

Keeping the Door Open Amidst the Global Financial Crisis

Lawrence J. Lau, Ph. D.

President and Ralph and Claire Landau Professor of Economics
The Chinese University of Hong Kong

and

Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University

China Development Forum 2009

China's Development and Reform in the Global Financial Crisis

Beijing, 22 March 2009

Phone: (852) 2609-8600; Fax: (852) 2603-5230

Email: LAWRENCELAU@CUHK.EDU.HK; WebPages: [HTTP://WWW.CUHK.EDU.HK/VC](http://www.cuhk.edu.hk/vc)

Outline

- ◆ Introduction
- ◆ The Success of the Reform and “Open Door” Policy
- ◆ Maintaining the Growth in International Trade
- ◆ Maintaining the Growth in International Investment
- ◆ Maintaining the Growth of International Exchange
- ◆ Enhancing Domestic Demand
- ◆ Concluding Remarks

Introduction

- ◆ The “open door” policy means China is open to the flow of goods and services, of capital, and of people, both outbound and inbound.
- ◆ The reform and open door policies introduced in 1978 have served the Chinese economy well. The open door policy greatly expanded international trade. It attracted foreign direct investment, which brought with it capital, technology, markets, new business models and methods that China really needed at the time. It permitted hundreds of thousands of Chinese scholars to go abroad for exchange or advanced study as well as a large number of foreign experts to come to and become involved with China.
- ◆ It is fair to say that without the “open door,” the Chinese economic reform would not have been nearly so successful.

