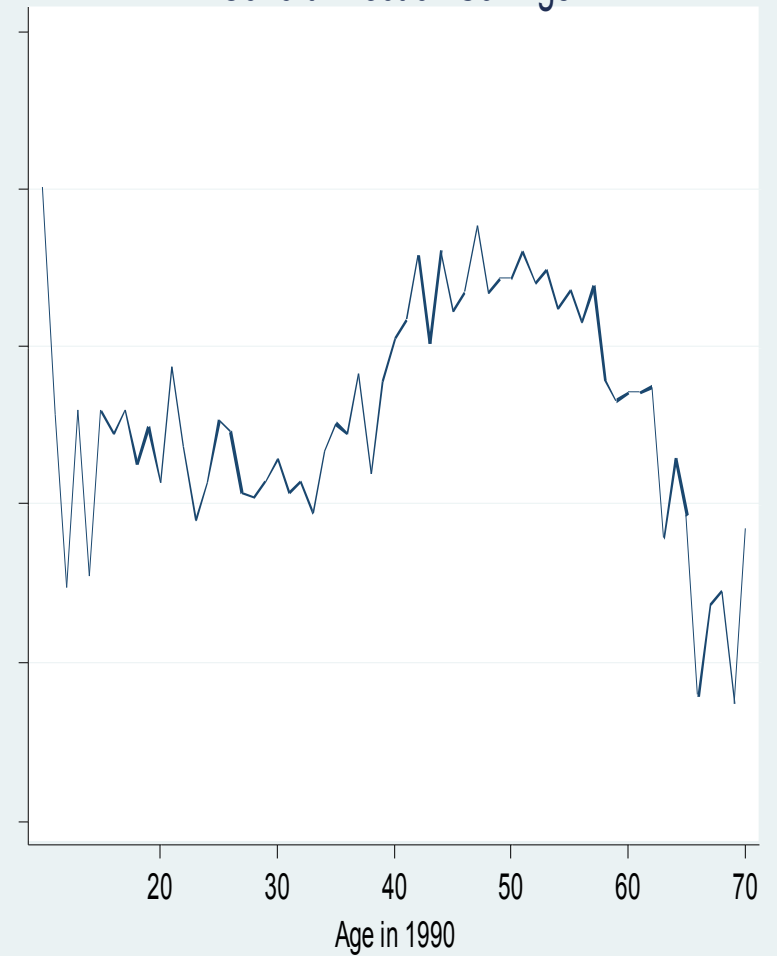


Cohort Effects on Income, Consumption, and Saving Rates

Income and Consumption

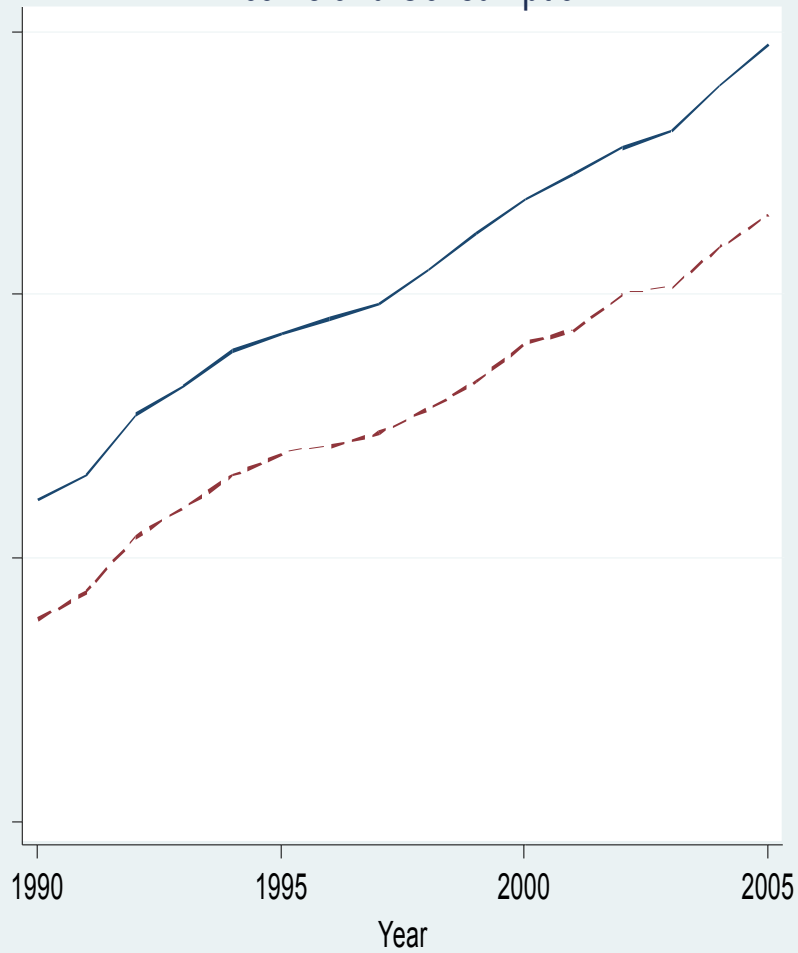


Cohort Effect on Savings

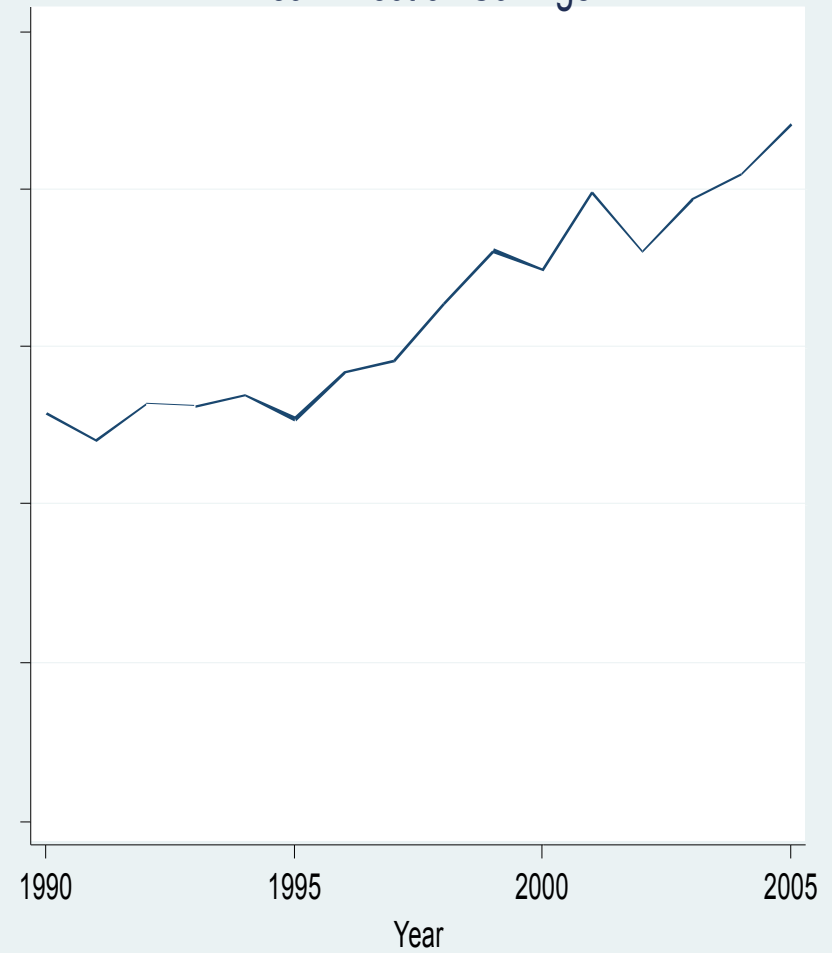


Year Effects on Income, Consumption, and Saving Rates

