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An Analysis of the Chinese Exchange Rate Policy

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ABSTRACT

While China has been making remarkable economic strides, stronger competition has caused Japanese and the US governments to intensify their demands in recent months for an appreciation in the Renminbi exchange rate. Such an appreciation, it is expected, would raise the cost of China's production exports, and would thus somewhat mitigate the threat that China poses to its two major trading partners.

China's official position on the issue, however, is that a stable currency rate is not only desirable for China but for the world economy as well. Yet, from the perspective of China's rapidly expanding market, maintaining a stable currency rate in relation to a single currency such as the dollar will lead, in the long run, to a gradual enlargement of the burden upon the real economy. A gradual appreciation of the currency, in other words, would be to China's benefit.

In terms of China's international revenue and expenditure, both its current balance and its capital balance have been kept in positive figures. While under normal circumstances, the influx of dollar-based investments would lead to a rise in the Renminbi, because China has adopted a foreign currency intensive management system, the People's Bank of China (the central bank) is buying dollars and selling Renminbi on a daily basis. As a result, while the Renminbi is being kept at 8.28 to the dollar, the foreign currency reserves managed by the central bank are rapidly increasing ($401 billion at the end of October 2003).

Broadly speaking, the US government wants China to refrain from this intervention, maintaining that the exchange rate should be determined by the market; i.e. it prefers a natural market appreciation to a government controlled appreciation. American researchers propose, moreover, that, in conjunction with less intervention, the Renminbi's margin of fluctuation be enlarged from below 1% where it currently stands to around 5%, and that the currency, instead of being based on the dollar, should be based on a euro-yen-dollar currency basket.

While the Chinese government has shown a positive attitude toward decreasing its intervention in the mid-term, allowing the currency to naturally appreciate, it remains very cautious about it in the short term. An immediate adjustment in the exchange rate, moreover, would not necessarily be beneficial for either companies or the economies of Japan and the US. It is possible, for instance, that an appreciation in the Renminbi would in fact be a drawback for American and Japanese companies that have entered the Chinese market. One more reason for

China's cautious attitude toward adjusting its currency is the uncertain direction of Hong Kong' economy, and the precarious status of the Hong Kong dollar.

Looking toward the next few years, China will continue to reform its financial systems, dispose of its nonperforming loans, and see overall progress in the liberation of its capital market. From this, it is likely that China will eventually decide to free up its currency market as well.

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1. Introduction

As the Chinese economy continues to undergo rapid development, Japan and the US, in the hopes of rectifying their competitive position, are heading the call for the revaluation of the Renminbi exchange rate. After its devaluation to 8.7 to the dollar in 1994, some slight adjustments brought down a notch to 8.3 in 1996 where it has stayed up until now. Though China was not directly affected by the Asian currency crisis in 1997, the sharp currency devaluation in almost every other Asian country helped weaken the competitiveness of its exports. Many predicted that China would respond by devaluing its currency to a level closer to that of its Asian neighbors, thereby reviving its export activities, but there was fear that doing so would only incite another wave of currency competition in East Asia and would thus only to exacerbate the problems caused by the currency crisis. For this reason, the Chinese government repeatedly rejected calls for exchange rate devaluation. Consequently, though China incurred some damage to its trade balance, the Renminbi exchange rate remained unchanged.

Then, with its accession to the WTO in December 2001, China began to open up its markets to foreign investors. Foreign exports steadily expanded and FDI heavily increased as a result. As China began to strengthen its presence as the "world's factory," developed countries, with Japan and the US at the forefront, began to warn of the threat China posed as a large-scale exporter of low cost goods. They demanded that the country revalue its currency, believing that this would raise the export price of Chinese products and thereby mitigate the nation's economic threat.

The Chinese government's official position concerning Renminbi revaluation is that a stable Chinese currency is desirable not just for China but also for the rest of the world. But, given the fast paced expansion of an economy of China's scale, keeping the domestic currency pegged to a single currency such as the US dollar for the long term will gradually place a large burden upon the real economy.

Generally speaking, fixed currency systems are put in place in countries with small economies and low dependence on foreign trade, neither of which characterizes present day China. Thus, it will be necessary for China to change to a floating currency system sooner or later. This is the reasoning behind China's assertion that it will shift over in the "mid-term." There is not doubt that a fluctuating currency system will ultimately be to China's benefit.

To state the case in broad terms, China should keep exchange rates stable in

the short-term while in the mid-term, it should carry out a step-by-step shift to a more flexible regime in conjunction with the reforms of its domestic financial system. This would be the best option from China's perspective. But this then leaves the question of what is the most appropriate exchange rate level. Though Japan and the US both claim that the current rate is heavily undervalued in light of China's international competitiveness, they show disagreement on the extent to which it is undervalued. The US National Association of Manufacturers, for instance, claims that it is undervalued by 40% while the Japanese Ministry of Finance takes a lighter view, putting the figure at 14%.

That the exchange rate should be based on purchasing power parity (PPP) is a view that is popular amongst academics. But a look at the currency rates of countries around the world reveals that the rate of most countries actually deviates markedly from their PPP.

Finally, another point that needs to be clarified with regard to the general issue of revaluation is how much the change in currency policy will affect the Japanese and US economies, and how much it will impact China itself. The impact of a Renminbi revaluation will vary depending on the extent of revaluation, the structure of international trade relationships, and the amount of FDI.

An expansion of the arguments introduced above, this report will discuss the various choices for currency rate regimes, the arguments for the most appropriate exchange rate level, and the impact that the revaluation will have on the US, Japan, and China. Furthermore, while bringing together the arguments and positions of researchers and government officials both outside and inside China, this paper will look at the approaches toward implementing the new currency policy and will lay out a roadmap for the future shift to a floating currency system.

2. The Reflux of Foreign Capital Based on the Expectation of Renminbi Revaluation

The call for China to revaluate its currency first came two years ago from Masano Matsushima, then chairman of the BOJ, at the Karuizawa Seminar held by the Japan Association of Corporate Executives. After the statement was made, the Minister of Finance and the Deputy Vice-Minister of Finance joined in what became a chorus of officials calling for revaluation. Up until 2003, however, the demand for revaluation was limited to Japan.

It was in 2003 that the issue of Renminbi revaluation suddenly surfaced in the international community. This can attributed to three main factors. First of all, in 2002, the US trade deficit with China surpassed the $100.0 billion mark, heightening the US government's concern over the Renminbi exchange rate. Secondly, according to China's 2002 statistics for its international accounts, as much as $7.8 billion dollars in errors and omissions flowed back into the country beyond the control of the currency authorities. Thirdly, the large-scale export in those years of low cost Chinese manufactured products was finally labeled a "threat" by developed countries. Thus, though Japan may have touched off the debate on China's currency exchange rate, the actual causes for the widespread revaluation demand can be found in these other factors. In anticipation of the Renminbi revaluation, the refuge capital, which had until then been flowing out of China into foreign countries[1], began to be stealthily re-circulated back into China. Though domestic investment was one the aims of this refluxing capital, the other was to capitalize on exchange rate margins that would emerge with the expected currency appreciation.

Figure 1 – International Account Balance and Foreign Currency Reserves (1997 – 2003 (June))

(Unit: $100 million)

	1997	1998	1999	2000	2001	2002	2002.1-6
Current Account	29.72	293.24	156.67	205.19	174.05	354.22	111.21
Capital Account	22.96	▲63.21	76.42	19.22	347.75	322.91	444.26
Errors and Omissions	**▲16.95**	**▲165.76**	**▲148.04**	**▲118.93**	**▲48.56**	**77.94**	**47.31**
Foreign Reserve	1,398.90	1,449.60	1,546.75	1,655.74	2,121.65	2,864.07	3,464.76

Source: Chinese Foreign Currency Management Agency

But the reflux of foreign capital was stimulated even further in 2003. In September of that year, the amount of foreign currency reserves held by the central bank had reached $401 billion, up $115 billion from the end of 2002. Because China's primary sources of foreign revenue during that time could only account for about $50 billion – there was a $9.1 billion surplus in the trade balance and FDI totaled $40.2

[1] In the five years between 1997 and 2001, the amount of foreign refuge capital totaled $50 billion.

billion[2] – it is conjectured that a large amount of hot money flowed into the foreign currency reserves on top of the legitimate inflow of capital from abroad.

This reflux of foreign capital was essentially based on the market's expectation of Renminbi appreciation. After the Asian Currency Crisis in 1997, the main actors in the flight of capital abroad were domestic investors and particularly the managers of exporting companies and private corporations. During that time, expectations for Renminbi depreciation had grown and private managers saw that more marginal gain could be acquired in the exchange rate if private assets based in Renminbi were converting to dollars and remitted abroad. Encouraging this trend was the lack of clear legal provisions in China to safeguard the private assets of private-sector managers. So, from the perspective of risk distribution, sending a portion of your portfolio abroad was the rational choice.

For China, joining the WTO and opening up its market to foreign investors in December of 2001 was a historical milestone. Legal provisions were finally put in place to legally protect individual property and this made domestic investors feel more comfortable owning domestic assets. At that time, the government also announced its optimistic plan for expanding the scale of the economy (GDP) to four times the level of 2000 by the year 2020. It was predicted that, in the 20 years that followed, China would sustain an average annual growth of about 7%. Such optimism spread the assumption that investors would become overwhelming more inclined to find investment opportunities domestically rather than searching for them abroad. People thus believed that even if the Renminbi were not revalued in the short term it would eventually have to appreciate in order to catch up with China's assured growth in economic competitiveness. Such was the speculation that brought about the reflux of capital into China.

Though the facts on foreign capital reflux have still not been completely clarified, it is certain that domestic investors were the main actors. What the Chinese government is wary of, however, are attacks on the Renminbi by international speculation, something like the hedge fund that precipitated the Asian Currency Crisis in July of 1997. For this reason, it would be wise for China to increase the fluctuation band on its exchange rate as it continue to gradually liberate its markets.

[2] According to the preliminary report of the National Bureau of Statistics of China, foreign trade from January to September of 2003 consisted of $307.7 billion in exports (up 32.3% over the same period of the previous year) and $298.6 billion in imports (up 40.5% over the same period of the previous year). FDI consisted of $40.2 billion on an effective basis (up 11.9% over the same quarter of the previous year) and $79.2 billion on a contract basis (up 36.0%).

3. The Appropriate Level for the Renminbi

While it is widely believed that the Renminbi exchange rate is undervalued, there is little consensus on how much. Treasury Secretary Snow, when he visited China in September, called for an appreciation of 40% while the Japanese Finance Ministry believes that the current rate of 8.28 to the dollar is undervalued by 14%. At the same time, there are many economists who insist that purchasing power parity (PPP) should be used as the guide.

Generally speaking, PPP is the exchange rate at which identical products and services will cost the same within each country. When it comes to making the calculation, however, the selection of the goods and services as well as the determination of their importance tends to be arbitrary, and thus PPP cannot always be regarded as objective. Moreover, as the argument for using PPP has yet to be logically supported, it will not be necessary to react to it at length here.

Figure 2 – Comparison of Renminbi Rates

	1996	1997	1998	1999	2000	2001	2002
Market Rate	8.31	8.29	8.28	8.28	8.28	8.28	8.28
Real Effective Rate	7.73	7.33	7.32	7.77	7.71	7.47	7.67
PPP Rate	1.78	1.86	1.86	1.82	1.76	1.94	1.82

Note: The market rate is the annual average, the real effective rate is from World Bank data, and the PPP rate is from IMF data. 95 years = 100.
Source: IMF, World Bank

The market rate for Renminbi is currently 8.28 to the dollar. As shown in Figure 2, the PPP used by the World Bank in evaluating each country's GDP puts the rate at 1.82 to the dollar (2002 annual average). But if World Bank's PPP figure were used to calculate China's per capita GDP, the figure, amounting to $4,935, would be 4.6 times more than the current value of $965, calculated using the current market rate. Though it should be noted that the basis for the World Bank's PPP calculation is not limited to traded goods and services but also includes the domestic consumption of goods and services.