The Success of the Reform and “Open Door” Policy

	Growth Rates	
	percent per annum	
	Pre-Reform	Reform
	1952-1978	1978-2007
Real GDP	6.15	9.79
Real GDP per Capita	4.06	8.61
Real Consumption	5.05	9.12
Real Consumption per Capita	2.99	7.95
Exports	9.99	18.11
Imports	9.14	16.68
Inflation (GDP Deflator)	0.50	5.38

Maintaining the Growth in International Trade

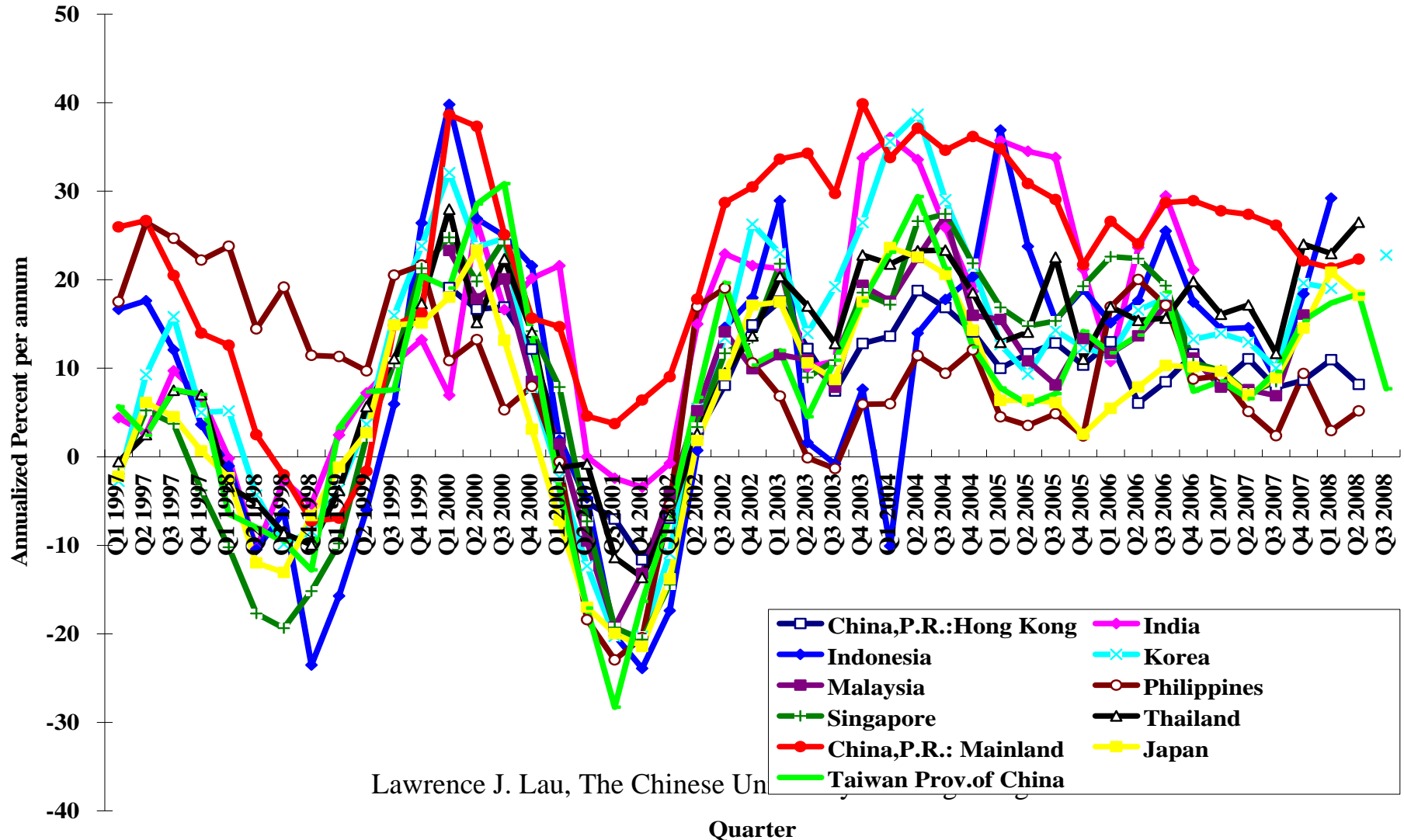
- ◆ It is important to maintain the growth of global international trade, and not just Chinese international trade.
- ◆ Not only must the Chinese Government resist the temptation of protectionism, it must also coordinate with the other major countries of the world to jointly resist protectionism. We must avoid a repetition of the experience in the 1930s, when every country erected tariff barriers against one another, prolonging the global economic depression. We must also avoid competitive devaluation during this crisis. The forthcoming G-20 summit is an ideal forum for taking a joint stand against protectionism.
- ◆ As most countries will be adopting and implementing economic stimulus packages at the same time, it will enhance the global multiplier, in the words of Prof. Joseph Stiglitz, and accelerate global economic recovery, if all countries can lower their tariff and non-tariff barriers to imports. This is because one country's imports is another country's exports. Thus, the economic stimulus packages will jointly benefit everyone, but in so doing everyone will be helping itself too.