Income and Consumption

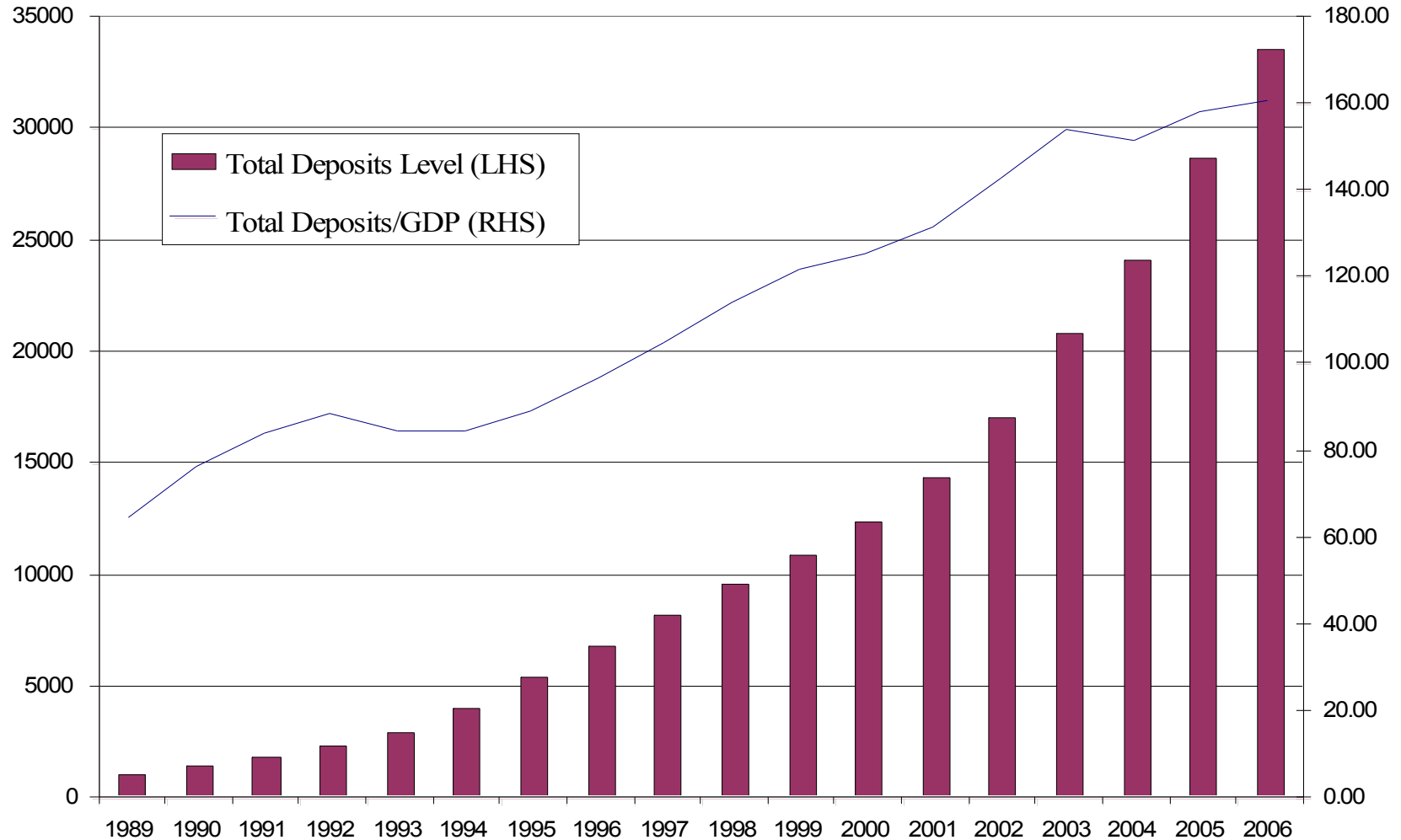


Year Effect on Savings

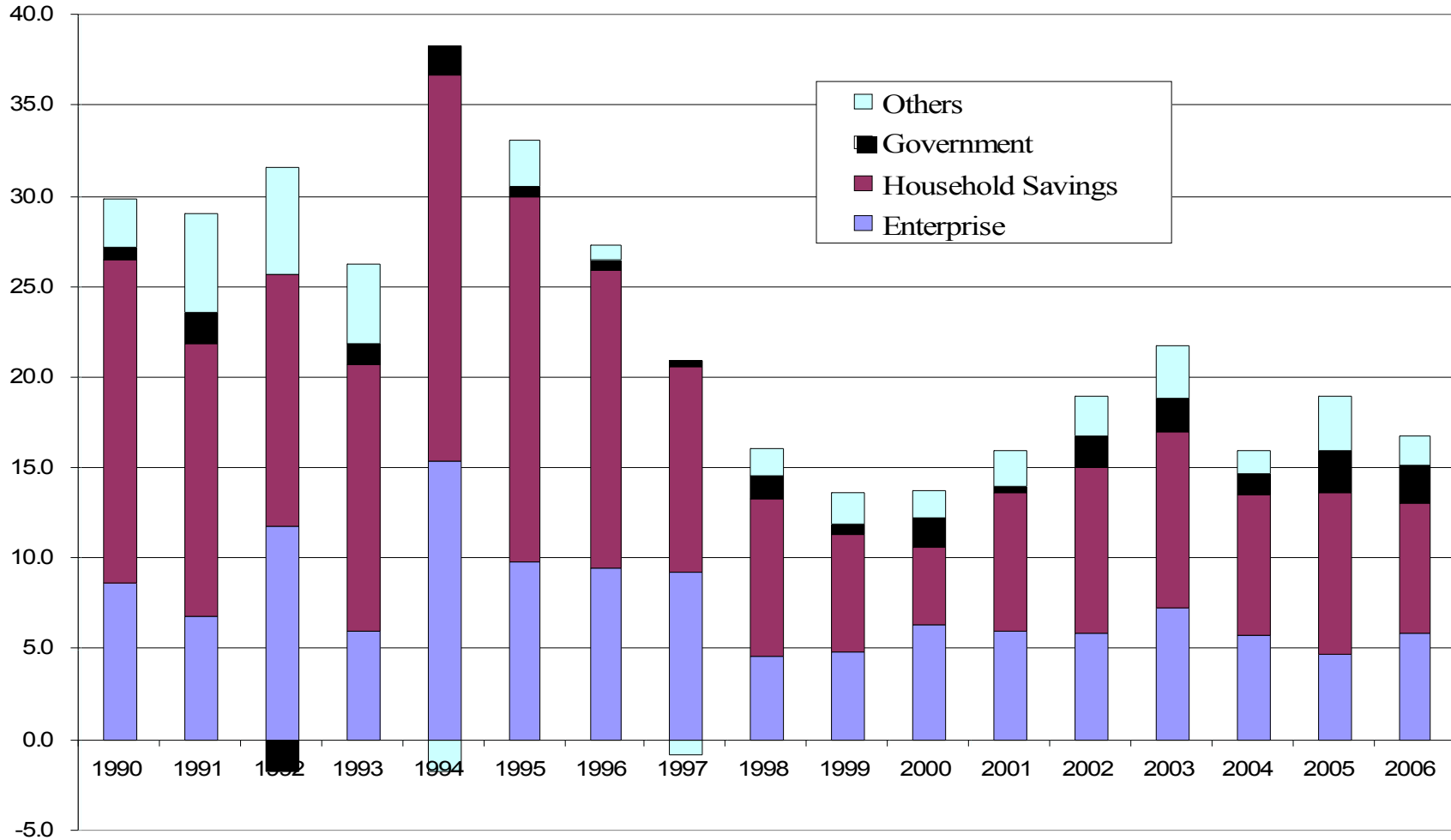


Deposits in the Chinese Banking System

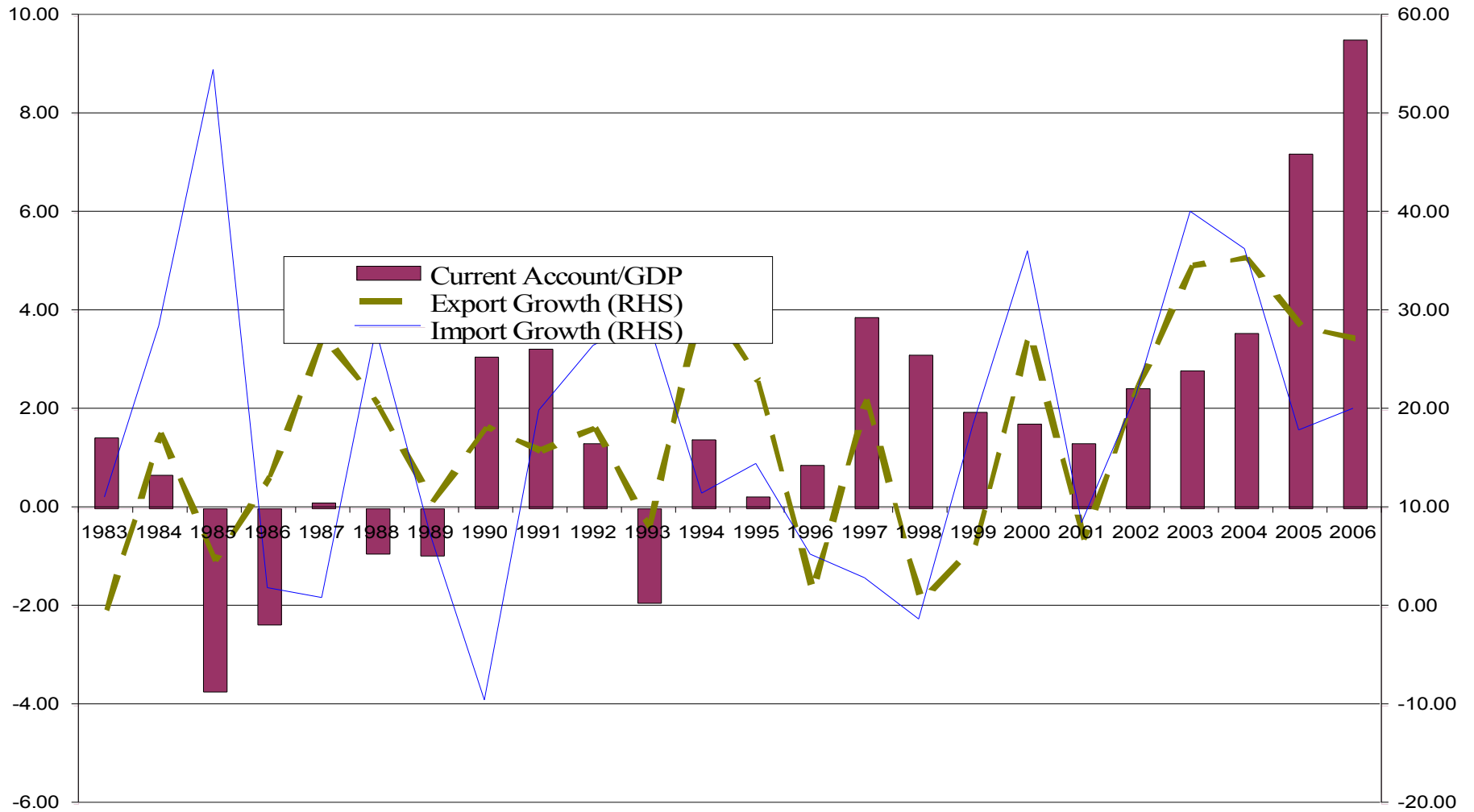
Total Deposits in Financial Institutions