Because the actual PPP is difficult to calculate, some use as an alternative the relative PPP, which is calculated by multiplying the current rate by the relative change

in consumer prices in each country from a fixed common point. According to relative PPP, the Renminbi is undervalued by about 15%. Even though this figure may in fact seem sensible to many, the relative PPP theory loses some of its persuasiveness when one considers that the general consumer price index is used for this calculation and that the goods and services used to calculate this index is not necessarily the same for China and the US.

But thinking realistically, the real effective rate, as it is based on the considerations of actual foreign trade, reflects international competitiveness better than PPP. The real effective rate is based on the weighted average of the country's trade volumes with its major trading partners and thus takes into account the volume of trade in calculating the inter-nation exchange rate. Indicated in Figure 2 is the Renminbi to dollar exchange rate that was recalculated using the real effective rate calculated by the IMF. The average value for 2002 was 7.67 to the dollar, which would mean that the current Renminbi exchange rate is undervalued by about 10%.

To summarize, with there is no established figure for the actual amount by which the Renminbi is undervalued, most of the arguments are, in reality, merely instinctual reactions to China's increasing exports. The 40% appreciation demand by the US National Association of Manufacturers, for instance, has met with many voices of doubt even within the US. According to a China expert from the Institute for International Economics (IIE), speaking at the US congressional financial services hearing held on October 1st of 2003, the 40% appreciation argument focuses solely on the America's trade deficit with China. If China's trade surplus were considered in its entirety, a revaluation of more 15-25% would simply be unreasonable. Realistically speaking, should the Renminbi be revaluated, it seems that somewhere between 20 to 30% would be the most sensible level.

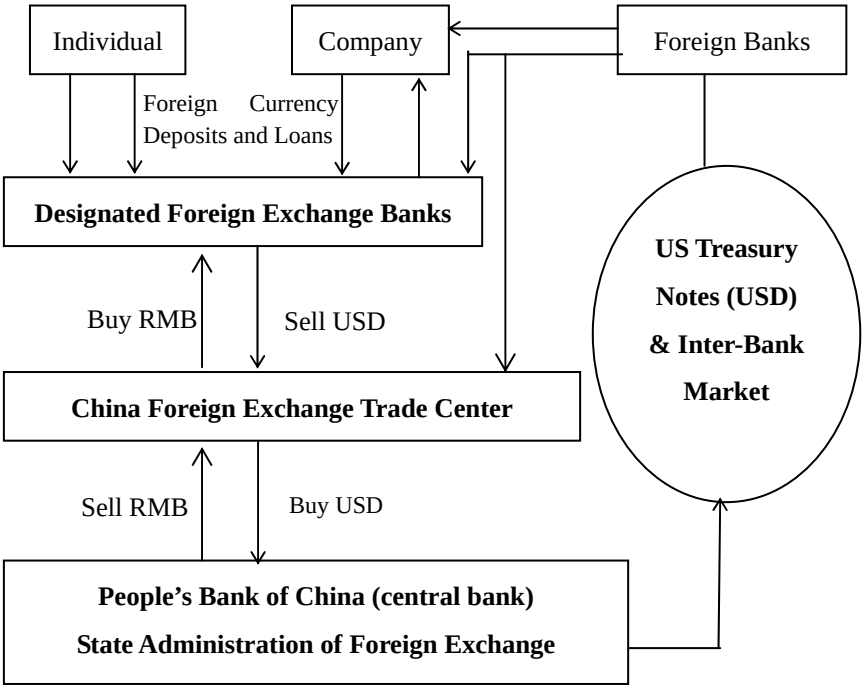
4. The Mechanisms for Exchange Rate Intervention

Essential, what the US wants is for China to base its foreign currency exchange rate upon market demand and to cease its artificial control of prices through market intervention. Because China has surpluses in both its current accounts and its capital accounts, the Renminbi will appreciate of its own accord once China ceases its interventions. This is the real intent behind Treasury Secretary Snow's request for revaluation.

What follows is an explanation of China mechanisms for intervention. In response to the many years in which the country was stricken by a shortage of foreign

currency, China has adopted a steadfast currency policy that secures foreign capital by preventing its outflow from the country. So far, the government has, for instance, demanded that all foreign companies maintain a balance of foreign capital. The government has also setup a rule whereby domestic companies must sell any foreign currency they receive to designated foreign exchange banks (though they are permitted to retain a certain amount based on their trade volume). A limit has been placed, in turn, upon the foreign currency holdings of these designated foreign exchange banks such that any amount of foreign currency exceeding the limit is sold on the currency market and then purchased by the People's Bank of China (PBC; a.k.a. the central bank) who stores it as national foreign currency reserve.

Figure 3 – China's Management of Foreign Exchange



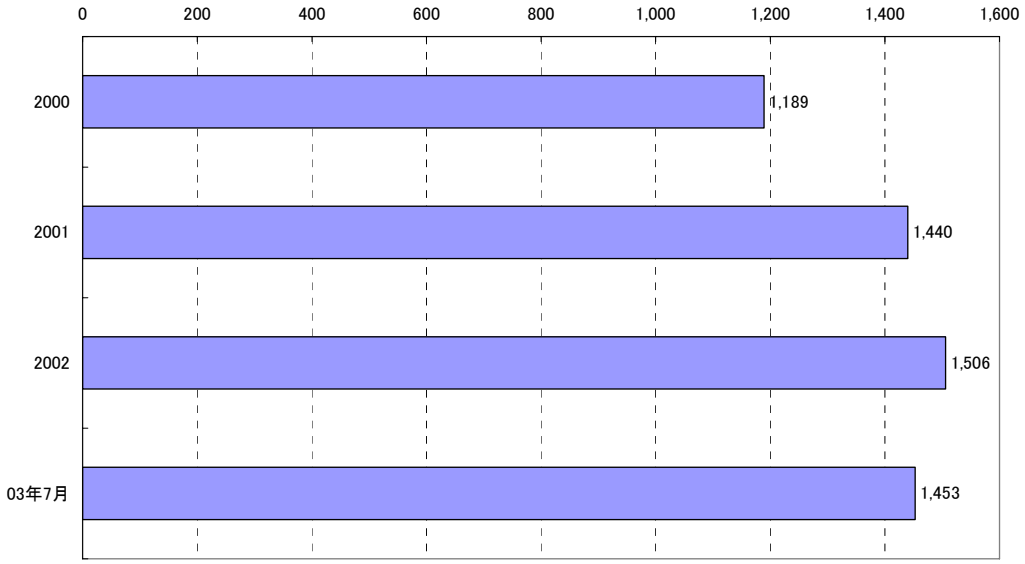
Source: Bank of Japan 2002

Figure 3 shows how, under the present system of foreign currency management, the foreign currency of individuals and corporations by in large flows through the designated foreign exchange banks to the China Foreign Exchange Trade Center and finally into the central bank.

1) Chinese households can acquire foreign currency through several means

including remittances from family members abroad, foreign currency purchases for the purpose of leaving country – e.g. traveling abroad (a limit of $2,000 per trip applies), or by converting cash on the black market. Though this foreign currency can be sold for Renminbi at anytime at the designated foreign exchange banks or at the foreign currency counters of hotels, most often it is deposited as is into an account at the foreign exchange bank.[3] At the end of July 2003, the amount of foreign currency deposits held by foreign exchange banks settled at $145.3 billion.

Figure 4 – The Total Foreign Currency Deposit Balances of all Chinese Financial Institutions (2000 – (July) 2002) Unit: $100 million



Note: The drop in 2003 is believed to be caused by the expectations for Renminbi appreciation.
Source: Central Bank of China

2) Just like the domestic sector, the corporate sector also deposits foreign currency that it receives from its exports or from its affiliations with foreign companies. The amount, however, is limited. Though corporations are permitted a certain deposit balance, gauged according to the necessities of international trade, it is strictly regulated in accordance with each company's trade volume.

3) Not only do corporation have strict foreign currency restrictions, but the

[3] When it comes to depositing foreign currency, the difference between Japan and China is that in China there are no service fees for changing foreign currency into the home currency (renminbi). Nor are there service fees for withdrawing dollars (cash) when the limitation period of the account has expired. Only in the case of exchanging renminbi (cash) for dollars is a service fee collected. This system was setup to encourage the deposit of foreign currency and thereby build up the foreign currency liquidity owned by the general household.

foreign currency banks themselves have a holdings limitation that is regulated by the PBC. Thus, in reality, though banks are able to buy the foreign currency sold to them by the households in addition to holding foreign currency deposits, this money immediately gets sold to the China Foreign Exchange Trade Center in Shanghai.

4) Thus, though the China Foreign Exchange Trade Center officially serves the function of a foreign currency exchange market, in actuality, it is also exists as a place where foreign and domestic banks adjust their overs and shorts in accordance with the principle of actual demand. Foreign banks also procure Renminbi and dollars from the China Foreign Exchange Trade Center based on the supply and demand of foreign companies. However, as can easily be grasped from China's economic situation with its high trade surplus and FDI influx, the demand for selling-dollars-buying-Renminbi at the China Foreign Exchange Trade Center is clearly much higher than that for buying-dollars-selling-Renminbi. As a result, the PBC absorbs the surplus dollar liquidity and, in this way, essentially intervenes on the buy-dollar-sell-Renminbi market on a daily basis. Currently, the average daily purchase figure for foreign currency has risen to $600 million. At the end of October, the foreign currency reserves held by the central bank reached $401.0 billion, a $114.6 billion rise from the end of the year 2002.

5) The PBC manages the majority of its massive foreign currency reserves through the purchase of US Treasury notes and the dollar inter-bank market. According to newspaper reports, about $200 billion of the bank's reserve goes to the purchase of US Treasury notes. Mr. Yang Li, member of the Committee on the Currency Policy of the PBC, has informed the media that the bank has a 5% profit ratio (annual performance) on its foreign currency.

In short, exploiting the framework of strict regulations on currency exchange, the PBC is in effect absorbing the international trade surplus by means of its exchange rate interventions. Though this is fed into the national foreign currency reserve, the main managers ultimately direct this capital toward the purchase of US Treasury notes.

Though it is necessary make an overall decision about whether the current exchange rate is appropriate or not, there are two points that must first be considered.

First of all, even though the current account surplus reached its peak in 2002 at $35.4 billion, for all other years it has fluctuated around the appropriate level of $20.0 billion. The problem arises only when international trade is looked at by country. China's trade surplus with the US went up to $103.2 billion in 2002, and at this rate, it is expected to reach $130.0 billion in 2003. In other words, from China's viewpoint, there is no imbalance in its overall trading. It is only with respect to individual

country that China has to correct its trade imbalances.

Second is the question of why the Renminbi is being kept at 8.28 to the dollar in the first place. It is necessary to make the basis for this more evident. Looking back at the past decade, the Renminbi was devalued to 8.7 in January of 1994 as one part of the reform measures for the foreign currency management system. Then in 1997, due to the effects of the Asian Currency Crisis, it was expected that the Renminbi would be devalued once again. Even after the government announced its rejection of the devaluation, there was a point at which the Renminbi was being sold at 9.00 to the dollar on the black market. At the NDF market in Hong Kong, the Renminbi was also devalued significantly throughout '98 and '99. On the other hand, the exchange rate at the China Foreign Exchange Trade Center in Shanghai returned from the devalued level it fell to in 1994 back to the neighborhood of 8.3 to the dollar.

The actual reason why the Renminbi exchange rate stabilized at 8.3 is still not clear today. The one thing that is clear is that the PBC halted the Renminbi's appreciation at an early stage and that its decision to go ahead with market intervention was motivated by a desire to eliminate the shortage in foreign currency reserves. For many years, China had been stricken by such a shortage. Both the Mexican debt crisis in '95 and the Asian Currency Crisis in '97 were important lessons for China. In both cases, China's lack of foreign currency liquidity had deepened the crisis. If the PBC were not making exchange rate interventions, the Renminbi would have slowly appreciated, the current account surplus would have shrunk, and the foreign reserves would not have expanded to where they are now.