Maintaining the Growth in International Trade

- ◆ The experience of the East Asian crisis of 1997-98 provides evidence of a sharp simultaneous economic downturn but also an equally sharp upturn due to simultaneous recovery.

Quarterly Rates of Growth of Exports of Goods: Selected East Asian Economies

Figure 3.2: Year-over-Year Quarterly Rates of Growth of Exports of Goods in US\$ (Percent)

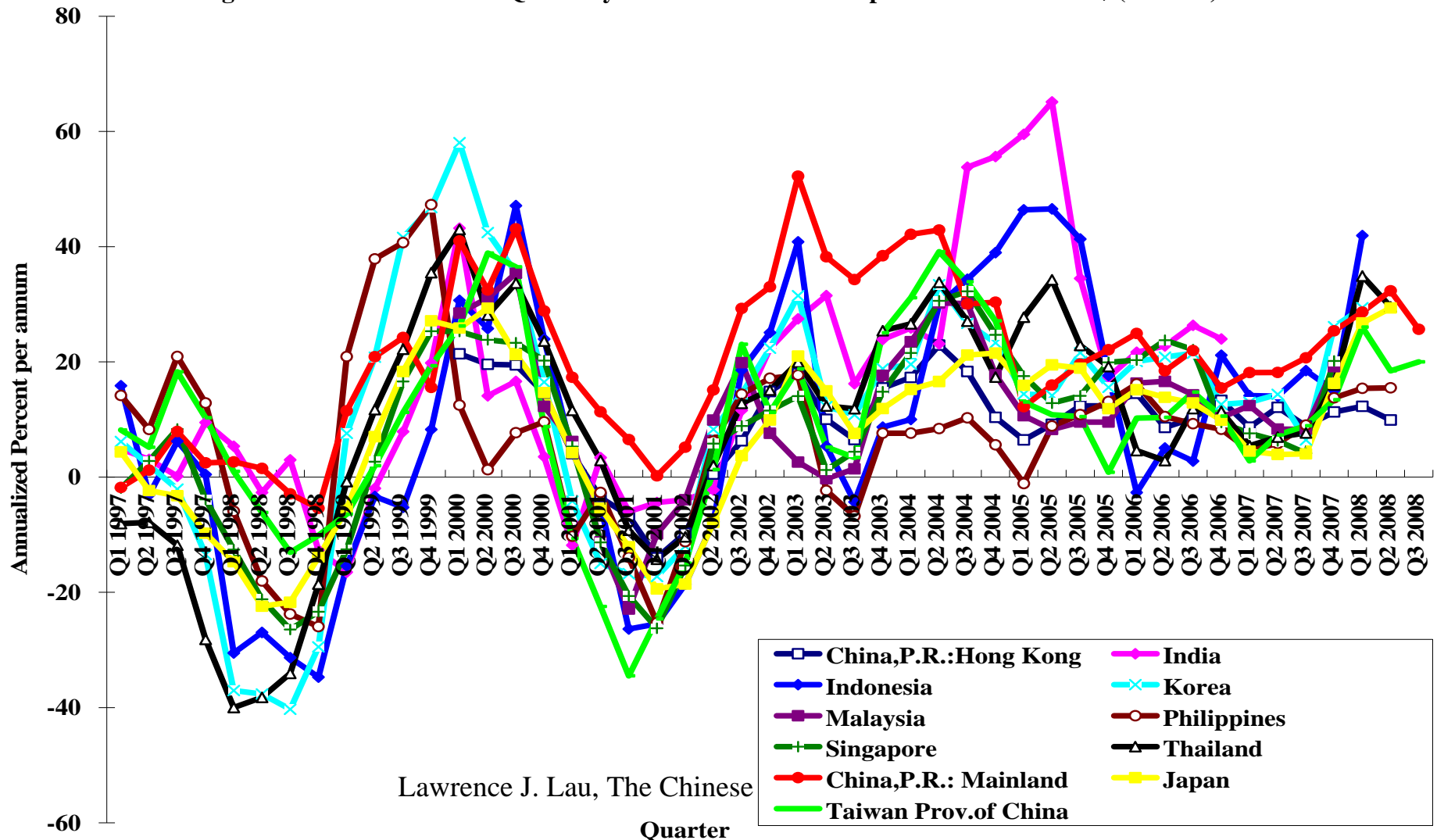


Lawrence J. Lau, The Chinese Un

Quarter

Quarterly Rates of Growth of Imports of Goods: Selected East Asian Economies

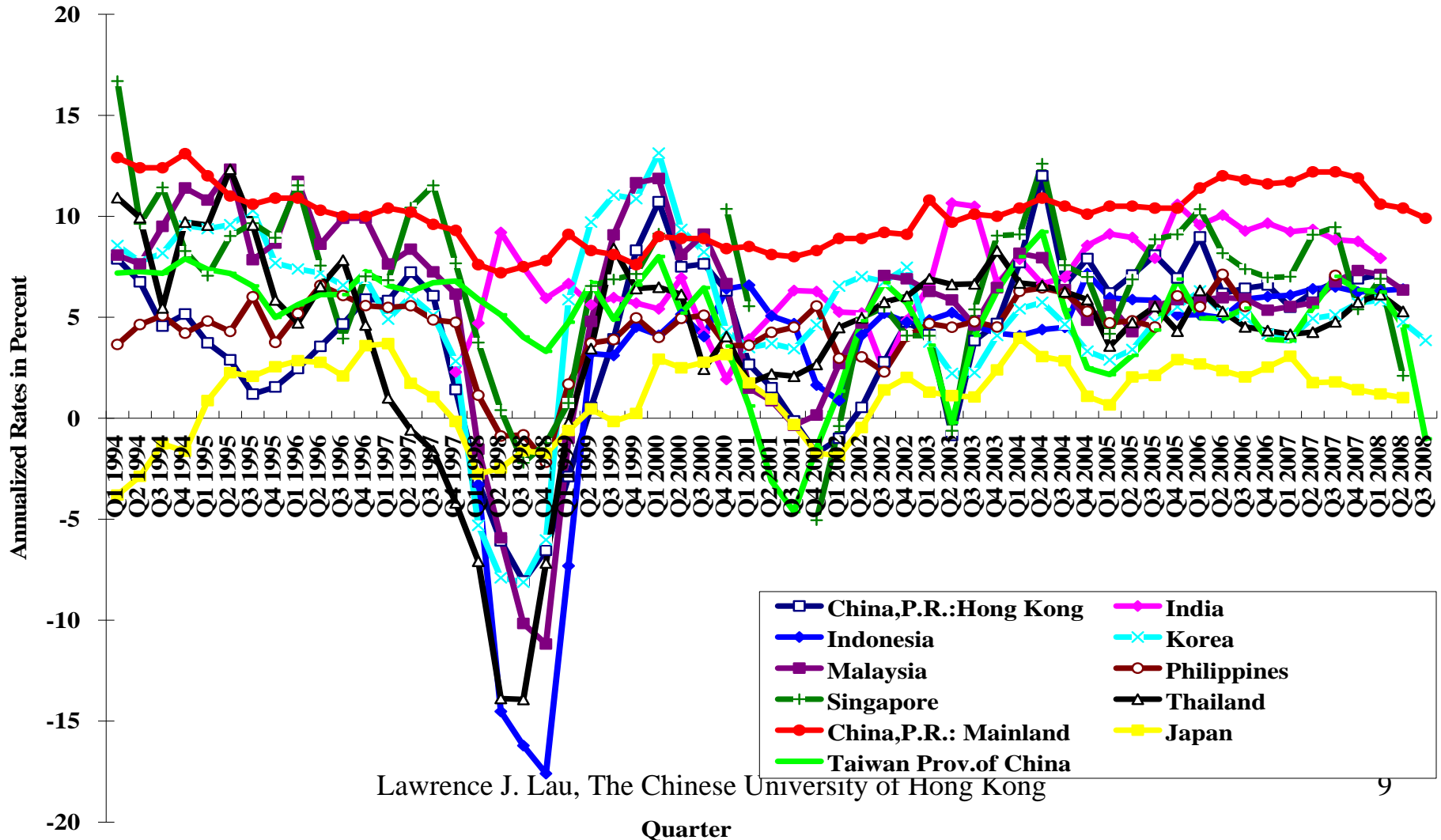
Figure 3.3: Year-over-Year Quarterly Rates of Growth of Imports of Goods in US\$ (Percent)



Lawrence J. Lau, The Chinese
Quarter

Quarterly Rates of Growth of Real GDP: Selected East Asian Economies

Figure 3.1: Quarterly Rates of Growth of Real GDP, Year-over-Year, Selected East Asian Economies



Lawrence J. Lau, The Chinese University of Hong Kong

Maintaining the Growth in International Trade

- ◆ In the context of the joint economic stimulus, this is also the right time to accelerate the implementation of Free Trade Areas (e.g., the ASEAN + 3 Free Trade Area) and the negotiation of free trade agreements (FTAs).
- ◆ Perhaps the Doha Round of negotiations can be revived, and an important contribution will be made to global trade if the mind-numbingly complex “Rules of Origin” regulations can be replaced by something simpler and more straightforward, based, say, on relative value-added.
