Macro-management in the post-crisis period

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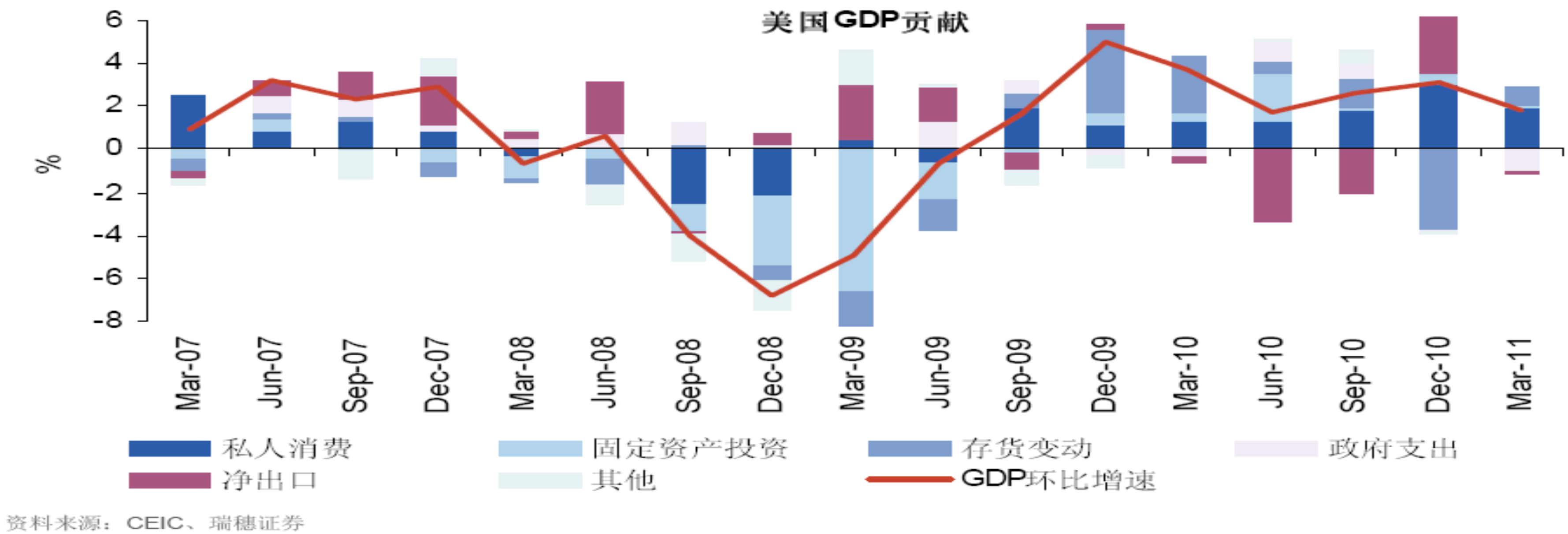
Challenges facing China

- Faltering global recovery
  - Growth of exports and hence GDP growth
- Capital losses for China's assets
  - due to dollar devaluation
  - due to increase in risks of US government securities
- Imported inflation
  - Hot money inflows, complicated PBOC's monetary tightening
  - Rising prices of commodities due to QEs

Slow recovery of the US economy



the US economy only grew at a 1.3 percent rate in the second quarter – an improvement over the first quarter (0.4 percent). Too weak to sustain the recovery and create enough jobs