Thus, there was no economic reason for the establishment of the defense line at precisely 8.28. Rather, the number was the result of a series of domestic and foreign factors affecting the economy. Thinking from China's point of view as a developing country, the decision to quickly accumulate a foreign currency reserve was an attempt to forestall the type of financial crises that a fragile financial system could bring about. Meanwhile, it was also a vital capital resource for buying and bringing in superior equipment and thereby filling in the technology gap between it and other developed countries. These are the two most important reasons why PBC opted to take a policy of exchange rate intervention and keep the Renminbi stable.

The essential problem, then, lies in the fact that China has been sustaining high economic growth for the past ten years and has made extraordinary improvements in its international competitiveness. Since its accession to the WTO, the globalization of its economy has progressed rapidly, and its foreign currency reserves have exceeded $400 billion. In the midst of such growth, it will become more and more difficult to

keep the currency rate fixed to the single currency of the dollar.

5. The Troubles Up Ahead For Exchange Rate Management

China continues its high economic growth in 2003 despite the effects of the war in Iraq and the onslaught of a new strand of the SARS virus. According to the advance report of the National Bureau of Statistics of China, the Chinese economy sustained an average economic growth of 8.5% over the first three quarters from January to September (9.8% in the first quarter, 6.7% in the second, and 9.1% in the third). Looking at the economic growth rate by industrial sector, though primary industries achieved an average of 2.8% growth, the secondary industries showed 11.8% and the tertiary industries 5.4%.

With such high growth figures, there are many who claim that the Chinese economy is overheating. But with the consumer price index averaging 2.2% for all three quarters and the retail price index going down 0.5%, the price of goods indicates that the economy is proceeding soundly and that there is no danger of overheating.

Conventionally, economic policy always aims for "inflation-less growth." But China's national policy makers look upon this current "ideal" situation with some apprehension. This is because the current growth is mainly a result of increases in FDI, consumption driven growth being low as always. It is believed that economic growth that is wholly dependent upon the expansion of investment has little potential for sustainability.

To give some specifics, fixed asset investment rose by 30.5% in the first three quarters while consumption growth stopped at 8.6%. Of the plant and equipment investors, the state and the corporate sector (both private and incorporated) heavily increased their investments by 31.4% and 27.6% respectively. The state expenditure consisted of 29.1% basic fixed asset investment for the upgrading of infrastructure, 37.2% plant and equipment renewal investment, and 32.8% real estate investment.

What I would like to emphasize here is the rapid increase in real estate investment. Several factors have contributed to this sudden boost in demand. First of all, a larger portion of the FDI that is now pouring into China has been directed toward renting and purchasing residences and office space. Also on the increase is the purchase of second homes by the domestic upper class. Many middle-income families are also buying new homes despite the fact that the price of real estate has gone up. Thus, the emergence of a domestic demand for property has combined with the onset of foreign demand to create a great surge in the real estate market. This is also a main

factor behind the sudden 51.7% increase in fixed asset investment that occurred between January and August.

Both the State Council and the PBC feared that the real estate market, booming under their noses, would become a speculation bubble and in a rare move they gave notice to the commercial banks to put self-restraints on their real estate financing. While the preferential interest rates could be applied, as before, to borrowers purchasing an initial house, the application of normal interest rates was ordered for borrowers purchasing a second house.

In response, the construction industry objected that the real estate market was developing soundly and requested that Prime Minister Wen Jiabao rescind the policy change. While the new policy would certainly calm the booming real estate market, there was also fear that it would bring about a hard landing for the economy. If this were to happen, the bank loans for real estate developments would go sour, causing economic stagnation. Ultimately, the State Council changed its mind. It announced that despite some reasons for concern, the real estate market was growing soundly and, in fact, rescinded the policy changes.

In any economy, over-lending almost inevitably accompanies over-investment. China is no exception. From January to September, the total figure for loans made by all of China's financial institutions reached 2.7 trillion Renminbi, 1.3 trillion more than the same period of the previous year.

In its monthly report, the PBC has issued warnings over the sudden rise in credit generation by financial institutions. It summarized the financial trend between January and February as showing 1) a sharp rise in money supply and bank loans, 2) a large increase in foreign currency reserves, and 3) stability in the currency exchange rate. In September, hoping to help soften the landing of the speculation inclined economy, the PBC raised the deposit reserve requirement ratio from 6% to 7%. Classical financial policy tells us, however, that out of the three main controls (interest rates, the public market, and the deposit reserve requirement ratio), adjusting the deposit reserve requirement ratio has the least effect. As for the reason why the PBC did not dare to raise the cost of money by hiking up interest rates, it was perhaps in consideration of the economic anxieties, such as the fear of recession, brought about by SARS and the war in the Iraq.

The question to ask, however, is what allowed the banking industry, beginning with the state-owned banks its center, to suddenly increase its financing activities.

The Chinese government has given no comment with regard to this question and neither foreign nor domestic researchers have focused on the issue. With the

fragility of the financial system becoming more and more apparent, the government should ordinarily be strengthening its management grip over the state-owned banks. It is extremely important to explore the reasons behind this somewhat irrational generation of credit. Here, I would like to offer a few thoughts.

Firstly, the expansion has connections to the turnover in administration. In the first major political change in 10 years, the top leaders of each government office including the Prime Minister was replaced and, under the new leadership, capital was increased in order to boast achievement. It was largely under the charisma of the former Prime Minister Zhu Rongji that a restrictive financial policy, which included constraints on the loaning power of commercial banks, was so successfully implemented. Demand for larger bank loans shot up with the end of his term.

A second reason was the temporary absence of a regulating body for the banks. Though the National People's Congress decided to establish the China Banking Regulatory Commission (CBRC) in March, it took more time than expected to actually form the commission creating a gap in the enforcement of banking regulations. This had previously been the responsibility of the PBC. Under its authority, however, a series of important reforms such as the cleaning up of bad loans in the commercial banks, the strengthening of asset assessment, and their conversion of the banks into public stock companies, though on the agenda, were not getting accomplished. The purpose of the CBRC, as its name implies, was to strengthen the regulations on banks, particularly the commercial banks, and to facilitate their reform. However, because of the delay in forming a national body for the CBRC, government sector interference in the management of commercial banks, forbidden under the Commercial Banking Law, began to resurface. This was especially salient in the regional areas where local governments successfully persuaded commercial banks to expand their finances

Thirdly, the PBC and the CBRC both wanted the commercial banks to accelerate the disposal of their bad loans. But the problem of bad loans had been festering for many years and would be cleaned up within a day. Thus commercial banks deliberately increased their capital in an effort to lower their rate of bad loans (i.e. enlarged their denominators).

Figure 5 – The Profit Ration and Bad Loan Ratio of the 4 Largest Commercial Banks (2002)

	Profit Ratio (%)	Ratio of Bad Loands (%)
Industrial and Commercial Bank of China	46.2	21.56
Bank of China	38.9	18.07
Construction Bank of China	37.8	11.92
Agricultural Bank of China	7.9	30.07

Source: The Asian Wall Street Journal Oct. 22, 2003

Fourthly is the rapid increase in bill discounts. Strengthening the finances of a small-medium company has always been seen as an important part of financial policy. This year, commercial banks have begun increasing the finances of small-medium companies through bill discounts that they give via small-medium financial institutions such as city commercial banks.

Finally, as a fifth reason, the banks themselves are riding on the wave of the domestic real estate boom, rapidly increasing their finances to meet demand. Up until now, most of the real estate finances in the commercial banks were put in housing loans. Now, however, they are being quickly focused into real estate developments. Figure 6 shows the financial procurements of domestic real estate developers.

Figure 6 – Financial Procurements of Real Estate Developers (1997～2002)

	Total	Personal Funds	Banks Loans	Foreign Capital	Other
1997	3,817	937(25.5)	911(23.9)	461(12.1)	1,472(38.6)
1998	4,415	1,167(26.4)	1,052(23.9)	362(8.2)	1,833(41.6)
1999	4,796	1,345(28.0)	1,112(23.2)	257(5.4)	2,802(43.4)
2000	5,998	1,614(26.9)	1,385(23.1)	169(2.8)	2,830(47.2)
2001	7,696	2,184(28.4)	1,692(22.0)	136(1.8)	3,684(47.9)
2002	9,750	2,738(28.1)	2,220(22.8)	157(1.6)	4,635(47.5)

Note: The numbers in parentheses are percentages (%)

Source: Chinese Statistical Yearbook (2003 edition)

On the other hand, external factors have also been contributing to the over-stimulation of the economy.

According to an announcement by the National Bureau of Statistics of China, the foreign currency reserves of the central bank reached $383.9 billion at the end of September, a rise of $97.5 billion from the beginning of the same year. The trade surplus ($9.1 billion) and FDI ($40.2 billion) accrued during that period account for about $50.0 billion of this amount. As a rule, the trading markets are governed by strict regulations and the government approves only small amounts of foreign investment into Chinese securities. This means that $30-40 billion of the capital investments now flowing into China is hot money.

Though not much is factually known about the hot money as of yet, the following points can be made based on the perusal of newspaper reports and the analysis of government affiliated think tanks.

First off, during the five years from 1997 to 2001, flight capital, or funds from the domestic sector going to markets abroad, was as much as $50 billion. This capital was remitted amidst the predictions for Renminbi devaluation brought about by the Asian currency crisis. The monetary authorities are not certain about how the money was remitted, but it seems that transfers through trade account settlements and the export of cash from Guangdong to Honk Kong were the primary methods. Much of this foreign capital was put away in tax havens in Hong Kong or in Bermuda (via Hong Kong). Judging from these factors, it can be inferred that much of the hot money now flowing into the country is the reflux of refugee capital, stimulated by expectations for renminbi appreciation.

Many Chinese living abroad, particularly those in America, are strengthening their investments into China through group funds. Because China's capital markets regulations, however, the majority of these fund based investment take the form of FDI and are injected into such fields as the development of luxury homes and office buildings.

Moreover, as of this year, the foreign currency deposit balance of commercial banks has shrunk from $150 to $140 billion. The difference, it appears, has been changed into Renminbi and put into various investments.

In this way, the influx of foreign currency has worked to turn up the heat on an already warming economy. The PBC, in an effort to put a lid on the rapidly increasing liquidity of the market (a result of its accumulation of foreign currency reserves), has been absorbing base money through buying operations and issuing central bank promissory notes. But even if the PBC uses its market controls to absorb some of the base money for the cash conversion of foreign currency, it cannot control the increasingly active financing of the domestic commercial banks. Ordinarily, the

domestic and foreign environments that currently surround the economy would no give reason to fear an economic bubble. What is different today, however, is that the market mechanism has not been sufficiently penetrated the financial system, beginning with the commercial banks. This is what has brought about over liquidity and this is what is causing the economy to overheat.

Amidst these developments, policy management has become increasingly difficult for the national policy makers. According to classical economic theory, in order to cool an overheating economy one must implement a policy of financial restraint by, for instance, raising the interest rates. In the present circumstance, however, the price of goods is stable and there is no inflation. If interest rates are raised, the Chinese economy will experience a sudden and across the board deflation that could potentially drive the economy into a serious recession. Moreover, it is reasonable to believe that a rise in interest rates would only invite a fresh influx of hot money. Thus, the PBC is daring to leave the interest rate alone and has instead decided on the less potent measure of reducing the deposit reserve requirement ratio from 7% to 6%. The danger is that if the heating economy were to take a hard landing, the balance sheets of commercial banks would further deteriorate, bringing about delays in badly needed financial system reforms. What is needed, at present, is the implementation of a direct and incisive policy that includes fundamental reforms for the financial system.

6. The Main Arguments for Devaluation from Japan, the US, and China

In 2000, the US government repeatedly demanded that China cease its controls over its exchange rate and leave it to market forces; or in other words, revaluate its currency.