Growth of Total Deposits and Contributions of Components (in percent)



Current Accounts/GDP, Export and Import Growth



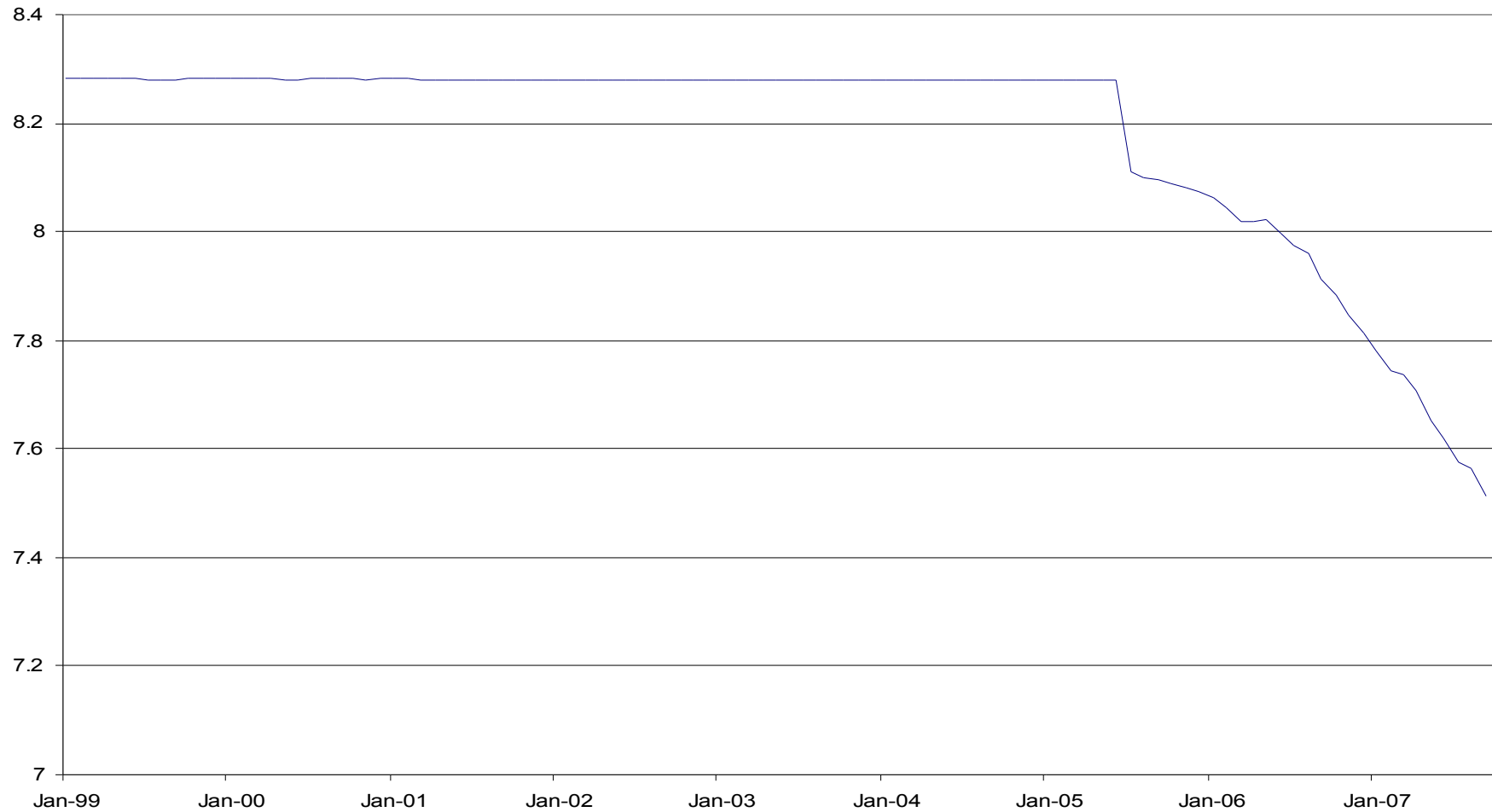
Macro Policy Distortions

- Lack of fx flexibility
 - Capital controls
 - Financial repression
-

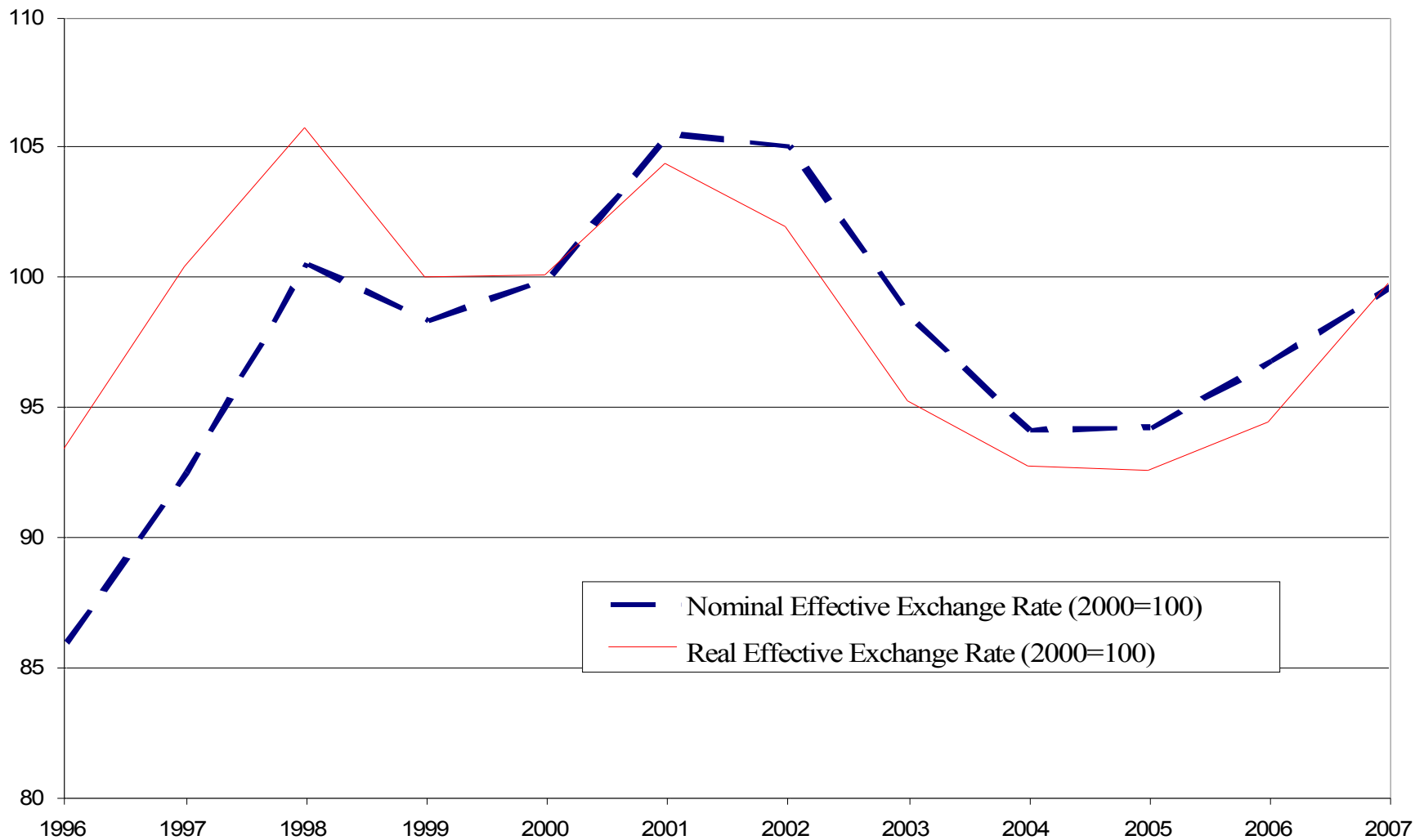
Exchange Rate Flexibility: Not!

