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How will China withstand the coming global imbalances?

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Abstract

It has long been suspected that US over indebtedness, largely financed by foreign investors, could not be sustainable in the long run. A possible adjustment consisted of orderly rebalancing growth between the US and ROW countries along with a gentle dollar depreciation. We know now that it will happen in the midst of a financial crisis along with a plummeting dollar. Because of a huge accumulation of reserves and much criticized exchange rate policy, China is a major partner in the global adjustment. Its handling of international pressures will impinge upon both the transition to a new stage of reform and the future of the international monetary system. The paper examines some of the upcoming changes.

First section explains the driving factors of global imbalances, including how China contributed to the process by absorbing and recycling excess dollars as foreign exchange reserves. The occurrence of the securitized credit cum real estate crisis in the US has altered that pattern dramatically. On the one hand the marked and prolonged slowdown in the US will improve its current account balance substantially. On the other hand, a portfolio adjustment in the private sector is taking the lead in betting emerging market assets. In particular Chinese assets are attractive against the loss of confidence in the US financial system. A simple portfolio balance model sketches how the change in returns expectations of a large range of dollar assets speeds up the dollar depreciation.

The second section investigates domestic consequences for China of the rapid buildup of massive reserves. To do so, we examine the money market through the estimation of a long-run money demand for China using an error-correction model to appraise to which extent the money market is off equilibrium. Our analysis suggests a booming demand for money in China which implies that the supply of money, although growing fast, is not in excess. Thus our analysis plays down inflationary pressures in goods markets. This is new to the literature. However the booming demand for money is impeded by the narrow array of assets available to Chinese savers and the restrictions to invest abroad. The consequences are bubbles in asset prices and persistent over investment. Concluding that partial capital outflows liberalization implying a decoupling from a waning dollar is appropriate at the present stage, we acknowledge that such a move will have profound consequences in international monetary relations.

The third section deals with those consequences. It will draw upon the theory of key currencies and the criteria of a well-functioning monetary system using Mundell's impossibility theorem. Four dimensions of the restructuring of international monetary relations from the viewpoint of China will be taken in turn. Firstly, can the management of reserves by the Chinese sovereign wealth fund mitigate the adverse monetary consequences and, in combination with other funds, contribute to alleviate the financial crisis and stabilize the price of the dollar? Secondly, is a monetary reform in Hong Kong called for? Because Hong Kong is the financial mediator between mainland financial system and international capital markets, the tensions in the yuan/ dollar exchange rate reverberates on the currency board. We will try to examine the impact of more flexible exchange rate regime in mainland China on Hong Kong monetary system. Thirdly economic integration in East Asia is vital for the prosperity of the entire zone. Whether the countries react in a dispersed non-cooperative way to the dollar downfall, the pattern of relative prices can be distorted and further integration jeopardized. Eastern Asian countries would face the same problem as Europeans in the Seventies. Some kind of regional exchange rate mechanism might become relevant. It would be appropriate to revive and deepen the Chiang Mai Initiative. Such a move will generate a de facto regional monetary area, far from a monetary union but that would nonetheless internationalize

the participant currencies. Fourthly the concomitance of dwindling dollar and a relative rise of emerging market economic powers will make the international monetary system more polycentric. We will outline the type of international governance that can make such a system work.

1 The driving factors in the accumulation of global imbalances and the position of China

1.1 World saving investment equilibrium

No excess saving at the world level but a polarization due to the collapse of household saving in the US. Creditor position shared between oil exporters and Asian countries.

1.2 Dollar pegging and China's balance of payments

Claims on the US concentrated in central bank reserves

1.3 US debt, portfolio behavior of foreign investors and exchange rates

A theoretical portfolio balance model to show how the deterioration of credit quality due to the financial crisis in the US impinges upon the dollar exchange rates of foreign currencies

2 Domestic consequences of excess liquidity in China

The monetary implications of China's central bank in stemming yuan appreciation against loss of confidence in the dollar of private investors consist in a fast rise in the money supply in China

2.1 The money market

Estimation of a long run money demand using an error-correction model. The high growth rate in China cum increase in the liquidity ratio due to the under development of the financial system imply a fast-rising demand for money. Fast-rising money supply due to the accumulation of foreign reserves meets the booming demand and does not result in inflationary pressures.

2.2 Subsequent Imbalances

2.2.1 Bubbles in asset prices

2.2.2 Huge discrepancy between real interest rate and neutral rate leading to persistent overinvestment

2.3 Lessons for monetary policy

Has the time come for decoupling the exchange rate from a waning dollar? What type of monetary policy is appropriate at the present stage?

3 Consequences for the position of China in the international monetary system

3.1 The stabilizing impact of sovereign funds

Hedge against losses due to the depreciation of the dollar, reshuffling US credit markets via alternative asset management, impact on prices in world financial markets.

3.2 The tensions on Hong Kong monetary system

Mediator between mainland China and international capital markets, HK financial markets bear risks from uncertainty on the yuan/dollar exchange rate. Possible threat on the currency board. Does the future of HK special financial role entail a monetary reform?

3.3 Beyond Chiang Mai, a regional monetary arrangement in East Asia

Preventing relative price distortions due to non-cooperative responses to the dollar downfall. Arrangements that can make a loose de facto monetary area: mutual financial support to ward off exchange rate crises, official bi-annual forum to discuss macroeconomic questions of common interest, a common unit of account to issue bonds on more than one market.

3.4 Beyond the semi-dollar standard, moving to a polycentric IMS

Preserving global capital markets and enhancing domestic monetary objectives require more flexible exchange rates. The public good character of the IMS (key currency, providing and regulating global liquidity) is at stake. Institutions of international governance are needed: a rekindled IMF (sweeping revision of quotas, mission of warning and managing global crises), an enlarged Basel club of central bankers to fulfill the international lender-of-last resort function, a new leading policy group in place of the G7.

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