

Introduction

“By the end of 2002, only a year after joining the WTO, China overtook the United States in foreign direct investment (FDI) inflows, becoming the most attractive FDI destination in the world,” say two of the contributing authors to this volume.

“In 2002, China’s gross domestic product exceeded RMB10.2 trillion (approximately 1.2 trillion dollars) for the first time, ranking it sixth in the world, and China’s total trade volume reached 620.8 billion dollars, ranking it the fifth of the world,” say two other contributing authors.

“China has one-fifth of the world’s population and its labour force is larger than the sum in all developed economies,” is yet another observation in this book.

That China is now a key country in the world economy is an undeniable fact that has become visible in almost every country around the world. Who has not seen “made in China” on sports shoes, a printer’s cartridge or a children’s toy?

Looking at China’s economy from the viewpoint of people living in the developing world, which is Fondad’s primary focus, the sheer size of China’s own population would be enough reason to examine the country’s prospects of financial stability and growth. If we consider the role China is playing in the Asian region and in the world economy, there are yet more reasons to analyse and discuss the current and future challenges of China’s economic performance.

In this book, a number of renowned Chinese scholars and other experts in international finance and development discuss the challenges faced by Chinese policymakers when dealing with domestic, regional and international economic issues. The book is divided into four parts. The first part deals with China’s economic reform agenda, the second with China’s role in regional financial cooperation efforts as well as in global finance, the third with the functioning of the global financial system, and the fourth with China’s future challenges as seen by a prominent Chinese, Japanese and Korean expert respectively.

In the first chapter, Chinese professors in economics Gang Fan and Xiaojing Zhang address three questions: (i) what has China achieved so far; (ii) what difficulties and risks are present in the Chinese economy; and (iii) how can the reform agenda be designed to resolve these risks and difficulties and realise yet another period of 20 years of high growth? The authors formulate a reform agenda that focuses on reform of the state sector, the establishment and improvement of a basic social security system, the reform of China's financial system, the deepening of rural reform, and changing the role of the government in the economy.

In his comment on Fan and Zhang, professor of economics Keun Lee of Seoul National University observes that a major problem of China is that its leaders want to bring about rapid growth while maintaining political hegemony, social stability and a socialist identity. According to Lee, this policy mix has led to the problems discussed by Fan and Zhang, such as the rising inequality between urban and rural areas, non-performing loans and increasing unemployment.

In the third chapter, Wing Thye Woo, professor of economics at the University of California, discusses the challenges in macroeconomic management China's new leaders are facing since the country became a member of the World Trade Organisation (WTO) in 2002. One of the biggest challenges that Woo sees for China is that its basic economic institutions will have to converge to those of an advanced capitalist country. He observes that such convergence will be particularly difficult given the low employment growth in the industrial sector. He investigates the probability of WTO-induced macroeconomic shocks, the resilience of China's economy to such shocks, the deficiencies in China's financial system, the sustainability of expansionary fiscal policy to keep aggregate demand high, and the problems of the "still too large" state enterprise sector. He concludes that the most serious threat to macroeconomic stability comes from the successive rounds of bank recapitalisation and argues that the key to eradicating the deflation bias in China's economy is to establish an efficient financial intermediation mechanism.

In his comment on Woo, Chang Kyu Lee, a fellow of the Korea Institute for International Economic Policy (KIEP), agrees with Woo's emphasis on the need to transform the Chinese banks into commercially viable entities. He warns, however, that improvements

in the financial system alone will be insufficient for tackling the urban-rural income disparities in China. In his view, the increase of rural income and consumptive spending in rural areas is one of the essential policy priorities.

In the floor discussion that ends the first part of the book, Xiaojing Zhang stresses that some of the issues of China's economic reform agenda cannot be solved in 20 years. He suggests that in the short run, China's policymakers should focus on the financial sector since many of the problems the country is facing are reflected in the banking system and the capital market. "The capital market is at the top of the property rights system," he says, "and unless we are able to establish a good capital market, the economy will not be robust."

In the first chapter of the second part of the book, Korean professors of economics Yung Chul Park and Yunjong Wang discuss the prospects for regional financial and monetary cooperation in East Asia. The crisis that erupted in Asia in 1997 gave Asians a strong impetus to search for a regional arrangement to forestall future crises. It resulted in the so-called Chiang Mai Initiative (CMI), a system of swap arrangements among Asian countries. The authors provide an overview of the current structure of the CMI and discuss a number of its pitfalls. They also explore the issues related to the creation of a monitoring and surveillance mechanism such as the proposed Asian Monetary Fund (AMF). After examining major barriers to financial cooperation and integration in East Asia they sketch three possible scenarios for financial and monetary cooperation in the region.

In his comment on Park and Wang, Charles Adams of the IMF says that the authors are too negative about the prospects for the Chiang Mai Initiative because they are too ambitious in their assessment of what it could and should accomplish. Adams observes that the deepening of financial cooperation takes time, and the development of mechanisms for regional dialogue, the discussion of appropriate financial arrangements for the region and the fact that countries are starting to undertake peer reviews of their policies are already important steps forward.

In the next chapter, Young Rok Cheong and Geng Xiao, professors of economics of Seoul National University and Hong Kong University respectively, discuss some structural and institutional factors that determine China's current and future position in global capital flows. The questions they examine include:

Is China attracting too much FDI? What is the impact of foreign portfolio investment on the stability of the Chinese financial markets and other Asian regional markets? Is China generating global deflation? Should China reevaluate its currency? Is China becoming a growth engine for the world?