Deleveraging takes long time

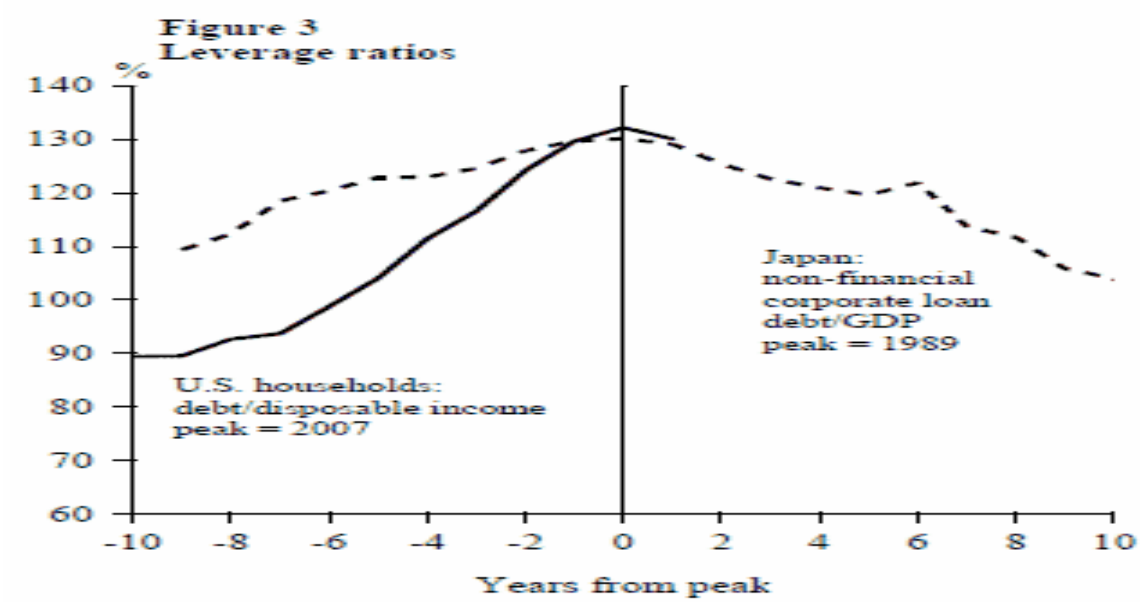