In September of 2003, before attending the APEC assembly, Treasury Secretary Snow came to Japan and came to an agreement of views concerning Renminbi revaluation with Minister of Finance Shiokawa. Following this, the Treasury Secretary visited China, met with Prime Minister Jiabao and Governor of the PBC Zhou Xiao-Chuan and, according to reports, conveyed his opinion that the Renminbi was undervalued by 40%. Though the objective basis for a 40% revaluation is not yet understood, it is clear that the number was presented by the National Association of Manufacturers in the US.

But Treasury Secretary Snow also made the following statement to a group of reporters accompanying him at the US Embassy in Beijing:

"I have been to Beijing a few times before, but always as a civilian. This time, I was making an official visit as the Treasury Secretary and made some frank exchanges of opinion with the new leadership of China. I was surprised at how extremely frank and clear the new leadership was. I am not asking the Chinese government for a timetable for changing the exchange rate, but I would like the government to show that it is heading in this direction. I received a satisfactory answer from Prime Minister Jiabao in this regard. He said that the government, in acting on the exchange rate issue, would setup a system in which the market mechanism would be at work. What I clearly demanded from China during this visit was that they import more beans from America…" The Treasury Secretary's words perhaps best reflect the real motivations of the US in their request for a Renminbi revaluation.

Again, on October 1st, at a public hearing of the House Financial Services Committee, M. Goldstein and N. Lardy presented a Two-Step Currency Reform in which reform would be split into two stages:

1) In stage one, the exchange rate would be revalued by 15%-25% and the band of fluctuation would be widened from less than 1%, where it is now, to 5%-7%. In addition, the Renminbi would be shifted from a US dollar peg to a currency basket of the three strongest currencies – the US dollar, the Yen, and the Euro – in which the influence of each currency would be determined by the weighted average of that country's trade with China.
2) In stage two, the Renminbi market would shift to a managed floating market. This, however, would assume that the financial system has been reformed, bad loans have been cleaned up, and the capital markets are liberalized.

The two touched on their reasons for proposing a 15%-20% revaluation. While the 40% figure offered by Treasury Secretary Snow was purely based on the trade deficit between the US and China (the US trade deficit to China was $103.2 billion in 2002), Goldstein and Lardy emphasized that it was necessary to look at China's foreign trade surplus as a whole (China's current account surplus in 2002 was $35.4 billion).

Though Goldstein and Lardy's proposal for an expanded band of fluctuation and a 20%-30% revaluation of the currency may be thought of as reasonable, the shift to a currency basket reveals what the US is really thinking. From China's perspective, there is no good reason for this reform. Certainly, such a currency basket would stabilize the Renminbi against the three axial currencies of the world. Nonetheless, even though four foreign currencies – the US Dollar, the Hong Kong Dollar, the Yen and

Euro – are traded at the China Foreign Exchange Trade Center in Shanghai, over 97% of the current trade volume is in US dollars. Moreover, most of China's currency account settlements for foreign trade are in dollars. Thus, if China wants to soundly expand its foreign trade and the FDI that it receives, and if it wants to hold down the risks of exchange rate reform to a bare minimum, the most important issue concerning exchange rate policy would be the Renminbi's stable movement against the US dollar.

Yet the stable maintenance of the exchange rate does not necessary mean a pegged currency. Indeed if the currency remains pegged for a long period of time, this would actually place a large economic burden on the real economy. What is needed is a gradual adjustment of the currency in accordance with the state of the real economy. Chinese researchers as well as the Chinese government are well aware of this logic and have already made various proposals for adjustment.

Figure 7 shows the policy plan proposed to the government by a research group from Beijing University. This plan, the most highly praised among the current proposals, lays out concrete reforms and specific policy measures based on a four-stage process. The weakness of this otherwise comprehensive roadmap to free capital markets, however, is its failure to indicate a clear timetable. I would like to examine this proposal in detail.

The first step 1 proposes an indirect liberalization of the capital markets. This will require expedient solutions to several difficult issues like the reform of state owned enterprises and state-owned banks. Even if these reforms were to come fast, they could not be feasibly implemented before 2007, the deadline for China's promise to liberalize its markets, which it made in return for its WTO membership. Having said that, it would not be wise to postpone the reform of the commercial bank centered financial system any later than this. Though it was originally planned that all four commercial banks would go public at the same time, the tone of argument in China now suggests that each bank will be put on the market as soon as it fulfills the necessary requirements. Judging from the constitutions of the four banks, the Bank of China and then the Construction Bank of China will most likely be the first to be listed. In addition, a domestically based equity financing institution is currently being considered by foreign companies. For this, it will just be a matter of time.

Figure 7 – The Four Stage Capital Market Liberalization Proposal by Beijing University

Stage 1	**Indirect Liberalization of the Capital Market** ① Implement stronger reforms for state owned enterprises, facilitate the commercialization of national banks, improve the management of listed companies ② Establish joint foreign/Chinese investment funds and securities firms ③ Permit equity finances for A type stocks issued by foreign companies ④ Promote the establishment of Chinese stock investment funds abroad
Stage 2	**Conditional and Piecemeal Liberalization of the Capital Market** ① Integrate A type and B type stocks ② Strengthen exchanges between the domestic and the Hong Kong capital market
Stage 3	**Conditional Liberalization of the Capital Market** ① Permit foreign companies to be listed on the stock market ② Permit Qualified Domestic Institutional Investors (QDII) to invest in securities abroad ③ Eliminate barriers between the domestic and Hong Kong markets and integrate H stocks and red chip stocks
Stage 4	**Free Renminbi Conversion and Complete Liberalization of the Capital Market** ① Permit ordinary domestic investors to invest in securities abroad ② Permit foreign investors to invest in domestic securities

Source: Feng-qi Cao, Recommendation and Steps for Internationalizing the Capital Market, (Beijing: Beijing University Guanghua School of Management, 2002). [曹鳳岐,「建議内地資本市場国際化分四階段」]

Stage two consists of the piecemeal liberalization, with conditions, of the capital market. The investment into type A[4] stocks by qualified foreign institutional investors has been allowed through the adoption of the QFII system (December 2002). Going forward, as the range of approved qualified foreign institutional investors expands, the actual distinction between Chinese directed A stocks and foreigner director B[5] stocks will begin to lose significance and the ultimate convergence of A and B stocks will also just be a matter of time. Market relations between Hong Kong and China

[4] Type A stocks are stocks that are only available to Chinese investors.
[5] Type B stocks, traded in Shanghai with US dollars, and in Shenzhen with Hong Kong dollars, are stocks that were once only available to foreign investors. They have already been made available to domestic investors.

have also deepened as the top Chinese companies listed on the Hong Kong stock exchange continue to anchor the market. Hong Kong has even setup a representative station in Beijing in an attempt to entice more domestic companies to enter their market. Stronger ties with the Hong Kong market will also benefit Chinese companies by providing them with valuable experiences in such undeveloped areas as securities management and corporate governance in the public arena.

Step three proposes three measures: the listing of foreign companies on the domestic stock exchange, the investment into foreign securities by qualified domestic institutional investors (QDII), and the elimination of the barrier between the domestic and Hong Kong market. With the number of foreign direct investments into China now exceeding 400,000 cases, the demand for Renminbi by foreign companies is rising. However, the means for securing this demand are not sufficient. Thus, while improving the markets in Shanghai and Shenzhen, foreign companies that meet the market standards should be permitted a place in the market. The rapid expansion of the international account surplus and the influx of foreign currency brought about by foreign direct investment is generating more pressure for Renminbi revaluation. Thus heightening its ability to export by adopting the QDII system will be very important in China's current situation. Looking at the progress of the reform plan as a whole, once the indirect market liberalizations of step 1 are achieved in 2007, as promised, these will become a foundation for the market liberalizations described in stages 2 and 3, which most likely will occur shortly before or after the Olympics of 2008.

The free conversion of Renminbi and the comprehensive liberalization of the capital markets are the measures outlined in step 4. The shift of the Renminbi into a hard currency is the ultimate goal for exchange rate reform and capital market liberalization. In this state, the movement of capital in and out of the country will be completely free, ordinary domestic investors can freely invest in foreign securities, and foreign investors can freely invest in domestic securities. However, considering the lengthy processes and future uncertainties pertaining to the reforms and liberalizations set forth in stages 1 through 3, the liberal market envisioned in stage 4 will not be realized, at the very best, until 2010 or later.

These are the main arguments and policy proposals from the US and China. As for Japan, though arguments about the exchange rate have taken a spotlight in the mass media, there are very few constructive proposals and the arguments are generally confused. "In Japan, the arguments for an exchange rate regime are being mixed up with the arguments for a market based exchange rate," points out Masaru Yoshibumi, former director of the Asian Development Bank Research Institute. Former Minister

of Finance Shiokawa asserted that the Renminbi is completely undervalued yet he did not point to any basis for his claim. From the sound of them, these statements seem to be domestically directed messages rather than signals aimed at China.

Nor can it be said that Japanese academics are directly engaging the problem of the Renminbi exchange rate in their research. This issue must be discussed not simply on the level of how a revaluation would affect the Japanese economy or Japanese corporations but in the larger context of how to build a framework that would contribute to the growth, stability, and sustainability of the Asian economic sphere. As to the effect that the revaluation would have upon Japanese and US economies, it may not necessarily be the simple chain reaction of revaluation → reduced deflation → recovery of employment rate that many in the US and Japan imagine.

7. The Impact of Revaluation Upon the Japanese and US Economies

From the perspective of China's Japanese trading partners, it is very likely that the price effect of a Renminbi revaluation will reduce imports from and increase export to China, thus remedying the trade imbalance between the two countries. Constraints on Chinese imports is indeed the objective for the Japanese and US demands for revaluation. Particularly in recent years, it is being said that the importation of large volumes of low priced "Made In China" garments, processed foods, produce, and sundries – i.e. products of labor intensive manufacturing – are causing the domestic prices of goods in Japan and the US to fall, are furthering deflation, and are putting a strain on employment.

However, it is not necessarily certain that the Renminbi revaluation will bring about the expected price effect. The impact of the revaluation will change greatly depending on the amount of revaluation. But even if the Renminbi exchange rate were to be revalued by 20%, this may not have such a tremendous effect on China's international trade.

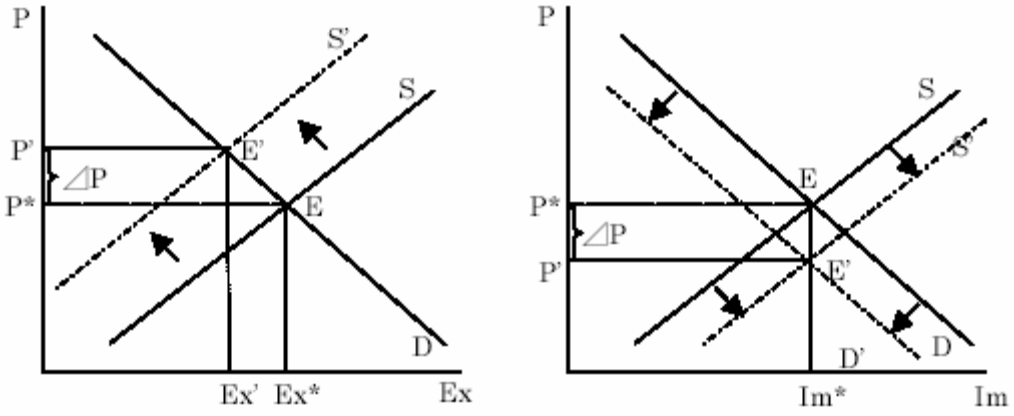
First of all, a look at China's international trade structure shows that over 50% of its exports are by foreign companies and, though the export products are definitely assembled in China, many of the parts and intermediary goods are procured from surrounding countries such as the ASEAN nations. In this production structure of "import parts and intermediary goods → assemble and manufacture products → export abroad," the amount of export price increase caused by a 20% to 30% adjustment in the exchange rate will be compensated by the drop in prices for imports. This can be

confirmed by looking at Figure 8.