- Renminbi tied to U.S. dollar since 1995
 - 2.1% revaluation on July 21, 2005
 - About 10% bilateral appreciation to date
 - Much smaller in nominal/real effective terms
-

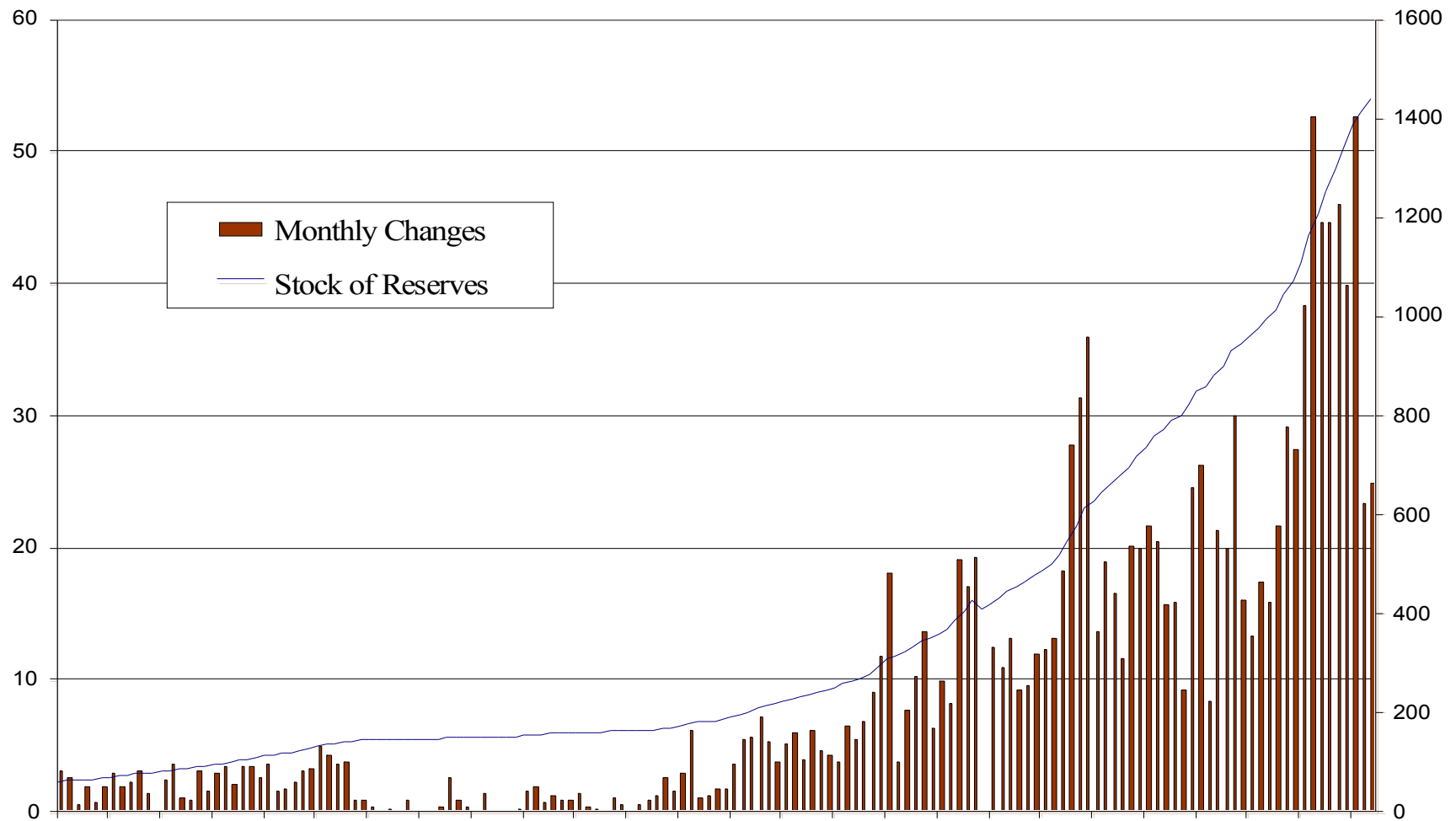
RMB-USD Exchange Rate (1999 – present)



Real and Nominal Effective Exchange Rates



Foreign Exchange Reserves: Flows and Stocks



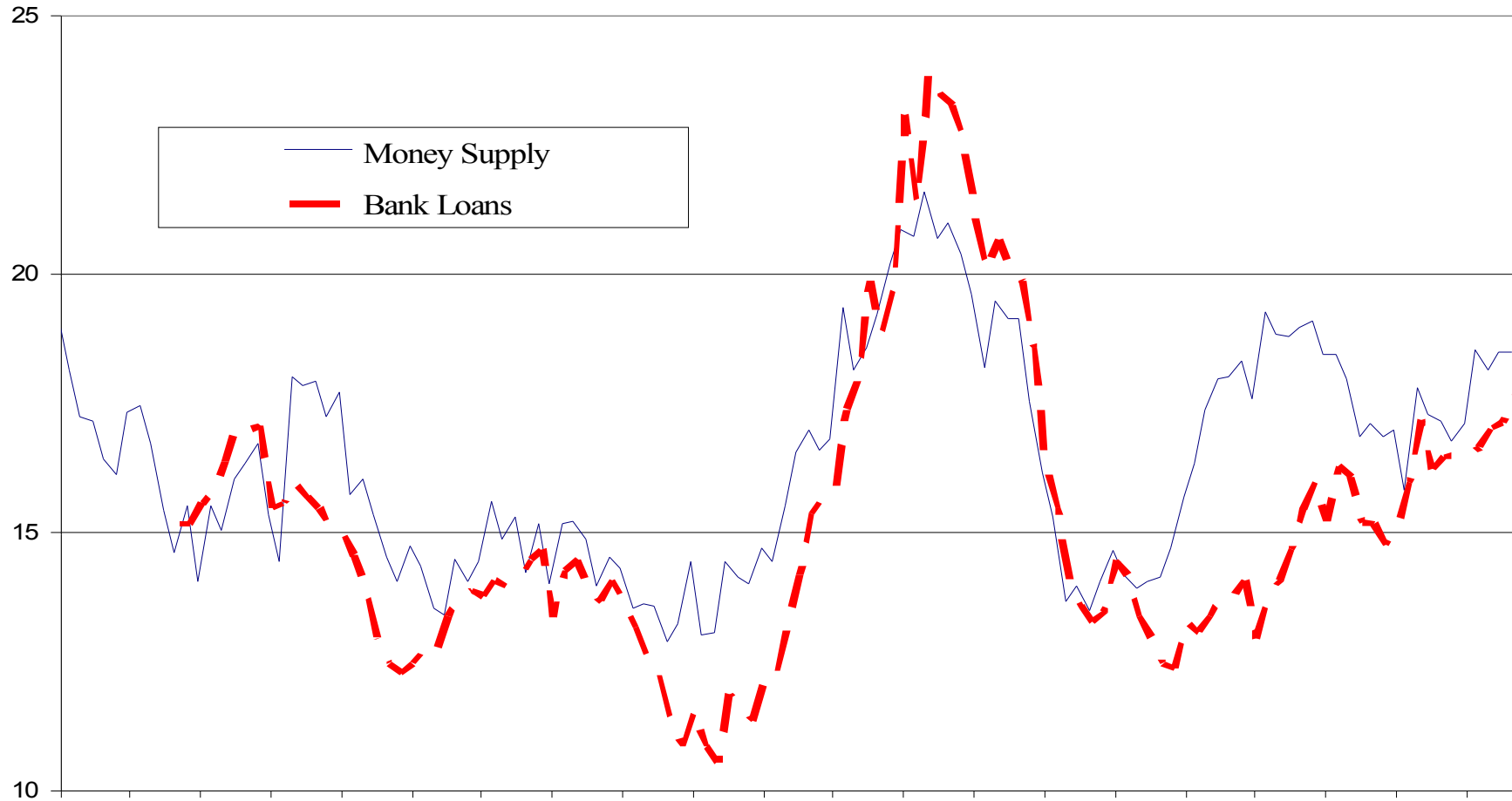
The Balance of Payments

	2000	2004	2006	2007 H1
Gross international reserves <i>(in percent of GDP)</i>	168.9 14.1	618.6 32.0	1072.6 40.8	1338.7
Change in international reserves	10.5	206.3	247.0	266.1
A. Current account balance <i>(in percent of GDP)</i>	20.5 1.7	68.7 3.6	249.9 9.5	162.9
Merchandise trade balance <i>(in percent of GDP)</i>	34.5 2.9	59.0 3.1	217.7 8.3	135.7
B. Capital account balance	2.0	110.7	10.0	90.2
FDI, net	37.5	53.1	60.3	51.0
C. Errors and omissions, net	-11.9	27.0	-12.9	13.1
<i>Memorandum Items:</i>				
Non-FDI capital account balance (including errors and omissions)	-47.4	84.6	-63.2	52.3
Nominal GDP	1198	1932	2626	