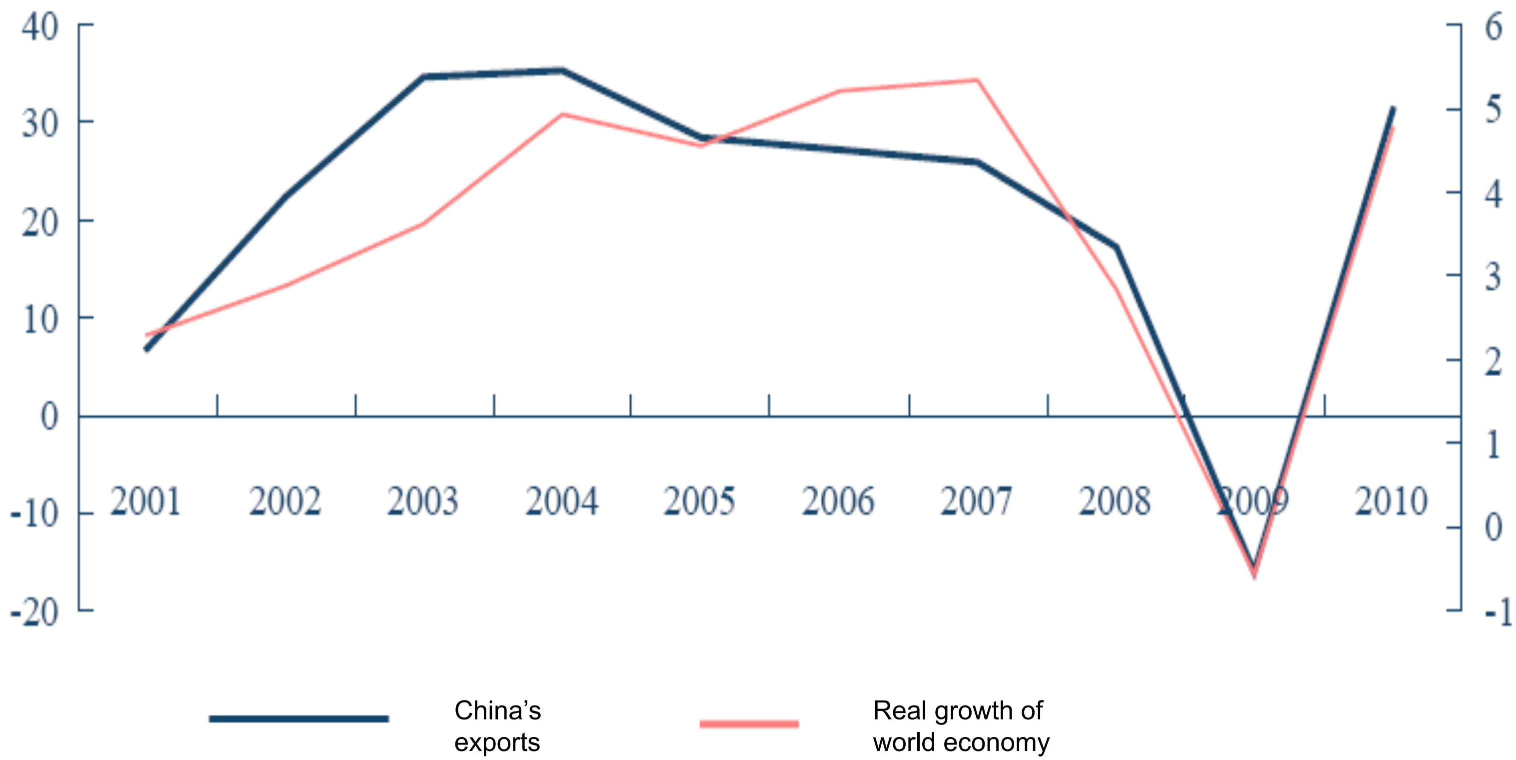
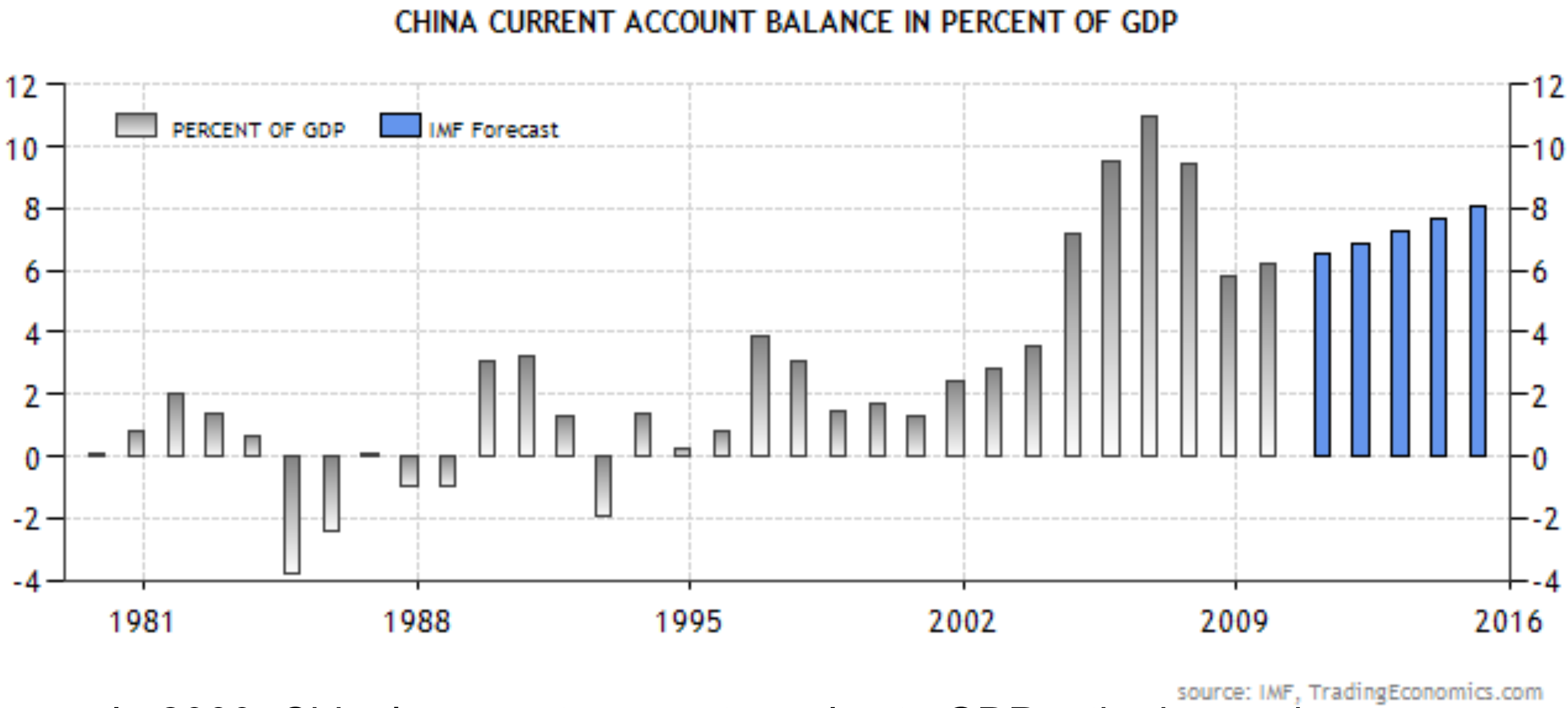