In 8-1, the horizontal axis is export volume (Ex), the vertical axis is export price (P), D is the curve for export demand, and S is the curve for export supply. International trade becomes balanced at point E, when Ex* is the export volume, and P* is the export price. Now, if the Renminbi is hypothetically revalued by 20%, the export price can be expected to rise by just that much (ΔP=P'-P*). Because of the rise in export prices, the export amount can be expected to decrease accordingly (ΔEx=Ex*-Ex'). This mechanism is what is referred to as the price effect of the Renminbi exchange rate adjustment. Yet, from China's perspective, with its large procurements of parts and intermediary goods from abroad, the price effect of the exchange rate adjustments will also apply to its imports. Figure 8-2 shows the price effect on the imports of parts and intermediary goods. The horizontal axis is imports (Im), the vertical axis is import price (P), D is the curve for import demand and S the curve for import supply. Though the import price will decrease due to a Renminbi appreciation, if, hypothetically, the volume of imports does not increase, the price of imports will decrease by that much (ΔP=P*-P'). The lowered cost of importing parts and intermediary goods will compensate for the upward pressure on the export price for completed goods. In this way, the revaluation of the Renminbi may have a smaller impact than is expected.

Figure 8 – The Compensation of the Price Effect Caused by the Exchange Rate Adjustment

8-1 Rise in export prices due to revaluation　　8-2 Drop in import prices due to revaluation



Furthermore, the hiring of low cost labor is another factor that might inhibit the price effect of a currency exchange rate adjustment. Although there is a trend of rising employment costs along the coastal regions where the processing trade is focused,

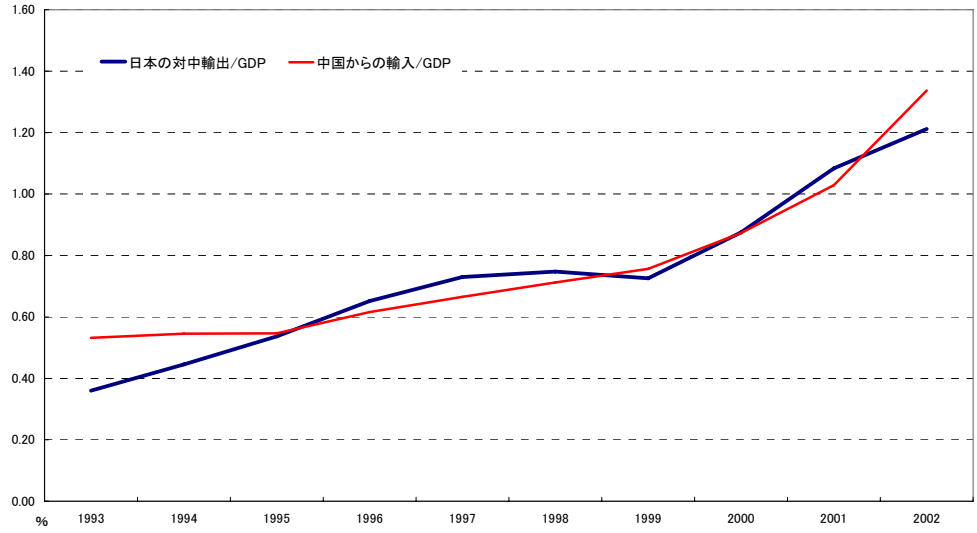
an effective way to keep down labor costs will be to bring in workers from the inland regions where employment costs are still cheap.

Japanese companies, by contrast, because they have not been actively pursing localization, have been employing Japanese personnel dispatched from the main office and are thus sustaining a high level of production costs. As a result, Japanese companies are now looking at the Renminbi revaluation as an opportunity to reduce the number of dispatched employees and push forward with the localization of management. Through such a maneuver they believe they can minimize the negative effects of the appreciation.

But when thinking now about the economic impact that the Renminbi revaluation will have upon the economies of Japan and the US, it is important to note, as shown in Figures 9 and 10, that Japan's trade with China consists of less than 3% of its GDP and that the US's trade with China consists of only about 1% if its GDP (both numbers from 2002). Thus, though the revaluation may somewhat remedy both country's trade deficits toward China, from a macroeconomic perspective it is hard to believe that this would have a large effect on the economy of either country.

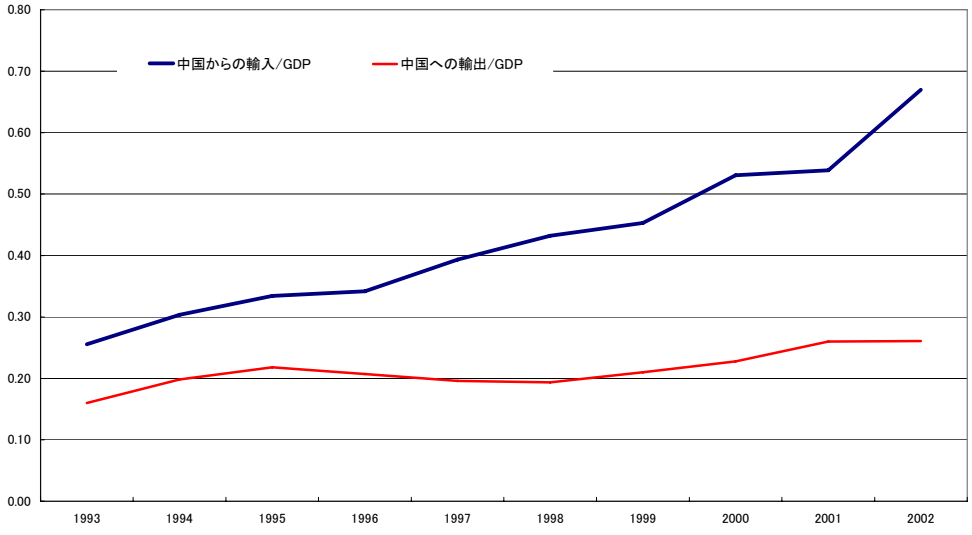
However, Japanese trade with China has been expanding as of late, an inevitable result of Japanese companies increasing their direct investments into China. While Japanese FDI was focused in the Southeast Asian countries of ASEAN in the 80s, due in part to the strengthening of the yen, Japan shifted the focus of its FDI toward China in the 90's. China's accession to the WTO in 2001 was also an important impetus for Japan to increase its investments into the country.

Figure 9 – Japanese Exports To and Imports From China as Percent of GDP (1993-2002)



Source: CEIC Data, IMF

Figure 10 – US Exports To and Imports From China as Percent of GDP (1993-2002)



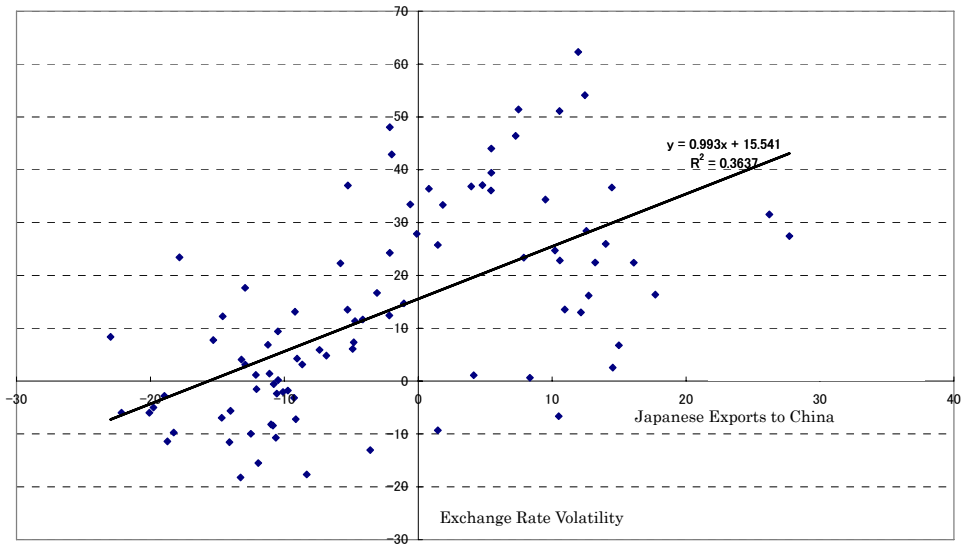
Source: CEIC Data, IMF

As has much existing research has already shown, the objective of Japan's investments in Asia has been to secure production bases with low employment costs. The products that are manufactured there, while also being sold in Asia, are in large

part imported back to Japan and re-exported to Europe and North America. In the 1990s, while employment costs in NIE and ASEAN countries went up drastically, the employment costs in China stayed relatively the stable. China quickly became the country of choice for re-export oriented manufacturing because it was also further along in terms of its legal system provisions, the streamlining of its distribution system, and improvements in its market environments. These were the factors that caused many Japanese companies to shift their investments from the Southeast Asian countries to China in the 90s. As a result, Japanese industrial clusters in the Guandong province and more generally in Southern China developed rapidly.

Most of the trade frictions surrounding agricultural products, processed food, and clothing that arise today between Japan and China are in fact what might be called "Japan-Japan" frictions between Japanese companies that have advanced into China and domestic companies in Japan. Thus, as trade friction between Japan and China begin to amplify, Japanese companies have become highly interested in Renminbi revaluation.

Figure 11 – Changes in the Yen/Renminbi Exchange Rate and Japanese Exports to China (1993-2002)

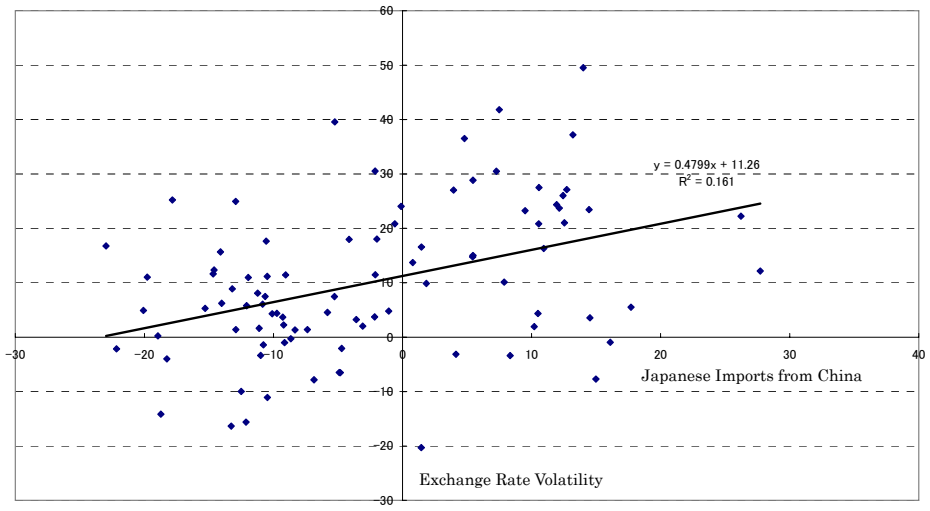


Source: CEIC Data, IMF

Because a Renminbi revaluation would necessarily effect the yen/Renminbi rate, the problem from Japan's perspective is figuring out what kind of impact Japan-China trade will absorb from such an adjustment. As the Renminbi is fixed to the US dollar, the yen/Renminbi exchange rate changes daily according to changes in

the yen/dollar rate. Figure 11 shows the relationship between the volatility of the yen/Renminbi exchange rate and Japanese exports to China while Figure 12 shows the relationship between the volatility of the yen/Renminbi exchange rate and Japanese imports from China. As can be seen in these figures, the level of Japan's trade with China has not had a strong correlation with the fluctuations of the yen/Renminbi exchange rate. For example, even when the Renminbi appreciated with respect to the yen, Japanese imports from China did not decrease (R^2=0.161). On the contrary, the appreciation of the Renminbi became a slight stimulus for Japanese exports to China. Though judging from the R^2=0.364 situation this impact was also rather limited.