- ◆ With the credit freeze in the United States and Europe, Chinese and East Asian commercial banks can, with the support of their Export-Import Banks, provide substitute financing for exports as well as imports. For example, a Chinese commercial bank can help to finance the exports of a Chinese enterprise to long-term customers the U.S. on a consignment basis or on extended payment terms. It can also finance imports from the U.S.

Maintaining the Growth in International Trade

- ◆ There is also the important question of the settlement of international trade transactions. Global trade is largely denominated in U.S. Dollars and settled in U.S. Dollars. That is what has given rise to the huge foreign demand for U.S. Dollar balances. The U.S. Dollar reserves held by central banks around the world provide in part the liquidity and transactions balances necessary to support the growth of world trade. With credit in U.S. Dollars becoming scarce, alternative means of settlement of trade transactions should be considered.

Maintaining the Growth in International Trade

- ◆ An obvious alternative is to allow the importer to pay for the imports in its own currency, provided that the exporter, or the exporter's country's central bank, is willing to accept and to hold the currency. For example, a Thai exporter may be willing to accept the Yuan as payment from a Chinese importer, making it unnecessary to use US\$ for this purpose. For another example, a Chinese exporter may be willing to accept the Indonesian Rupiah as payment for its exports to Indonesia, as long as he knows he can sell it to the People's Bank of China, China's central bank. The People's Bank of China may decide to hold the Indonesian Rupiah as part of its reserves (after netting out the payments for Indonesian imports denominated in Rupiah).