Figure 3 compares Japan's nonfinancial corporate sector with the U.S. household sector over 10-year periods before and after the leverage-ratio peaks. In both countries, leverage ratios rose rapidly in the years before the peak. FED SANFANCISCO

Correlation between growth of global economy and China's exports



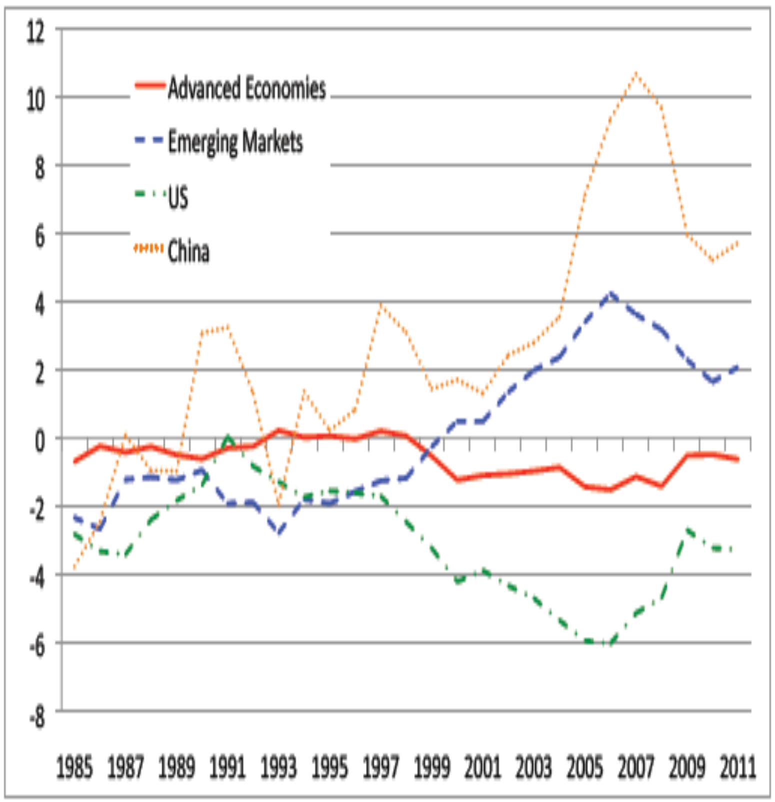
Current account surplus is still large



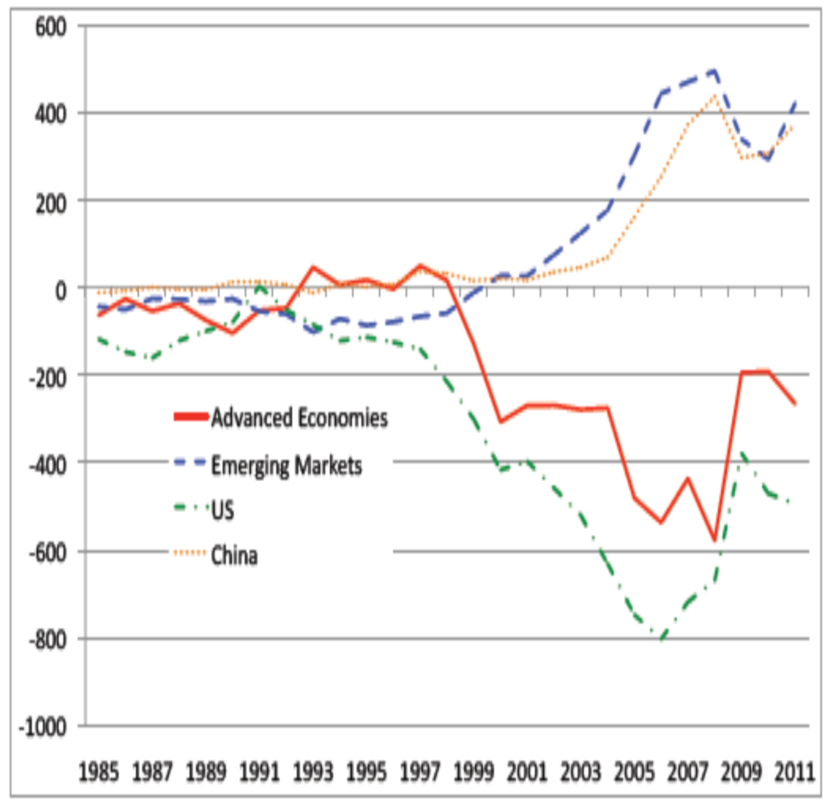
In 2009, China's current account surplus to GDP ratio dropped precipitately. However, it was attributable partially to the external demand. In Q1 2011, China ran 1 billion USD trade deficit, the first time in 6 years. According to OECD, in 2011, the current account surplus to GDP ratio will be 4.5%. Chinese authority predicted a much lower figure.