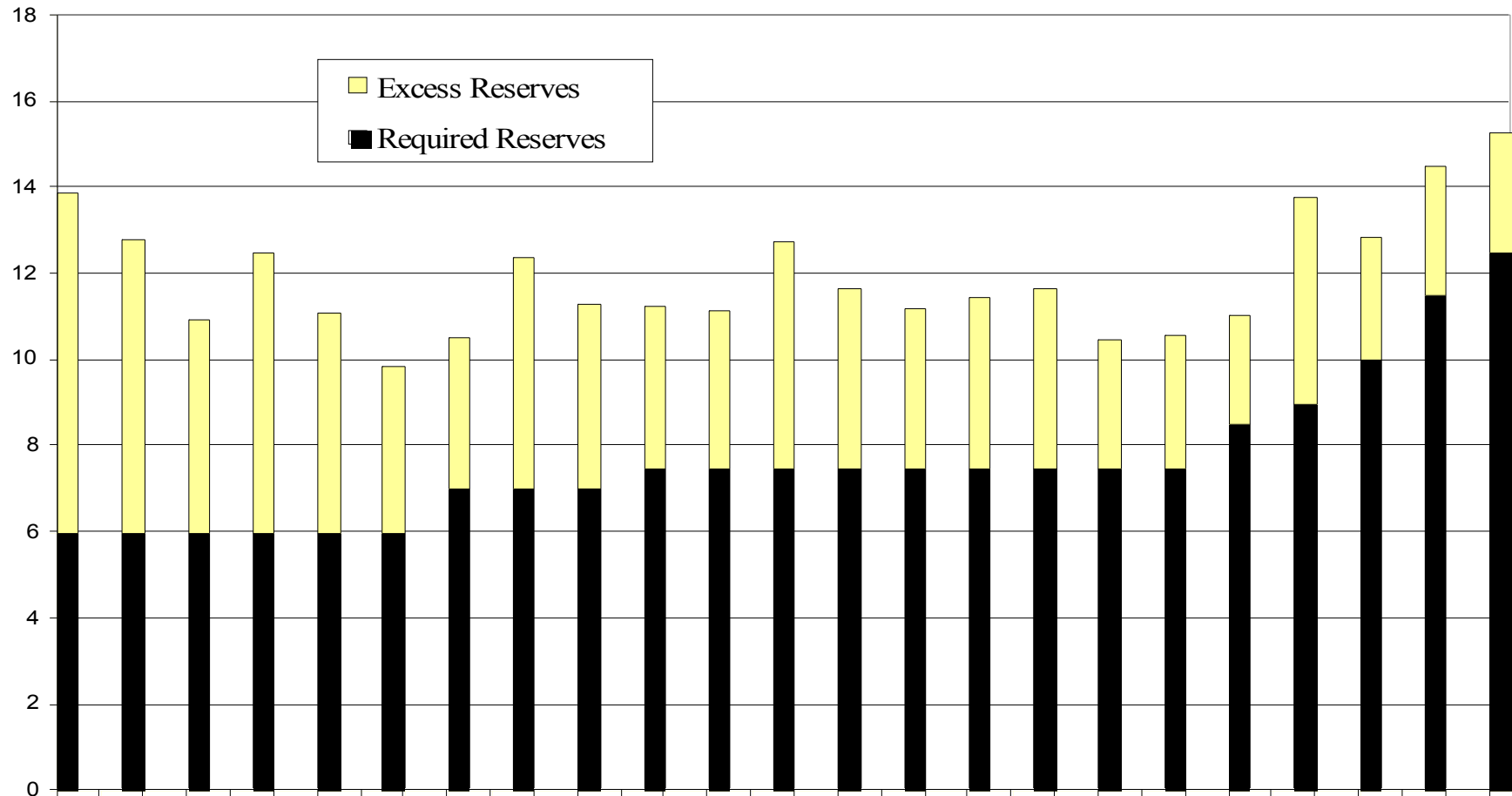
Decomposition of the Recent Reserve Buildup

	Annual averages			Changes	
	1998-2000	2001-04	2005-06	2001-04 - 1998-00	2005-06 - 2001-04
	(1)	(2)	(3)	(2) - (1)	(3) - (2)
Increase in foreign reserves	8.5	112.4	227.0	103.9	114.6
Current account balance	24.4	41.9	205.4	17.5	163.5
Capital account balance	0.3	57.7	36.5	57.4	-21.2
FDI, net	38.5	46.1	64.1	7.6	17.9
Errors and omissions, net	-16.1	12.1	-14.9	28.2	-26.9
Non-FDI capital account balance (including errors and omissions)	-54.4	23.6	-42.4	78.0	-66.0

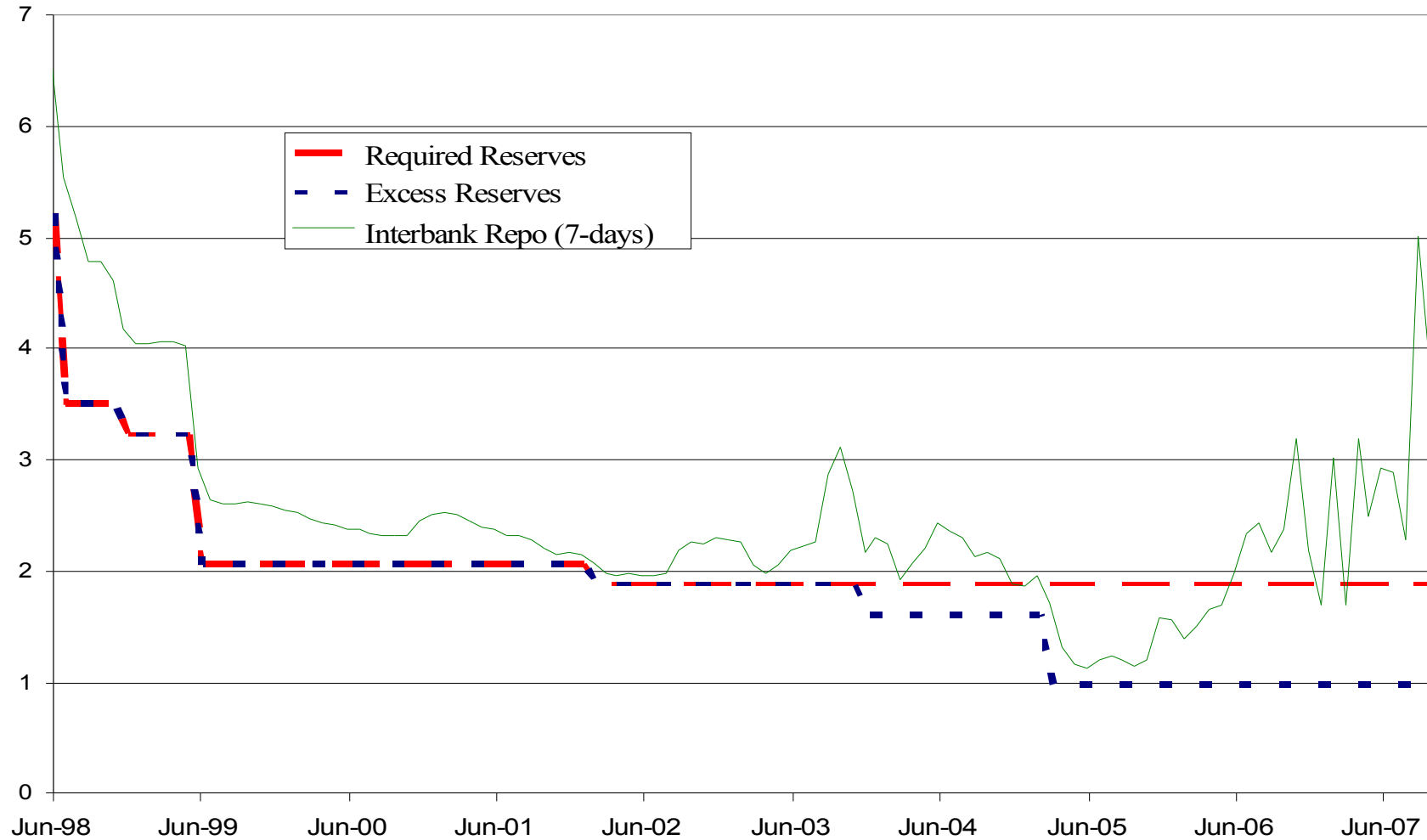
Money and Credit Growth (year on year, in percent)