Figure 12 – Changes in the Yen/Renminbi Exchange Rate and Japanese Imports from China (1993-2002)



Source: CEIC Data, IMF

In 2002, the US trade deficit toward China reached $103.2 billion. According to the predictions of the US Department of Commerce, the trade deficit will reach $130.0 billion in 2003. Amidst these forecasts, while Treasury Secretary Snow is outwardly calling for Renminbi revaluation, what he really wants is an expansion of China's agricultural imports from the US. When he visited China in September of 2003, the Treasury Secretary requested that the Chinese government expand its imports of US beans and other agricultural products. Following the Treasury Secretary's visit to China was a visit by Mr. Zerich, representative of the USTR, and then a visit by Commerce Secretary Evans. Speaking on the currency problem, both of them implicitly requested that China expand its imports from the US. Soon after the

visit of Commerce Secretary **Evans** in October of 2003 and shortly before Prime Minister Jiabao's scheduled visit to the US, China announced the dispatch of a Chinese mission to buy Boeing airplanes, GM cars, and GE engines. The total figure for the purchase is said to reach $6.7 billion. Based on this series of maneuvers, the following intentions can be construed:

1) Because of the current fragility of China's financial system, the adjustment of the Renminbi exchange rate and the liberalization of the capital market, if executed in the short term, will incite another currency crisis. These issues, instead, are problems that must be engaged on a mid- to long-term basis.
2) As the US presidential elections approach (Fall 2004), the trade deficit with China is being blamed for certain negative effects upon US domestic employment. Thus, it seems that Bush is trying to gather votes by demanding that China expand its US imports.
3) If the Renminbi were actually revaluated, American multi-national corporations that have advanced into China will most likely sustain heavy losses. While the US is seeking exchange rate adjustments in the mid- to long-term, it is aware that a stable Renminbi is the short terms will mean very large gains for the it multinationals.
4) From China's standpoint, it is necessary that it has the US's understanding with regard to maintaining a stable currency. The US is China's largest surplus trading partner and its largest export market. Thus, it is necessary for China to avoid, as much as possible, trade frictions with the US through its purchase of high-tech manufactured products. By purchasing from representative US multi-national corporations like Boeing, GE, and GM, China hopes to leverage the influence that such companies have on the government to mitigate the pressure it receives for currency revaluation.

The exchanges between the US and China on the issues of trade and diplomacy is something that will continue. Especially because China, though it may make larges purchases US products, has shown that it intends to hold on firmly to its national sovereignty with regard to its currency rates and will not bow down to the outside pressure of the US. Part of this has to do with the Jintao-Jiabao administration being in its first year in office and dealing with various issues both domestic and foreign. At the same time, with its accession to the WTO in December of 2001, China has invigorated its economic ties with other Asian nations. Thus, from its standpoint as a

leader to the Asian region, China will not allows itself to yield to the US on the issue of currency exchange.

8. The Impact of the Renminbi Exchange Rate Adjustment Upon Japanese and US Corporations

Japan and the US differ greatly in terms of the industrial makeup of their corporate investments into China. As shown in Figure 13, 57% of the US businesses that have penetrated the Chinese market were manufacturing companies (2002). The manufacturing investments are focused in computer and energy related enterprises. Furthermore, the financial industry takes up a large portion of US investment activities. In comparison, as shown in Figure 14, 88.3% of Japanese businesses in China are manufacturing companies, clearly much higher than the US, and Japanese manufacturing in China mainly consists of electronics, transport machinery, and chemicals.

The differences in Japanese and US investment into China, however, are not just limited to the industrial characteristics of manufacturing and non-manufacturing. The investment strategies of the two countries also differ greatly.

First of all, US corporate investment into China has been an attempt to approach the overall Asian market, the center of which it sees as China. Especially in the latter half of the 1990s, US multinationals such as Microsoft, GE, and GM advanced into China all at once. US FDI into China was actually somewhat delayed during the 1980s because it feared that China would fold on its "reform and liberalization" policies. But from the middle of the 90s onward, the US became confident that China's policies as well as its development of a market economy would not be able to fall back on itself and the representative companies began to focus their investments into the country.

In contrast to this, Japan's FDI into China can be traced back to the 1980s. The investments at that time, however, were not targeted toward the Chinese market. The rectification of Japan-China relations had brought forth a wave of Japanese investments into China, a large part of which was "homesick investment" on the part of Japanese business executives. In other words, there were many Japanese business managers that were born in Manchuria or had some connection to pre-war China. "Homesick investment," more than being aimed at investment returns, were based on the investors' personal affections for the country.

The other characteristic of Japanese FDI into China was that it was spurred by an investment boom. Ordinarily, the decision to invest is based on thorough marketing

research and the formulation of a business model that takes into consideration the placing of the target company and the pricing of the products. However, not a few Japanese companies went ahead with their investment without so much as forming a strategy, blindly obeying the calls of their presidents and chairmen.

It is evident from the fact that, over the years, Chinese business has accounted for less than 5% of the sales and revenue of the larger business group that Japanese corporations have not been devoting as much energy in this sector as they are said to. For Japanese corporations, while European and US markets were very important export destinations, China was still a latent market. A slight change in the Japanese consciousness toward China was noticed when the nation received its membership to the WTO. Japan's view of China as simply a production base for export goods has shifted over the past two years, and continues to shift, toward the perception of China as a hopeful market.

Just as the investment purposes for Japan and the US differ, so too do their investment strategies. Internationalizing its investments and pursuing localization, the US's strategy for investment in China is just one part of its larger globalization strategy. A comparison of the globalization strategies between US, Japanese, and Chinese companies can be found in Appendix 2. The TNI index[6] of US multinational corporations is 54.98%: their proportion of foreign assets is 59.09%, their proportion of sales from abroad is 48.49%, and their proportion of foreign employees is 57.35%. Such figures clearly show that global management has permeated these corporations. (All data for 2001.)

[6] (Trans-nationality Index) The index is calculated by averaging the proportions for foreign assets, foreign sales, and foreign employment.

Figure 13 – US FDI into China by Industry (1994-2002)

	All Industries	Oil	Manufacturing								Non Manufacturing				
			Total	Food	Chemicals	Metals	Mech. Equip.	Electronics	Trans. Machines	Other Manufact.	Wholesale	Financial Instit.	Services		Other
1994	100	34.9	39.1	5.1	8.6	4.0	N.A.	6.6		8.5	5.2	12.7	2.8		5
1995	100	34.3	45.6	3.9	7.5	4.1	N.A.	15.6	N.A.	6.8	7.0	7.3	0.1		5.4
1996	100	26.4	47.7	4.8	7.7	3.1	4.5	19.3	N.A.	N.A.	5.8	12.7	1.9		5.3
1997	100	17.9	54.2	4.9	7.4	3.0	N.A.	21.8	1.1	N.A.	6.9	14.3	1.4		5
1998	100	14.7	60.8	2.6	5.1	3.1	10.3	27.7	0.5	11.1	3.0	11.8	1.1		8.3
	All Industries	Mining	Total	Food	Chemicals	Metals	Machinery	PC Related	Trans. Machines	Electric Related	Wholesale	Services	Public Enterprise	Information	Other
1999	100	-2.6	64.7	2.9	1.9	2.4	-4	33.2	20.3	0.1	6.7	-2.8	5.8	-0.2	28.1
2000	100	23.8	73.3	0.4	-2.5	-2.2	1.7	65.8	0.9	4.1	5.5	0.8	-1.2	1.6	-3.6
2001	100	-9.5	130.3	3.5	-4.6	-1.6	0.4	67.5	-3.9	62.8	1.1	4.9	-8.9	-1	-6.7
2002	100	24.9	56.5	5.5	17.5	-2.2	3	2.5	13.4	-7.6	9.9	8.4	6.3	-1	-4.3

Unit %

Source : Figures are derived from US Department of Commerce data

Figure 14 – Japanese FDI into China by Industry (1993-2001)

	1986	1990	1994	1995	1996	1997	1998	1999	2000	2001
Food	2	3	5	3	7.3	4.8	7.6	3.5	2.1	0.7
Textile	0.4	6	13	11	7.5	11.2	3.4	3.6	2.7	2.4
Lumber/Pulp	0.4	0	0.4	2	1.6	1.5	0.7	0.4	0.5	1.5
Chemicals	2	4	4	3	3.5	6.6	11.1	11.9	6.0	10.3
Ferrous/Non Ferrous Metals	1	14	6	8	7.2	7.4	6.9	5.7	4.2	9.0
Machinery	1	6	5	11	11.3	9.5	8.3	5.2	8.6	9.0
Electronics	2	0.4	19	21	15.7	21.2	11.9	8.9	32.5	35.5
Trans. Machinery		9	9	9	9.9	5.0	13.0	12.4	10.0	14.3
Others	1	46	11	11	7.9	8.9	11.9	20.4	10.9	5.6
Manufacturing Total	**10**	**0.4**	**72**	**78**	**71.9**	**76.1**	**75.3**	**72.0**	**76.4**	**88.3**
Agriculture/Forestry	0.2	1	0.1	0.4						
Fishery and Marine Products	1	6	0.3	0.2	0.2			0.1		
Mining	1	2		0.2	0.2	0.1				
Construction		1	3	2	2.4	3.3	5.9	0.1	0.3	0.1
Commerce	9	1	6	6	5.1	5.1	3.1	8.5	5.6	6.5
Finance/Insurance	1	39	0.04		0.8		2.8		0.4	2.2
Services	45	0.2	8	4	10.1	7.3	7.1	12.3	15.2	2.3
Transportation	0.4	3	1	1	0.8	1.3	0.5	2.3	0.5	
Real Estate	6	53	5	6	6.9	5.4	3.2	0.4	1.3	0.6
Other	4	1								
Non Manufacturing Total	**66**		**24**	**20**	**26.5**	**22.5**	**23.0**	**23.7**	**23.3**	**11.6**
Branch	23		4	2	1.6	1.3	1.6	4.3	0.2	0.1
Total	100	100	100	100	100	100	100	100	100	100

Source: Ministry of Finance, "Inward and Outward Direct Investment" (Annual Edition)

Though it is often pointed out that Japanese corporations are lagging in their globalization efforts, while the globalization of business management is slightly behind the US when just looking at certain factors of the TNI, it is not all that delayed when looking at the index as a whole. The proportion of foreign assets in Japanese multinationals is 37.39%, the proportion of foreign sales is 49.05%, and the proportion of foreign employees is 43.36%. (All data for 2001.)

As Japanese corporations continue to expand abroad, however, there is a still much room for improvement in their management systems. Though the proportion of foreign employment has exceeded 40%, the number of foreigners in executive positions remains low. Moreover, because Japanese corporations are late in adopting performance based methods in their main offices, the adoption of these methods in their local branches abroad have become significantly delayed, particularly when compared to those of American and European corporations.

Thirdly, in comparing US and Japanese companies, because Japanese companies produce much of their products by themselves, they have a strong tendency to overrate their technologies. Also, while Japanese companies have extremely sophisticated technologies with respect to cars, IT products, and digital equipment, their overseas sales strategies and after-services are not quite up to par. Such unevenness is based on the Japanese business conception that "a good thing will sell." But the time for "a good thing will sell" was the 80s. After the mid 90s, with oversupply occurring on a global scale, business suddenly entered a new phase in which good things did *not* sell. Closely related to this business conception was the belief that "whatever will sell in Japan will certainly sell in Asia." Thus, there was no active product planning for the Asian market. Mobile phones are good example. Though the phones sold in Asia came with an email function, the Japanese manufactured phones did not support Asian languages like Chinese, Korean, or Thai. Likewise, many product plans lacked an Asia version.

On the other hand, the Asian-China strategies of US corporations have recovered under the stimulus of the IT boom in the late 90s. Even now, representative US companies like Microsoft and GM are building serious R&D centers in China. Why does Motorola's mobile phone sell in China? Aside from the fact that it is excellent technology, it has also been built through Chinese product planning.