Maintaining the Growth in International Trade

- ◆ With the gradual accumulation of Indonesian Rupiah in the central bank's foreign exchange reserves, the central bank may wish to consider holding the Indonesian Rupiah in interest-bearing assets such as bonds issued by the Government of Indonesia, preferably indexed to Indonesian inflation, so that the purchasing power of the central bank's Indonesian Rupiah-denominated assets are preserved.

Maintaining the Growth in International Trade

- ◆ Such an arrangement is actually not so different from what has been made possible by the Chiangmai accords. However, the issuance of inflation-protected bonds by developing economies in their own currencies is a first, but it has many advantages, amongst which is the possibility of borrowing in its own currency, rather than a foreign currency, which frequently causes financial crises because of currency mis-match (and often also maturity mis-match).

Maintaining the Growth in International Investment

- ◆ In investment, both direct and portfolio, as in international trade, one must also guard against economic nationalism in cross-border investment flows. We must remember, every country will sooner or later have one of its enterprises being either a buyer or a seller. One must be symmetric in one's treatment whether one is on the buying side or the selling side. Ultimately reciprocity is likely to be the rule.
- ◆ The best way to safeguard against economic nationalism in investment is to extend national treatment to all enterprises, domestic and foreign. Industries that for national security reasons are not permitted to be foreign-owned, or to be foreign-owned above a certain percentage, should be specified in advance rather than afterwards. Rules should be clean and transparent and not ad hoc.

Maintaining the Growth in International Investment

- ◆ China, in particular, can improve the investment environment for both domestic and foreign direct investors by reducing or removing internal trade barriers, illegal under Chinese Law, erected by the local authorities. Only thus can investors truly benefit from China's huge market.
- ◆ Adequate protection of intellectual property is also important in attracting foreign direct investment into China.

Maintaining the Growth in International Investment

- ◆ In this time of global financial crisis, China, with its high savings rate, can supplement the global capital market. In particular, it can open up its stock markets for blue-chip overseas enterprises to raise capital in the form of Chinese Depositary Receipts (CDRs) and corporate bonds. It can encourage its commercial banks to provide US\$ financing to blue-chip foreign enterprises, e.g., by purchasing their commercial papers, for example.

Maintaining the Growth in International Investment

- ◆ It can also encourage its commercial banks to finance inbound foreign direct investment. China really does not need any additional foreign exchange or capital. It should continue to welcome foreign direct investment because it brings with it technology, knowhow, markets, etc., something that Chinese enterprises do not have. Chinese commercial banks should be ready to finance qualified foreign direct investment projects 100 percent as long as the parent company in the home country guarantees the loan.
- ◆ One advantage of such an arrangement to the foreign direct investor is that it is relieved of the exchange rate risk as its assets and its liabilities are both in China and denominated in Yuan.

Maintaining the Growth of International Exchange

- ◆ By international exchange I mean the flow of people across borders. Despite the temporary setback in the U.S. and other developed economies, they are still fundamentally strong and technologically advanced. Cultural and educational exchange should continue to be encouraged. Reciprocal visa relaxations and waivers should be considered with selected countries and regions. Both inbound and outbound tourism should be promoted. Tourism is also an important form of consumption activity.
- ◆ International exchange also benefits China and the World by enhancing mutual understanding.

Enhancing Domestic Demand

- ◆ In my presentation at the Academic Summit of this Forum, titled “Strategy for Chinese Economic Growth,” I already discussed several possible sources of long-term sustainable growth of domestic aggregate demand. They are:
 - ◆ The Owner-Occupied Residential Sector
 - ◆ The Education Sector
 - ◆ Urbanization and Mass-Transit Systems
 - ◆ Environmental Protection and Green Technologies

Enhancing Domestic Demand

- ◆ I agree with Prof. Bert Ruerup that strengthening the social safety net will help enhance the consumption propensity of Chinese households.
- ◆ In the short and intermediate term, the most promising areas of increases in consumption are probably consumer durable, including housing, automobiles, large-ticket items such as refrigerators, television sets and other home appliances, education, healthcare and tourism.
- ◆ Due to time constraint I shall not discuss them in detail and you are welcomed to visit my WebPages to read my presentation at the Academic Summit.

Concluding Remarks

- ◆ I believe that in this global financial crisis, it is in the interests of China and the World for China to continue to maintain an “Open Door” policy with respect to the international movement of goods and services, capital, and people.