Chinese Money—How much is there? Where is it Going?

By

William R. Polk

Decisions being made in China will affect the money supply, the cost of living and the jobs of people throughout Europe. This was the message delivered to a group of senior Chinese government and business leaders yesterday at a forum sponsored by the Arizona State University W.P. Carey School of Business and the Shanghai National Accounting Institute in Shanghai by Dr. Robert Mundell, the 1999 Nobel Prize Laureate in economics.

Despite pressures put on the Government of China to revalue its currency, he said, the Chinese Government is not prepared to do so. Over the last few years, China has been charged with the whole range of economic "crimes" -- what economists call "overheating" (growing too fast), exporting deflation and also with exporting inflation. But, Mundell, the economist who is regarded as perhaps the world's outstanding expert on currency problems and who is best known for having done much of the work in designing the Euro, the Chinese have actually been doing nearly everything right for their economy.

Speaking at a conference organized by the University of Arizona's W.P. Carey School of Business in conjunction with the Shanghai National Institute of Accounting, Dr. Mundell praised the way the Chinese had avoided excessive inflation and currency instability by anchoring their currency in the dollar.

Partially as a result of having achieved currency stability, he pointed out, China has been able to grow at a 9% yearly average since 1979. That is well over twice the world's average. Actually, during many of those years, a number of countries fell far short of that figure. Despite that, he said, there are still some 150-200 million Chinese who are unemployed or under employed, mostly in the rural areas and wages even in industrial jobs remain low. So, the Chinese government realizes that there is much that still must be done to increase the well-being of its citizens. This suggests that China must continue a rapid rate of growth and can do so, his analysis shows, Dr. Mundell continued, because its economy is not "over-heated."

China currently has a gross domestic product or GDP, which is the sum of all production inside of China, of the equivalent of U.S. dollars 1.4 trillion. That is about one tenth of the American ($11 trillion) and about one sixth the Euro zone yearly GDPs. It still ranks below Japan's $5 trillion and Britain's $1.7 trillion.

Today China "anchors" its currency in the dollar. That is, it pegs its exchange rate to a fixed equivalent in dollars. Thus, effectively, it increases what economists call the "monetary mass" of the dollar. But, from time to time, Chinese government officials have considered, as has recently been suggested by officials of the European Union, switching the currency to the Euro zone. Should China decide to anchor its currency in the Euro instead of the dollar, the Euro "monetary mass" would nearly match the dollar and would signal a glacial shift in the world finances.

Had China given in to Western pressure either to revalue its currency from the current 8.3 to the dollar or to allow it to float, the move would be disruptive for the Chinese economy and would impact severely on both America and Europe. It would almost certainly increase unemployment and probably bring about great social unrest as well as stopping or slowing down development. On the contrary keeping to fixed exchange rates for the last decade has given China greater price stability than Europe which has attempted to achieve price stability by what is called "price-level targeting." Price-level targeting, however, failed to control wide swings in the conversion of the Euro to the dollar – from roughly 115 down to 80 and back up to nearly 130 before going down today to about 117.

What is of critical importance in the achievement of world financial stability, Dr. Mundell said, is not so much the actual conversion rate as the certainty that the rate will be maintained. When even small changes are made, the ensuing uncertainty causes speculators to make runs on the currency. For this and other reasons, he did not believe that the Chinese government was likely to consider changes in its current policies.

Among other reasons that the Chinese government was unlikely to change is that what it is doing is working well. China now accounts for about 3% of the world economy (in comparison to 25% by the US) but expects to pass Germany within the next few years. Its rate of growth appears unlikely to slow in the coming year.

Following Dr. Mandell, the Vice-Minister of Finance of the People's Republic of China, Mr. Li Yong, focused the attention of the forum on what was not being well done in the Chinese economy. As China moves toward globalization and entry into the World Trade Organization, he was particularly disturbed, he said, by the poor performance of the state-owned banks. They have contracted huge "non-performing" loan portfolios and required the infusion of hundreds of billions of dollars of capital during the last few years to keep them from going bankrupt. Since the banking system will be "opened" in three years, some of China's largest banks may then fail unless their managements learn Western techniques of risk management, marketing and innovation.

Change will be required, Minister Li pointed out, because the share of the national economy in state enterprises will fall during the coming five years from 70% to 20%. It will be in part because gearing the rate of interest to risk reminds Chinese of gouging money lenders. Thus bank managers seek to avoid underwriting projects that would cause western bankers to demand more than 5.5%-6%. They are also accustomed to making loans, as is still in Russia, at the direction of the government rather than on commercial criteria. This is partly a legacy of the push to uplift the 70% of the Chinese population which is rural and poor, but it is a policy which is now hampering economic progress and must be changed.

Worse has been the failure of information in the system. Some borrowers, he said, use the same assets to borrow from several banks and thus borrow far more money than is justified. This is at the root of the problem of non-performing loans. Even in the issuance of credit cards, little has been done to check credit worthiness. Many credit card holders simply do not pay their bills. The result is that while the Chinese economy is booming, the essential banking center of the financial system is in danger of bankruptcy.

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