So are Capital inflows

A. Ratio to GDP (in percent)



B. Levels (in billions of U.S. dollars)



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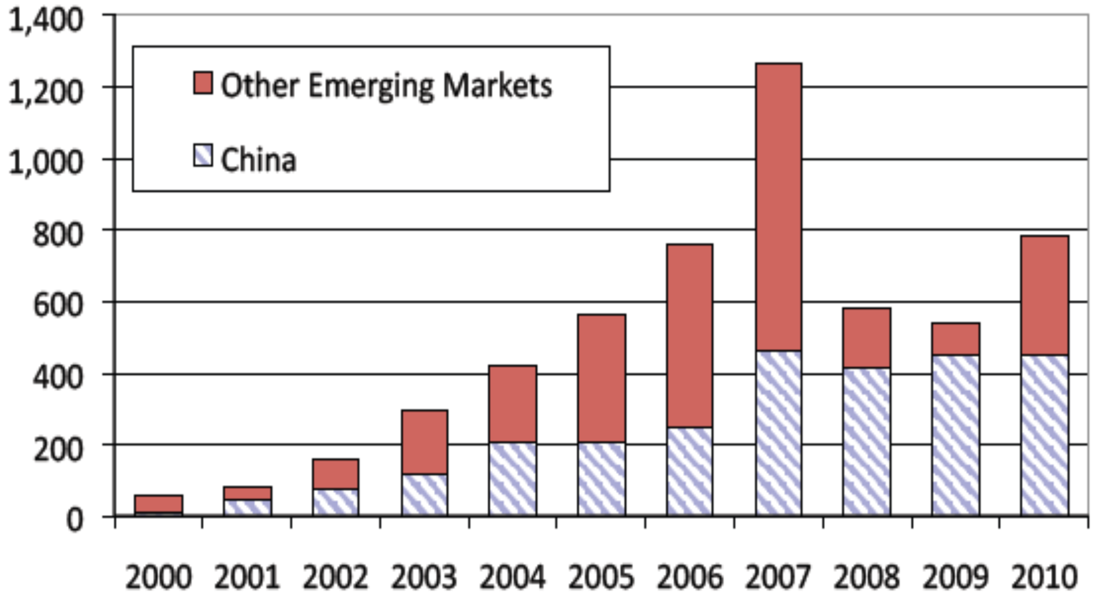
Data source: IMF's World Economic Outlook

Twin surpluses result in endless accumulation of foreign exchange reserves

(in billions of U.S. dollars)