After becoming a member to the WTO in December of 2001, China has fully emerged as the "factory of the world." Meanwhile, China has been very active in negotiating free trade agreements with the ASEAN nations and otherwise enthusiastically pursuing economic diplomacy. The strengthening of the mutual

economic interdependence of Asian countries will contribute greatly to the efficiency of the region's resource distribution and the sustainability of its economic growth. In 1997, the Asian Currency Crisis, set off by the crash of the Thai baht, taught Asian countries several lessons. Most important was that Asia needed to strengthen its economic alliances. Economic growth that was dependent upon the exports of the US was unreliable. In order to create sustained economic growth, Asian countries needed strengthen their affiliations amongst themselves by promoting regional interdependence, inter-regional trade, and fostering a common regional market. While Asian countries are currently headed in this direction several problems still remain.

For example, the accounting currency of most of Asian intra-regional trade has always been the US dollar. Even if regional trade is expanding, the main Asian currencies – China (in effect, pegged to the dollar), the Hong Kong dollar (currency board), Singapore (currency board), and Malaysia (dollar peg) – are all stabilized to the dollar. Though a currency tied to the dollar may contribute to the expansion of exports abroad to the US, it is also capable of hindering the development of intra-regional trade. That is to say, under the openly established trade structure of "parts procurement from the Asian regions → product assembly in China → export to the US," the dollar-pegged currency makes it difficult to make any policies for a common Asian market.

In this context, let us consider what will happen to Japanese and US companies if the Renminbi were to appreciate.

The merits and demerits for Japanese and US companies with regard to the Renminbi appreciation are not cut and dry. 1) For companies that procure parts from other regions (i.e. countries outside of China) and sell their products domestically in China, the appreciation of the Renminbi will come as a great benefit. Among Japanese and US companies, there are many companies who are developing their strategies based on this business model. 2) For companies who procure their raw materials from within China and export their products abroad, the appreciation of the Renminbi will mean a rise in costs, which will translate into profit losses. These are the companies that are causing trade frictions between Japan and China in their production of processed foods, agriculture, and garments. 3) For those companies that procure all or part of their raw materials from abroad, commission their production to local dealers then import to local dealers, i.e. the Uniqlo model, it is expected that the Renminbi appreciation will cause human resource costs to rise and decrease the advantage in outsourcing to China.

Nonetheless, even if it becomes less advantageous to do business in China, as is expected from a currency appreciation, it is hard to believe that companies will

suddenly rethink their China strategies, fold up shop and leave. From the perspective of many foreign companies, China is gradually transforming from "the world's factory" to "the world's market," presenting tremendous potential for business in the coming years. Cars are a good example. Thinking that China's motorization would not happen until much later, Japanese automakers had been holding off on their investments into China. On the other hand, Europe (German automakers in particular) and the US (GM) have several successful investments already under their belts. In a sudden effort to catch up, Japanese automakers have begun to zealously engage the Chinese market and have made remarkable advances in the past one to two years. With Honda in Guangzhou, Nissan in Wuhan, and Toyota in Chanchun, Tianjin, Sichuan, and Guangzhou, Japanese automakers are visibly strengthening their production infrastructure in China.

According to a report by the National Bureau of Statistics of China, only 1% of urban households own a car. What does this number mean? The fact that only one urban household for everyone one hundred owns a car undoubtedly means that the country has not yet become motorized. From the perspective of Japan, however, a late entrant into the Chinese market, this can also mean that it still has a chance.

Up until now, foreign companies entering the Chinese market have invested with a sense of security in that they did not have to worry about the risk of foreign exchange rates. In fact, many Japanese companies have invested without anticipating the possibility of exchange rate adjustment. Thus, the important work for Japanese companies going forward is the creation and strengthening of systems to manage the rise in risk that can be expected from the adjustment of the Renminbi.

9. The Direction of the Hong Kong Economy and How It Will Influence the Renminbi Exchange Rate Policy

When thinking about the exchange rate policy for the Renminbi it is all too easy to forget about the existence of Hong Kong.

On July 1st, 1997, Hong Kong changed its sovereign from British colonial rule to the 'One Country, Two Systems' arrangement under China. Yet, haplessly for Hong Kong, the Asian Currency Crisis erupted July 2nd, the very next day after it reverted to China. Attacked by international financial speculators, mainly made up of American hedge funds, the currencies of Thailand, Malaysia, Indonesia, Korea, and the Philippines all crashed simultaneously. The governments of these countries almost exhausted the foreign currency reserves that they had kept to protect their currency,

and Thailand, Indonesia, and Korea were pushed to the edge of bankruptcy. It was into this financial crisis that Hong Kong was suddenly plunged. Hong Kong was able to sustain itself because its currency was fixed to the dollar through a currency board. However, the heavy fall in real estate prices caused serious deflation and the level of unemployment rose rapidly. Because the dollar peg meant that it could not realistically implement a monetary policy, the Hong Kong government decided on a fiscal stimulus package as the way to reinvigorate the economy. Yet, as a result, in addition to plunging further into deflation and unemployment, Hong Kong's budget deficit shot up (in 2002, the budget deficit was 5.3% of GDP).

Figure 15 – Economic Indicators for Hong Kong, China, and Japan

	Hong Kong	China	Japan
Growth Rate of Real GDP	2.3	8.0	0.3
Growth Rate of Nominal GDP	-0.7	6.7	-1.3
Consumer Price Index	-3.0	-0.8	-0.8
Treasury Budget/GDP	-5.3	-3.0	-4.5
Currency Exchange Rate System	Fixed to the US dollar through a currency board since 1983	Technically a managed floating rate system, the currency is in effect fixed to the US dollar	Floating rate system

Source: R&I

The causes of Honk Kong's recession can be found in its structural problems and policy management failures. At one point, its strength lay in its free markets and its role as a center for international financial service distribution. In recent years, however, as China's economy has begun to rise, the freight that had once gone via Hong Kong to China is now being sent directly to Chinese harbors such as Shanghai. In addition, though Hong Kong was once the window into China for foreign investors, China's accession into the WTO has now made it less and less necessary to go through Hong Kong.

Thus, it is easy to understand why Hong Kong locals, in the middle of a recession and now aware that the Renminbi is undervalued, are increasing their Renminbi-based assets. In fact, with Renminbi being brought from domestic Chinese visitors, the amount of Renminbi circulating through Hong Kong is now around the level of $80 billion. Moreover, local shops and convenience stores in Hong Kong have

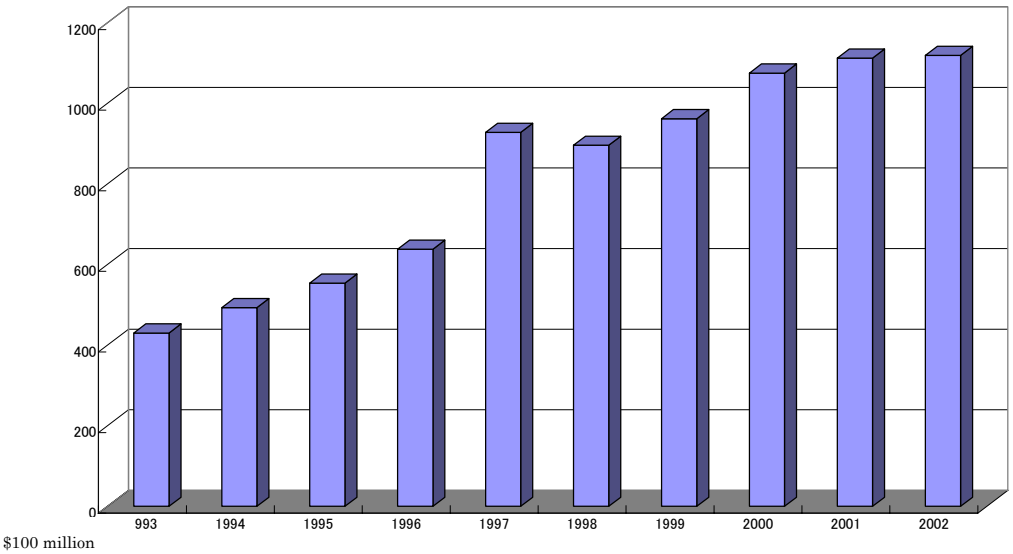
begun to accept payments in Renminbi. In effect, a dual currency system is gradually beginning to take root in Hong Kong.

From a mid-term point of view, the day in which the Renminbi will drive out the Hong Kong dollar cannot be too far away.

For China, the treatment of the Hong Kong dollar is a problem that has clearly surpassed the realm of economics. Upon the reversion of Hong Kong in 1997, the Chinese government promised the people of Hong Kong that the 'One Country, Two Systems" arrangement would be strictly preserved for the next 50 years. Included in this divide were the various systems pertaining to currency. Thus, it would not be easy for China to absorb the Hong Kong dollar and begin circulating Renminbi in Hong Kong. Taiwan is another problem. From Taiwan's point of view, the sudden onset of a recession in Hong Kong immediately after its reversion to China has become a reason for rejecting China's overtures for a peaceful integration. On the other hand, breaking the promise to uphold the 'One Country, Two Systems' policy would only give new firepower to the independence faction in Taiwan. Thus, from China's point of view, it is politically unwise to adjust the Renminbi exchange rate without taking the Hong Kong dollar into consideration.

In 2003, in an effort to revive the Hong Kong economy, the Chinese government rushed to sign the Closer Economic Partnership Arrangement (CEPA), which essentially amounts to a free trade agreement with Hong Kong. At the same time, it decided to condone the Renminbi transactions (exchange, deposit, and account settlement) of Hong Kong banks.

Figure 16 – Hong Kong's Foreign Currency Reserves (1993～2002, annual balance)



Source: IMF

With Hong Kong's foreign currency reserve of about $100 billion, it is hard to believe that the economy could enter a crisis and go bankrupt in the near future. However, judging from its structural problems, that is to say the shift of the manufacturing and service industries toward China, the Hong Kong economy may start hollowing out with increasing speed. However, the burgeoning strategic unification of the Hong Kong economy with the Southern China economy may likely give rise to a large new economic bloc with Hong Kong as its center. According to the predictions of an HSBC economist, the signs say that Hong Kong's outstanding balance for Renminbi will reach 150 billion by the year 2006, and 300 billion by 2010. This gives us further reason to believe that the complete replacement of the Hong Kong dollar by the Renminbi cannot be too far away.

Generally speaking, China will proceed with its financial system reforms while keeping an eye on the developments of the Hong Kong economy. Meanwhile, it is likely that China will continue, if cautiously, to promote the hard currency conversion of the Renminbi.

10. In Conclusion: The Outlook for Renminbi Exchange Rate Adjustment

The Chinese economy has reached an important turning point. From the 80s to the 90s, China has produced large results by gradually pursuing a policy of "reform

and liberalization." The domestic production in 2000 was more four times the size it was when the "reform and liberalization" policy was first announced. Moreover, the economy has grown to the extent that its presence is now regarded as a "threat" by the international community. With the expansion in scale of its domestic market, China now has the world's attention as the next great global market and continues to receive large amounts of FDI. While the world is struggling under economic recession, the Chinese economy alone has shown positive signs. Finally, China has strengthened its economic affiliations with other Asian countries by actively engaging them in negotiations for free trade agreements. This is what one might call the bright side of the economy.

On the other hand, however, we must not forget the shadows that haunt the economy. Various structural problems such as the ineptly managed SOEs, the inefficient monetary system, the expanding income gap, the issues of farmers and agriculture, and the lack of energy resources are all risk factors that present potential constraints to economic development.

Thus, China sustains two contradictory facets to its economy, a light side and a dark side. Though it has already overcome many twists and turns to finally walk the road of economic growth, it is likely that the uncertainties surrounding the Chinese economy will grow in the future.

Yet, as the economy continues to increase its presence on the global stage, the international community has strengthened its call for more liberalized markets. This demand has now taken the shape of the currency exchange problem. If one considers China's export competitiveness, a slight appreciation of the Renminbi would not seem to be much of a problem. However, when one understands the fragility of the Chinese financial system and the large amounts of bad loans still held by the state-owned banks, one sees that there is nothing to do but postpone the adjustment and the full liberalization of the economy.