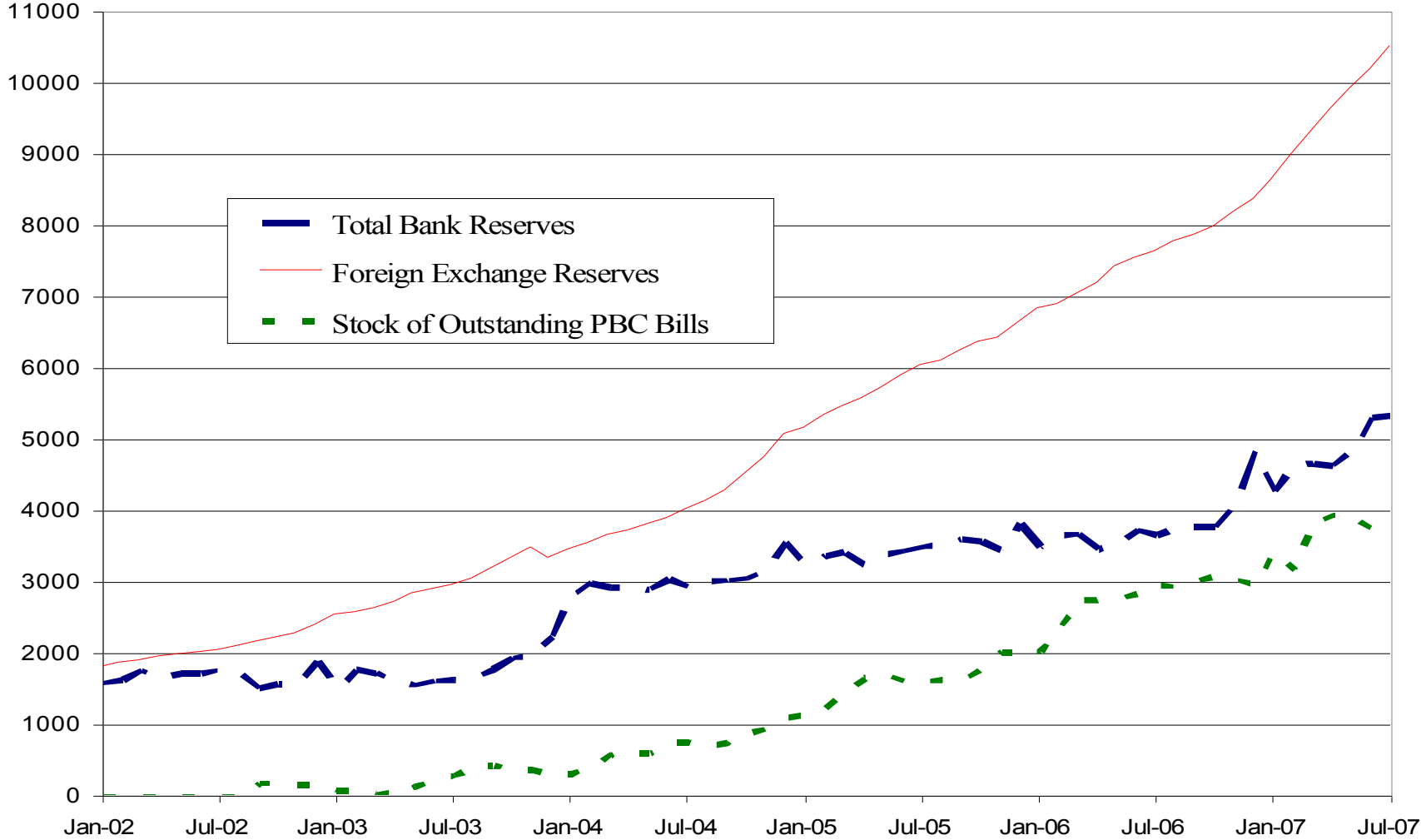
Required Reserves and Excess Reserves Ratio (in percent of total deposits)



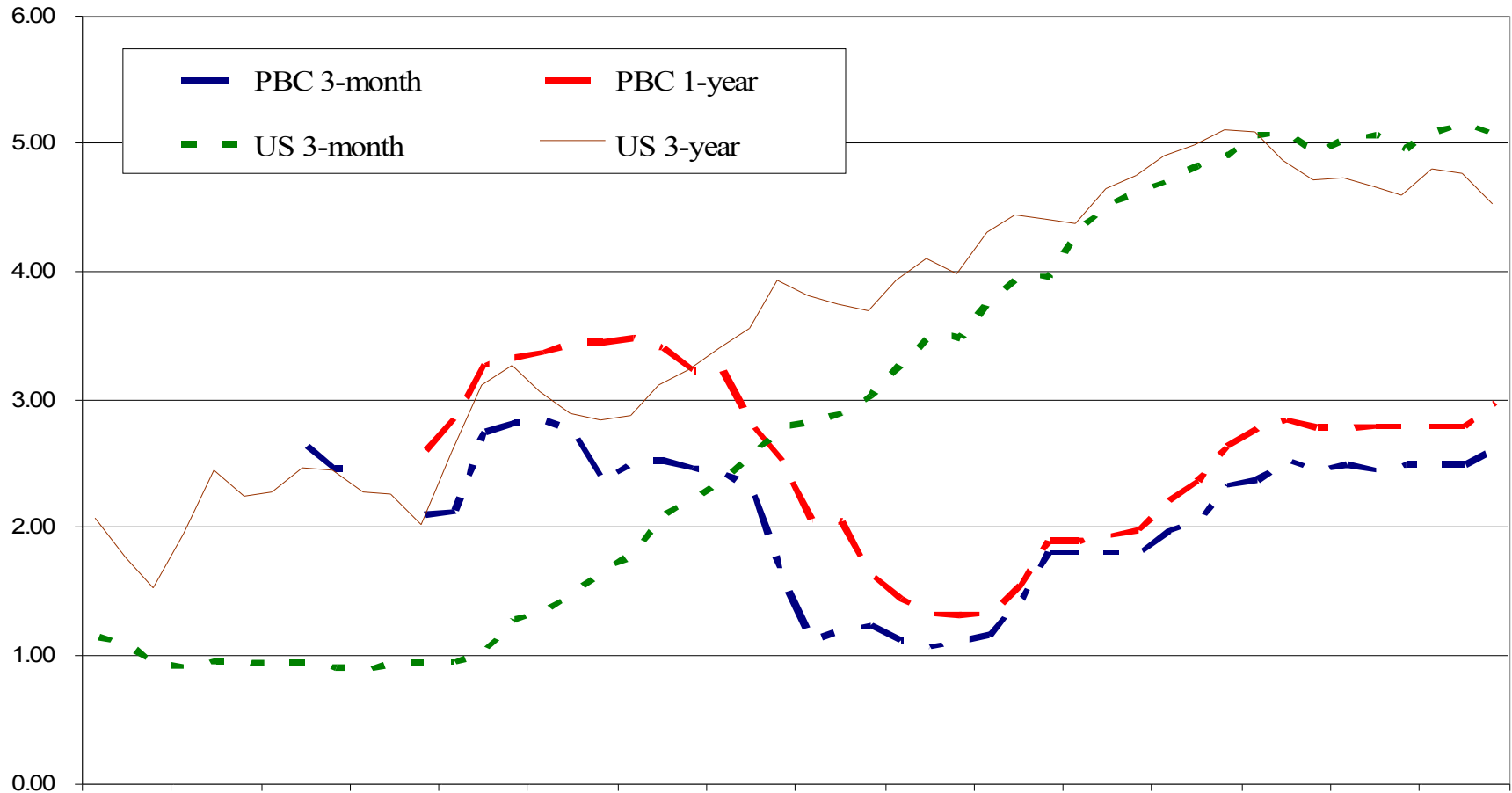
Rate of Remuneration on Reserves (in percent)