Data sources: IMF COFER Database, June 30, 2011; The People's Bank of China

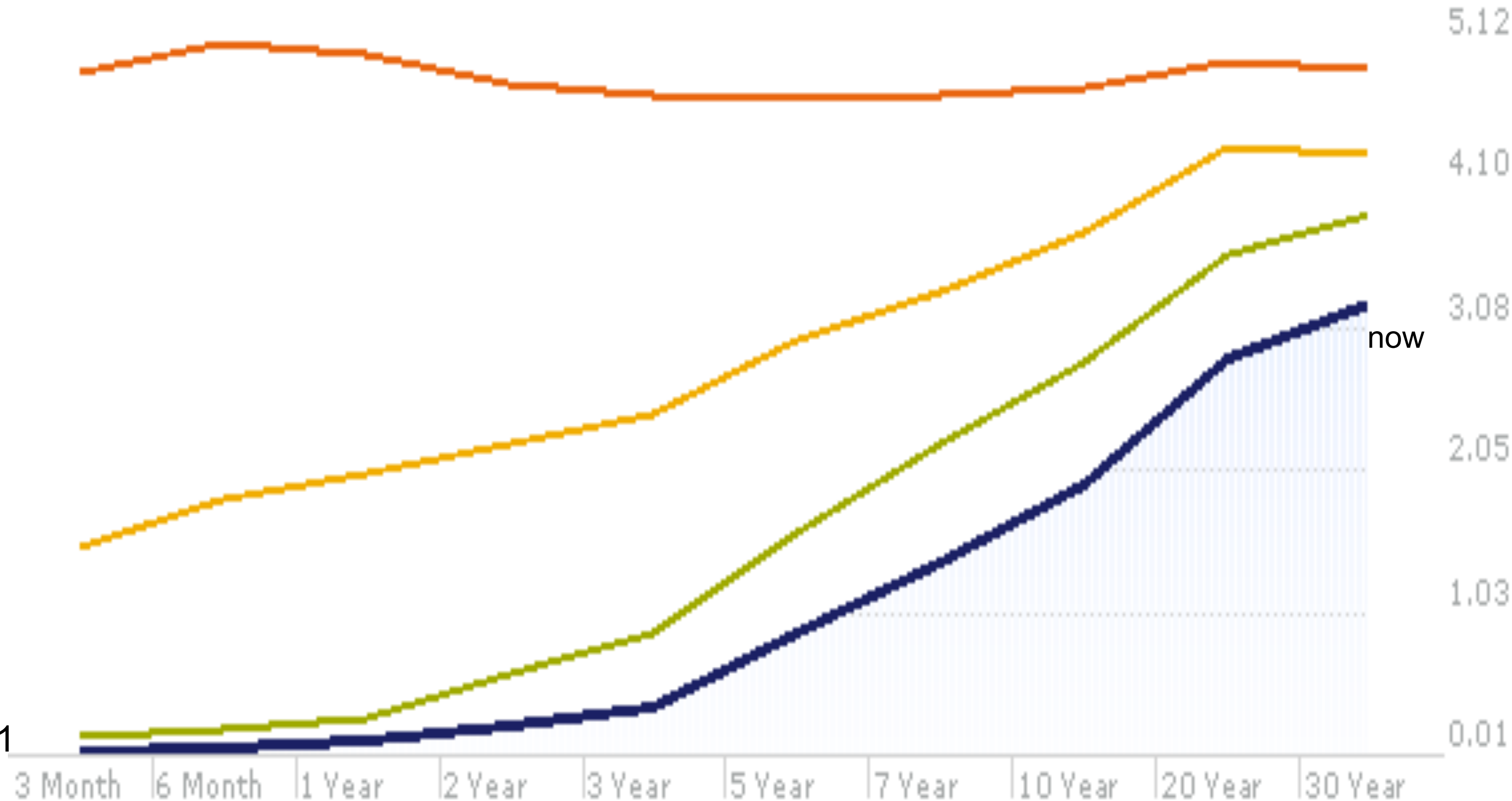
Eswar Prasad

Fiscal consolidation or job creation?

- Lipsky: "The longer **fiscal consolidation** is delayed, the more likely there would be a sharper rise in Treasury yields – which could prove disruptive for global financial markets and for the world economy."
- Krugman: it would involve an all-out effort by the Federal Reserve to get the economy moving, **with the deliberate goal of generating higher inflation to help alleviate debt problems**. With more Qes?
- why, exactly, should we regard **dollar decline** as a problem? It helps exports — and export booms are the normal way countries emerge from financial crisis…. In some cases, currency declines have caused major balance sheet problems — but that's because highly leverage players have large debts in foreign currency. US households are plenty indebted — but those debts are in dollars.