In discussing China's increasing role as a "world factory" and the impact this has on the rest of the world, the authors argue that the single most important impact of China's outstanding economic performance is on changes in global relative prices. In their view, there is no doubt that China's new labour supply to the global market will lead to a secular fall in the prices of labour-intensive manufacturing products. Such a fall in prices is already occurring, they say, even though China's huge contribution to the increase of the standards of living in both developed and developing countries is invisible in statistics. "Today's lucky kids around the world can testify to this with their made-in-China toys," they say. Without China's production, most toys would cost five to ten times more. The authors conclude that China is becoming an engine of growth for the world and argue that China's successes and problems should be seriously studied "since they have profound implications for all of us."

In his comment on Cheong and Xiao, Li-Gang Liu, formerly with the Asian Development Bank Institute (ADB), explores the puzzling questions of why wages in the export sector have been stagnant over the last ten years despite an impressive improvement in the sophistication of Chinese exports, and why China – notwithstanding its high growth rates – has grown so little in terms of US dollars. In his view, this indicates that the wealth from FDI-generated income is located overseas rather than within China. The net value added in China's exports has been minimal, mainly in the form of cheap labour income, Liu observes.

The floor discussion that ends this second part of the book includes an observation by Young Rok Cheong who echoes the view expressed earlier by Xiaojing Zhang that reform of the financial sector will be crucial for China's economic success. "The financial sector is a derivative of the real sector and anything that goes wrong will be reflected in the financial sector," says Cheong.

The third part of the book begins with a chapter by Xie Ping, research director of China's central bank, who addresses three questions: (i) given the competition in global financial markets, what

are the costs and benefits of financial integration for Asian economies?; (ii) in response to the shocks of global financial integration, how can Asian countries build a new regional policy cooperation regime after the crisis of 1997-98?; and (iii) given the post-crisis policy option between currency stability and financial deepening, how should Asia's goals be defined?

According to Xie, the Chiang Mai Initiative reveals Asia's intention to follow the European Union mode rather than remain isolated countries linked separately to the world economic system. He expects that the Asian economies will, step by step, unify their foreign exchange systems, bond markets, stock markets, and finally their currencies. Given the dramatic growth of unstable global capital flows, intra-regional crisis prevention and a proper sequencing of financial reform are needed to achieve long-run currency stability in Asia.

In his comment on Xie, Zdeněk Drábek of the WTO assesses the main features of the so-called neo-financial dualism hypothesis and its implications for regional cooperation in East Asia. He concludes that a multilateral approach would be better than a regional approach.

In the next chapter, Barbara Stallings, professor of economics at Brown University, discusses the role of the financial sector in creating growth and stability by drawing some lessons for China from experiences in Latin America and East Asia. Pointing at the way Korea and Chile have eliminated the bad loans in their banking systems and improved their regulatory and supervisory regimes, Stallings stresses the need for China to increase the credibility and functionality of its financial sector. She warns, however, that mismanaged financial liberalisation – improper sequencing, excessive speed, or extreme versions of liberalisation – can lead to financial crisis. She advocates a gradual capital account opening, with long-term flows liberated before short-term, and the ability to take precautionary steps against capital surges, to protect the fragile financial sector against devastating volatility.

In his comment on Stallings, Robert McCauley of the BIS discusses four themes: preventing and responding to financial crisis; unifying the bond market; defining the role of foreign banks; and liberalising the capital account. He observes that Stallings has an unconventional view on the resolution of non-performing loans. "The conventional view holds that the big banks should be

recapitalised and then privatised. Fan Gang argues that since they will not be privatised, they should not be recapitalised. Stallings argues that they should be recapitalised, but not necessarily privatised.”

The floor discussion that ends the third part of the book includes Wing Thye Woo’s suggestion that China should take a more active role in leading the developing countries in efforts at reforming the international financial system. He also suggests that China should participate actively in Asian efforts at regional cooperation. “Regional financial institutions can be useful instruments to complement and critically review global institutions,” Woo observes.

The fourth part of the book includes three short panel presentations. It starts with Xie Ping of China’s central bank, who gives his view on the main financial challenges China is facing: (i) how to deal with the problem of non-performing loans; (ii) how to sequence capital account liberalisation; (iii) how to maintain independent monetary policy and a stable exchange rate; (iv) how to deal with China’s domestic government bond market; and (v) how to liberalise domestic interest rates.

Masaru Yoshitomi, former dean of the Asian Development Bank Institute, summarises ADBI’s risk-based approach to sequencing financial liberalisation and economic reform, applied to the case of China. The seven-point proposal he outlines gives top priority to restoring banking sector solvency through prompt resolution to the problem of non-performing loans. Just like Stallings and others, Yoshitomi warns that China should be cautious with opening the capital account.

Choong Yong Ahn, president of KIEP, ends the book by presenting his view on five major issues concerning China’s role in the region and in the global economy. First, he believes that China’s continuing high growth rate is going to change the economic landscape of not only East Asia but also of the entire world in the next two decades. Second, he thinks that China should work closely together with other Asian countries to ensure regional exchange rate stability. Third, he observes that China’s ability to produce a low-price and high-quality product in shipbuilding, iron, steel and semi-conductors may cause overproduction resulting in a global downward pressure on the price level. Fourth, he stresses that the regional economic leadership struggle between Japan and China

should end because it is harmful for the East Asian integration process. Fifth, he wonders whether China will be able to realise its own version of a socialist market economy without political pluralism. “The future role of China, in the long term, depends on how China is going to combine the market economy and political democracy,” concludes Ahn.

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