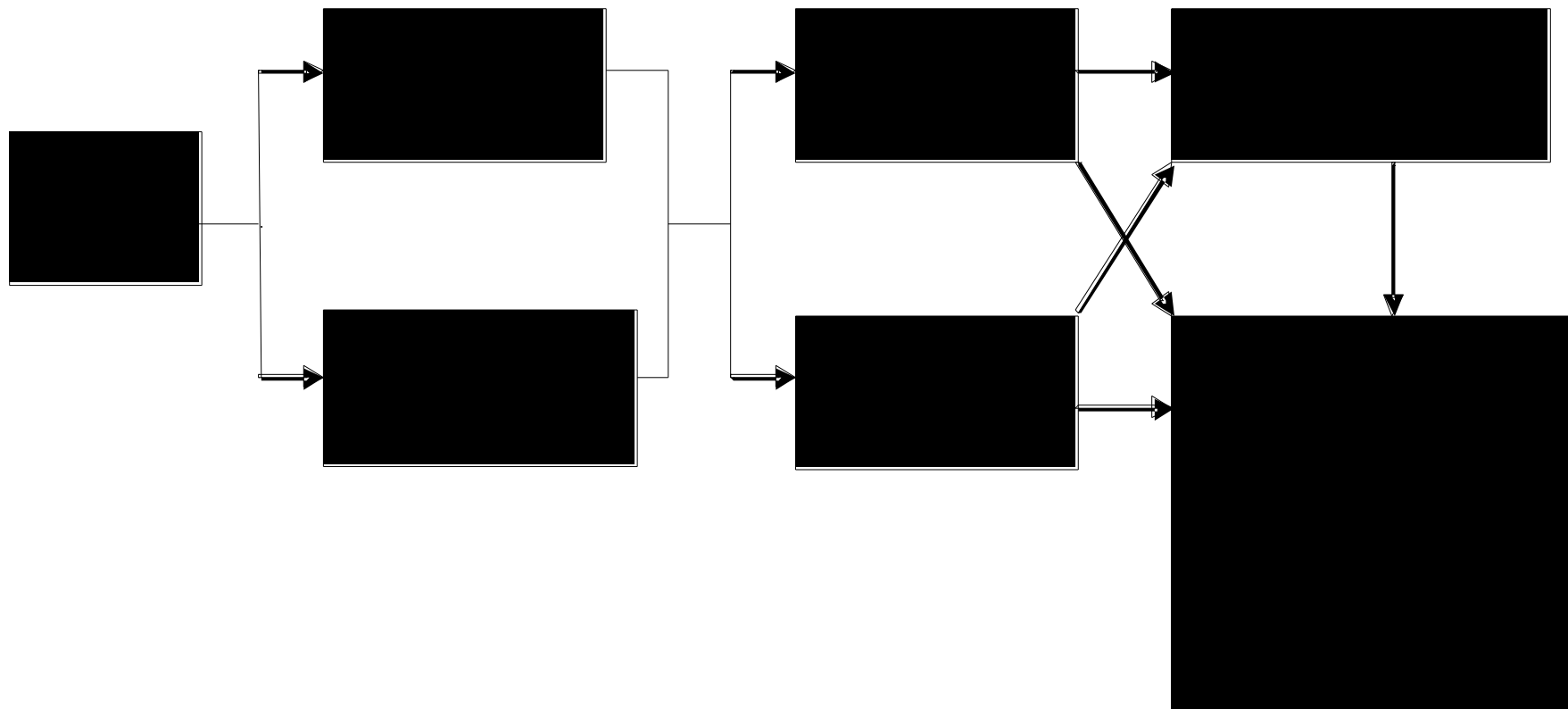
Stocks of Reserves and Central Bank Bills (in billion of RMB)



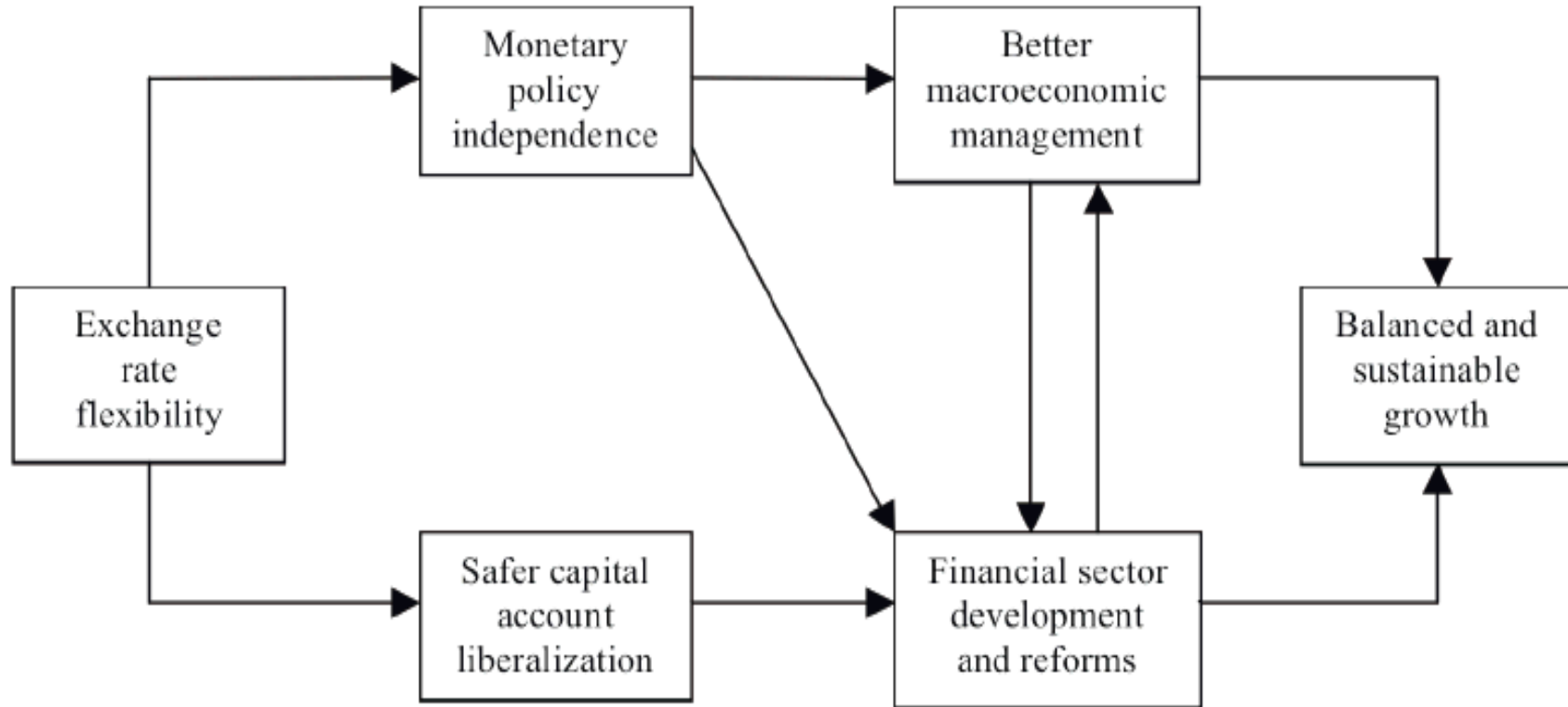
PBC Bill Rates vs. U.S. Treasury Yields (in percent, annualized)



Lack of Exchange Rate Flexibility Complicates Macro Policy and Reforms



Making the Right Connections



A Framework for Independent Monetary Policy

- A long-run low inflation objective
 - Macro and financial stability
 - Fx flexibility would evolve naturally
 - Would assist in financial sector reforms
 - Good time to put new framework in place
-

Independent Monetary Policy

- Flexibility, not revaluation
 - Flexibility, not free float
 - Capital account liberalization not solution in itself
-

The Reform Process

- Incremental approach not easy
 - Controlled experiments harder
 - Reforms are connected
 - Need a framework for reforms
-

Risks:

External and Internal Shocks

- Sudden stop/reversal of capital inflows
-

China's International Investment Position

	2004	2005	2006
Net Position	293	423	662
A. Assets	930	1223	1627
Reserve assets	619	826	1073
Other	311	397	554
B. Liabilities	637	800	965
FDI	369	472	544
Other	268	329	420

Risks

- Sudden stop/reversal of capital inflows
 - Plunge in value of US dollar
 - Collapse of external demand
 - U.S. trade sanctions
-

China-U.S. Relations

- The exchange rate issue
 - Opening up of the financial services sector
 - Common interests not often emphasized
 - Strategic Economic Dialogue needs benchmarks
 - Risks of the legislative process
 - Legislation in motion in Senate, House
-