Yields of US treasuries

5 years
ago



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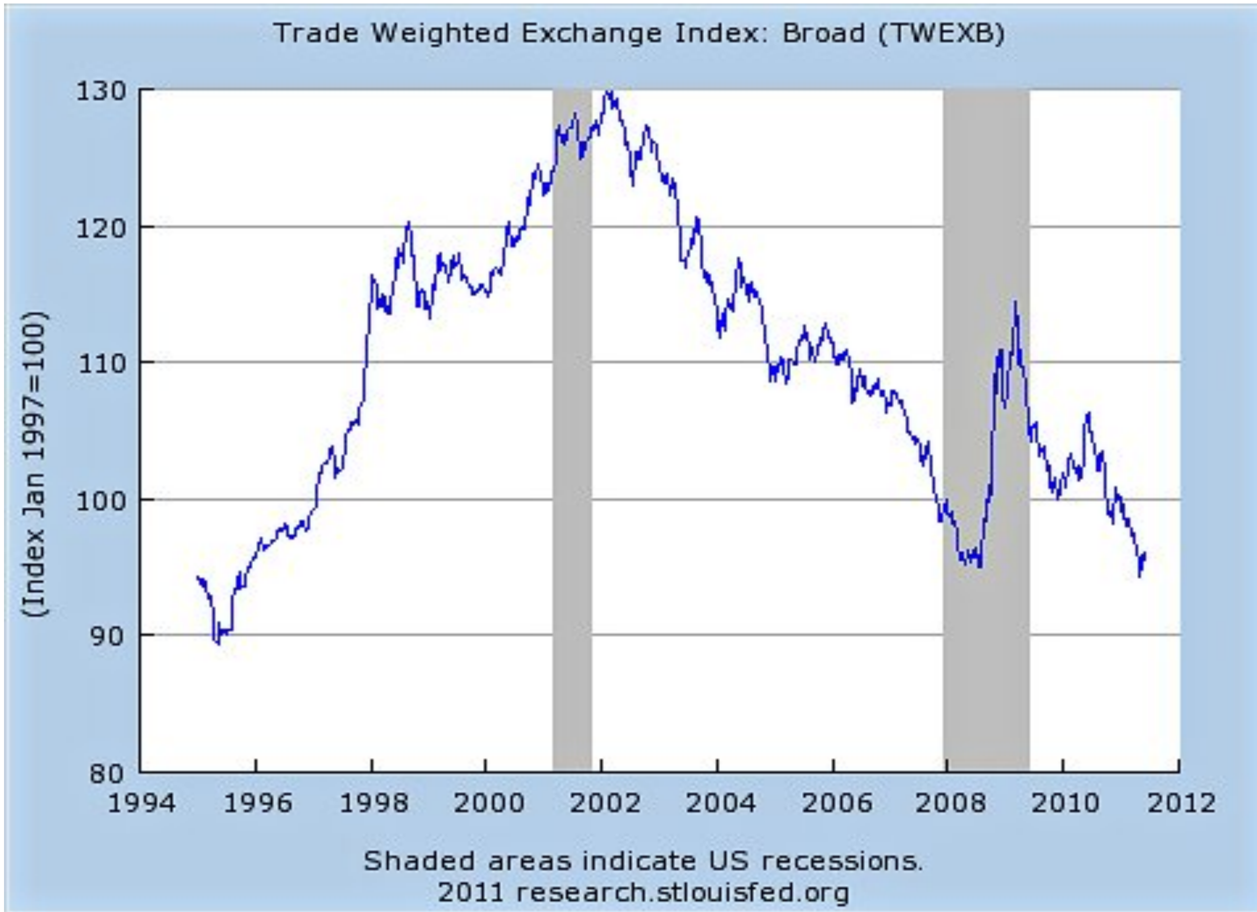
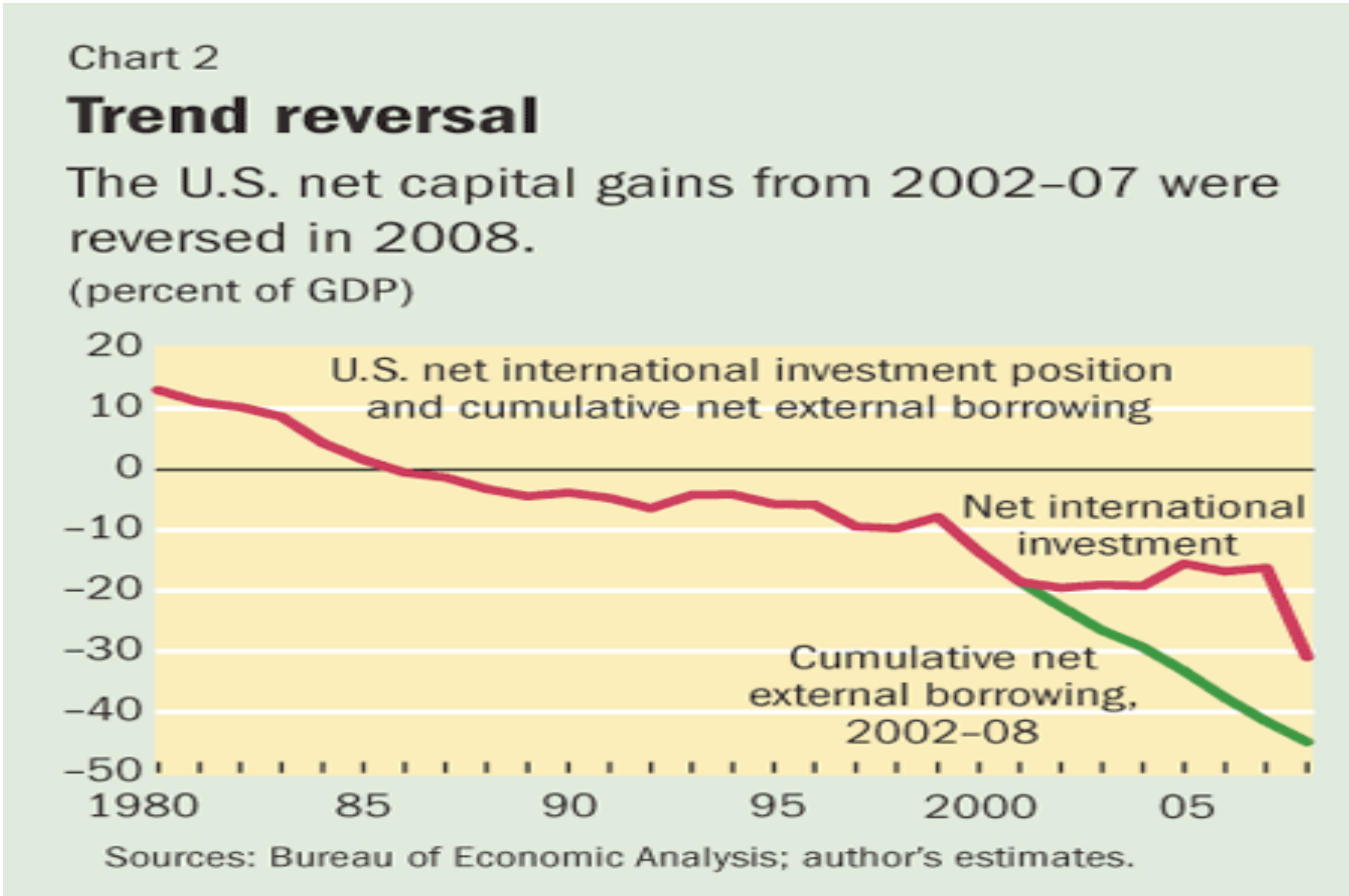
Prices have not fallen yet. But how about future