Nonetheless, it is necessary to establish a timetable for action. By the time China fully liberalizes its markets in the year 2007, a commitment it made as part of its initiation into the WTO, the reforms of the commercial banks and the disposal of bad loans should be complete. Because this will require capital reinforcement of the commercial banks in 2004-05, there is a strong possibility that the national government will make another capital injection into the commercial banks (the first injection, of 270 billion Renminbi, was made in 1998). Another round of purchases of the bad loans, moreover, by national assets management companies is also very possible. Through such surgical operations, China will be able to list the stocks of its commercial banks on

the stock market by 2005-06.[7]

However, the adoption of systems for QFII (Qualified Foreign Institutional Investors) and QDII (Qualified Domestic Institutional Investors) makes it clear that the liberalization of the market will be piecemeal. Though China will most likely continue its strict monitoring of capital movement until 2007, it likely that it will apply the experience gained during this period to more adeptly ease the regulations in 2008, around the time of the Beijing Olympics. The actual realization of a completely liberalized market will most likely occur after the Shanghai World Exposition in 2010.

The adjustment of the Renminbi exchange rate will occur gradually alongside this schedule for system reforms and market liberalization. Taking into account the lessons learned from the 1997 currency crisis, it is hard to believe that China would rush the liberalization of its capital markets. But thinking realistically, it is very possible that, while preserving the regulations on the capital markets, the band of fluctuation in the exchange rate would be widened from below 1% where it is today to 5% in 2007, around the time when the bank markets are liberalized. Though Goldstein & Lardy have proposed that the Renminbi be pegged to a yen-euro-dollar currency basket, there seems to be little possibility for this seeing that the majority of China's international trade is settled in US dollars. Second, it is likely that China, while keeping an eye on the progress of capital market liberalization, will continue pushing toward complete freedom in converting currency, i.e. creating a hard currency. Judging from the maintenance of its trade surplus, upward pressure on the exchange rate will continue. However, whether the currency will be revaluated or not will depend not just on the international accounts but also on many uncertain factors such as the movement of capital outside and inside China and the direction the Chinese economy will take in the future. But more important for Japanese companies than this type of fortune telling is the rapid institutional preparation for currency exchange management and currency exchange risk, two measures which it has not taken for its investments thus far.

Appendix 1: Chinese Economic Problems from a Macroeconomic Perspective

Here, let us consider the Chinese economy's structural problems.

The balance equation for economic growth that one finds in a macroeconomic

[7] Though it has been understood that the four major state-owned banks would initially enter the market all at once, another proposal has arisen to allow each bank to enter the market as soon as it meets the necessary requirements. The Bank of China and the Construction Bank of China have been mentioned as viable candidates.

textbook, $Y=I+C+Ex-Im$ (Y: GDP, I: Investment, C: Consumption, Ex: Exports, Im: Imports), can be rewritten as:

$$Y-C=I+Ex-Im$$

Because $Y-C=S$ (S: Savings) the above formula can be rewritten in the following way.

$$S - I=Ex-Im$$

This formula is generally referred to as the two-gap balance equation. Here, S can be divided into S_d (domestic savings) and S_f (foreign savings). S_f consists of foreign capital procurements primarily made up of foreign debt and foreign direct investment.

$$S_d+S_f- I=Ex-Im$$

Because China has a current account surplus, this formula can rewritten again as follows:

$S_d+S_f-I>0$, which, in other words, becomes $S_d+S_f>I$

This inequality, $S_d+S_f>I$, means that even though one might have an influx of foreign currency (S_f) that is greater than the demand for investment (I), as long as savings ($S=S_d+S_f$) does not sufficiently meet investment, the macroeconomic marginal productivity will not improve. This is a problem that can be seen in most developing countries and its chief cause is the fragility and the inefficiency of the financial system.

Up until now, because the majority of China's foreign currency procurements have taken the form of FDI, there have been no solvency problems (i.e. debt repayment problems). However, going into 2003, there has been a change in China's methods for foreign currency procurement. Foreign debts have suddenly increased from January to June, when the outstanding balance reached $182.5 billion, an increase of $14.0 billion ($11.2 billion of which is short term debt) from the end of the previous year. Moreover, of all the foreign debt, short term foreign debt has grown to $61.2 billion, its proportion to the total debt reaching 35.2%, which far surpasses the alert level of 25%.

Considering that China holds foreign currency reserves in excess of $400 billion, its hard to imagine that the country would encounter problems paying debts, let alone fall suddenly into a debt crisis. Nonetheless, because short term debt has reached the high level of 35%, the strategies of the government's debt management will become a new issue going forward.

Figure 17 – Rate of Saving and Rate of Investment（1995～2002）

	1995	1998	1999	2000	2001	2002
Domestic Savings Rate (S_d)	42.5	40.8	39.4	38.9	38.5	39.4
Foreign Procurements (S_f)	6.4	5.8	4.9	4.6	4.9	5.2
$S_d + S_f$	48.9	46.6	44.3	43.5	43.4	44.6
Investment Rate (I)	40.8	37.7	37.4	36.3	39.0	41.0

Source: ADB, "Key Indicators 2003."

Appendix 2: The Foreign Dependence of Japanese, US, and Chinese Multi-National Corporations Using the TNI Index

Here, I would like to use the TNI index to examine the investment strategies of Japanese, US, and Chinese multi-nationals. TNI is an index that measures the level of a company's foreign dependency by averaging the three proportions of foreign assets (foreign assets / total assets), foreign sales (foreign sales / total sales), and foreign employment (number of foreign employees / total employees).

1. The Characteristics of Japanese, US, and Chinese multinationals from the perspective of industrial category

A comparison of the top ten multinationals in Japan, the US, China puts the overseas industrial composition of these countries into sharp relief. In Japan, the exports of cars, electronic devices, and semi-conductors form the engine for economic growth. Out of the ten global companies, eight of them are manufacturing companies. Four are electronics companies, three are car companies, and one is a tire manufacturing company.

Figure 18 – The Foreign Dependency of the Top 10 Japanese, US, and Chinese Multinationals

Japan (2000)	TNI %	**US** (2000)	TNI %	**China** (2001)	TNI %
Bridgestone	65.91	Exxon Mobil	67.69	China National Cereals, Oils & Foodstuffs Imp. & Exp. Corporation	41.62
Honda	59.46	Coca-Cola	66.96	SINOCHEM Corporation	39.37
Sony	57.18	Carnival	64.69	China Ocean Shipping Company (COSCO)	30.92
Nissan Motors	44.59	McDonald's	61.77	China National Offshore Oil Corporation	27.47
Canon	40.92	IBM	53.49	China State Construction Engineering Group	26.82
Nissho Iwai Futures	39.73	Pfizer	51.08	China National Trust and Investment Corporation	19.13
Panasonic	39.26	Dow Chemical	48.27	China Harbor Engineering Company	17.99
Toyota	35.00	Chevron Texaco	47.23	Haier	8.77
Fujitsu	31.67	Conoco	44.52	Shougang Group	8.76
Marubeni	29.28	Motorola	44.07	ZTE	5.92
Average	44.37	Average	54.98	Average	22.65

Source: UNCTAD

Compared to this, perhaps because the US is the world's largest consumer of energy, oil related companies have their names amongst its top ten multinationals. Electronics companies are also represented except not by household gadget manufactures but by PC related IBM and the communication device maker Motorola, who both take the top spots. Besides the three oil companies and the two electronics companies, there is one company each from the industries of services, tourism, food products, restaurant chains, pharmaceuticals, and chemicals.

With China, on the other hand, the majority of global corporations are government owned. Among these are three specialized trading companies that are respectively in the business of trading food products, petro-chemicals, and mining products. Then, there are two building companies involved in the construction of infrastructure such as ports and harbors while the others are companies that deal in transportation, oil, steel, communications, and household electronics. The industrial composition of Chinese global corporations is a result of government direction and the majority of the businesses are designated "priority companies" by the government.

2. Foreign Dependence of the Japanese, US, and Chinese Multinationals as

Seen Through the TNI Index

The nature of foreign dependence that multinationals from each country exhibited was used to examine the differences in the general foreign investment strategies of these countries.

When the average TNI value for the top ten multinationals in each nation was calculated, as could be predicted, the US had the highest average with 54.98%, Japan was next with 44.37%, and China was third with 22.65%.

Figure 19 – Proportions of Foreign Assets, Foreign Sales, and Foreign Employees for the Top Ten Japanese, US, and Chinese Multinationals (%)

	Proportion of Foreign Assets	Proportion of Foreign Sales	Proportion of Foreign Employees
Japan	37.59	49.05	43.36
US	59.09	48.49	57.35
China	35.60	29.62	2.81

Source: UNCTAD

The difference in the foreign strategies of these countries becomes even clearer if the three values of the TNI, share of foreign assets, share of foreign sales, and share of foreign employees, are looked at separately (Figure 18).

In the case of Japanese corporations, since their foreign investments are fundamentally targeted toward re-exports, their share of foreign sales is the highest of the three values at 49.05%. Because these corporations also hire a great deal of foreign labor for their manufacturing operations, their average share of foreign employees has reached 43.36%. In comparison, the average share of foreign assets is relatively low at 37.59% (2000).

With a higher foreign dependency than Japan, the US multinationals have the highest average share of foreign assets at 59.09%. The proportion of foreign employees to total employees is also high at 57.35%. Their share of foreign sales was relatively lower at 48.49% (2000).

The highest percentage for Chinese global corporations was their share of foreign assets, which has reached 35.60%. Similar to Japan in its strategy to promote exports, their share of foreign sales is also high at 29.62%. However, since Chinese global corporations hardly have any production activities abroad, their share of foreign

employees is a mere 2.81% (Figure 19). (2001)

In summary, it is not perhaps fair to say, as far as examining the TNI is concerned, that the performance of Japanese foreign investments are poor because they are delayed in their localization. Japanese companies' share of foreign employees has risen greatly under its re-export directed investments. What is important from now on is for Japanese companies to first carry out a new strategy of local production and local sales. Once this is done, they must work to establish a localized the management, a directing body that would naturally plan for more local decision-making and a more efficient marketing strategy.

Chronology: Changes in the Chinese Management of Foreign Currency Exchange

1979		Adoption of a foreign currency reserve
1979	March	Establishment of State Administration of Foreign Exchange
1980	April	Circulation of foreign bank notes begins (Bank of China)
		Induction into the IMF
1980	October	Begins adjusting the foreign currency holdings of government owned companies
1980	Dec.	Implementation of Provisional Regulation on Management of Foreign Currency.
1981		Adoption of dual foreign exchange market
		Setting of exchange rate for tourists at $1=1.5 Renminbi
		Setting of exchange rate for trade at $1= 2.8 Renminbi
1985	Jan.	Elimination of the dual foreign exchange market; the exchange rate becomes unified
1988		Creation of a transnational network of Foreign Currency Adjustment Centers
1988		Adoption of the contract system for foreign trade
1990		Fall of Renminbi exchange rate to 5.22 (from 2.8 in '85)
1991		Adoption of the subsidy system for foreign trade
1993	Nov.	Declaration of a socialist market economy
1994	Jan.	Elimination of foreign bank notes (circulated until the end of '94)
		Elimination of official exchange rate ($1=8.7 Renminbi at market rate)
1994	April	Establishment of (interbank) China Foreign Exchange Trade Center in Shanghai (currencies traded: US dollars and Hong Kong dollars)
1994	Aug.	Adoption of an inspection system for imports bought with foreign currency
1995	March	Yen becomes a traded currency at the China Foreign Exchange Trade Center
1996	Dec.	Liberalization of foreign currency trade related to current accounts (IMF Article 8)
1997	Jan.	Announcement and implementation of Foreign Currency Management Regulations
1997	July	Asian Currency Crisis
2000	Feb.	Implementation of the Renminbi Management Regulations
2001	Dec.	Induction into the WTO
2002	April	Adoption of the Euro at the China Foreign Exchange Trade Center
2002	Nov.	Beginning of talks concerning an ASEAN free trade agreement
2002	Dec.	Permission for qualified institutional investors (QFII) to invest in the domestic stock market
2003	Jan.	Implementation of the Provisional Expedient Law for the Management of Foreign Debt