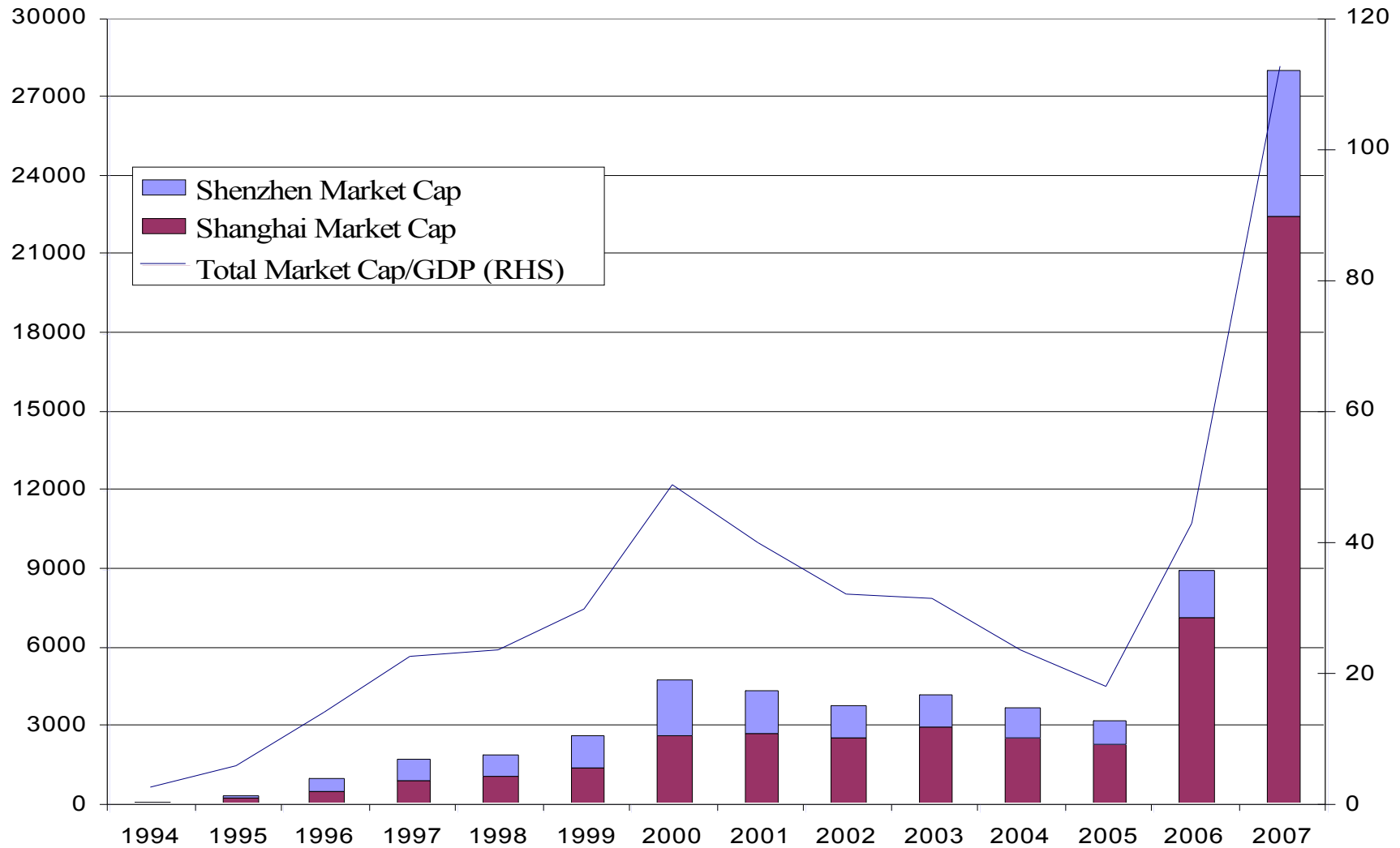
Risks

- Sudden stop/reversal of capital inflows
 - Plunge in value of US dollar
 - Collapse of external demand
 - U.S. trade sanctions
 - Loss of confidence in banking system
-

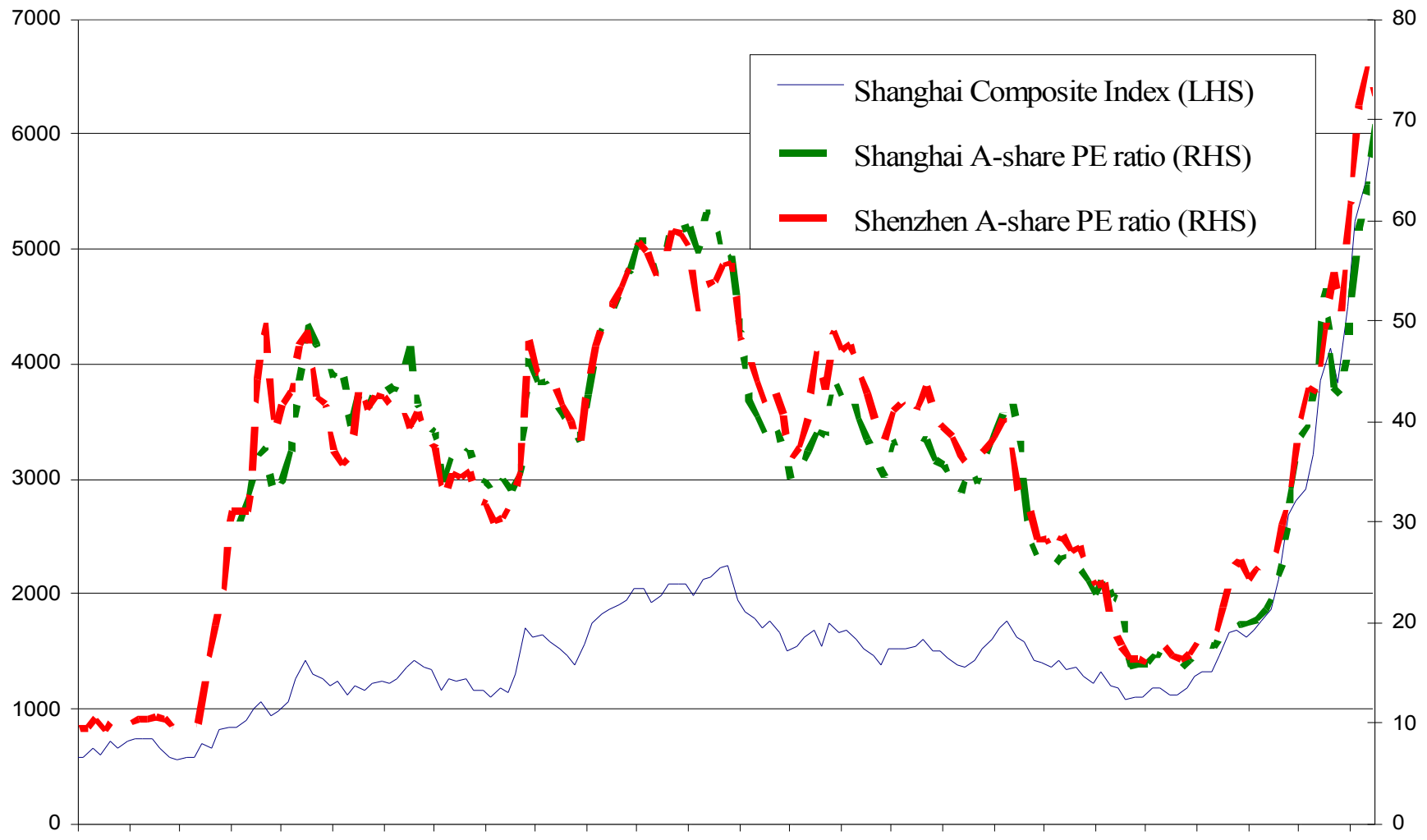
Risks

- Sudden stop/reversal of capital inflows
 - Plunge in value of US dollar
 - Collapse of external demand
 - U.S. trade sanctions
 - Loss of confidence in banking system
 - Asset price busts
-

Stock Market Capitalization



Stock Market Valuations



Risks

- Sudden stop/reversal of capital inflows
 - Plunge in value of US dollar
 - Collapse of external demand
 - U.S. trade sanctions
 - Loss of confidence in banking system
 - Asset price busts
 - **Social instability**
-

Looking Ahead

- Economy has many fundamental strengths
 - System rigid; some shocks could trigger growth slowdown (but meltdown unlikely)
 - External pressure could help, if done right
-

China's International Investment Position

	2004	2005	2006
Net Position	293	423	662
A. Assets	930	1223	1627
1. FDI	53	65	82
2. Portfolio	92	117	229
Equity	0	0	2
Debt	92	117	228
3. Other investment	167	216	242
4. Reserve assets	619	826	1073
Foreign exchange reserves	610	819	1066
B. Liabilities	637	800	965
1. FDI	369	472	544
2. Portfolio	57	77	121
Equity	43	64	107
Debt	13	13	14
3. Other investment	212	252	300