The dollar is falling again



Revaluation effect of dollar devaluation

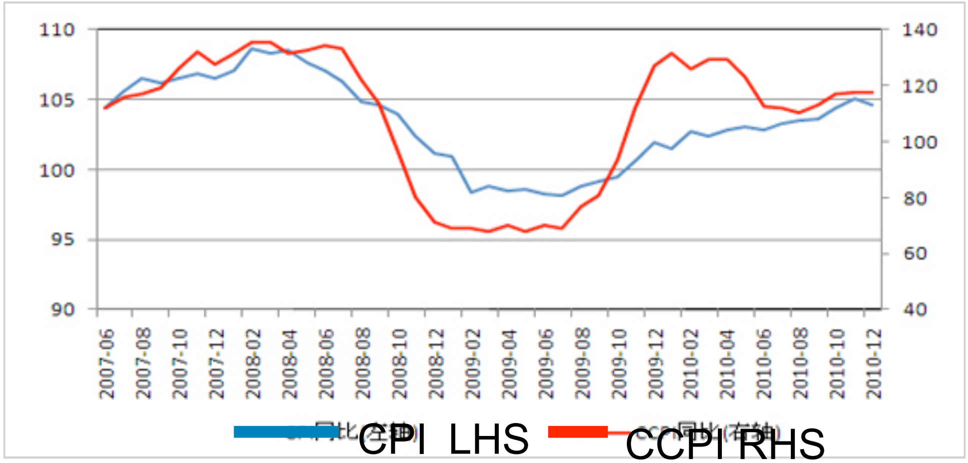


China's assets denominated in the dollar, liabilities in the renminb. Dollar devaluation will cause net capital losses to China vis-à-vis gains for the US

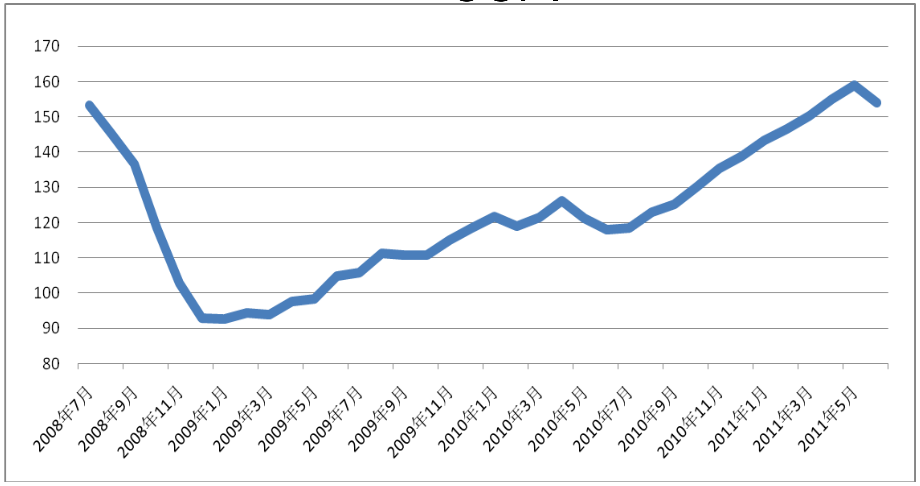
Imported inflation

- Since the middle of 2010 commodity prices had an important impact on China's inflation
- CCPI has increased by more than 100% since its 2009 low.
- The CCPI seems to begin falling recently

CPI and CCPI



CCPI



What should be China's policy responses

- Stop further accumulation of foreign exchange reserves by
  - Promoting domestic consumption by
    - Increasing wages and salaries
    - Narrowing income distribution gap by fiscal policies
    - Further improvement of the provision of public goods
  - Dismantling trade promotion policies, continuing RMB appreciation
- Adjusting the currency structure of China's international assets and liabilities: reducing China's dollar denominated assets and renminbi denominated liabilities, increase China's dollar denominated liabilities and dollar denominated liabilities. RMB internationalization should be conducive to the adjustment of the currency structure
- Cooperating with the US government to safeguard the safety and value of China's holding's US government securities
  - TIPS, SDR substitution account, partial shift to renminbi denomination
  - China promises a speed up of appreciation and a smooth and undisruptive adjustment of its holdings of US government securities.

Different solutions

- Unilateral
- Bilateral
- Regional
- Multi-lateral