

THURSDAY 7 MAY 2009

Present

Crickhowell, L.
Hamilton of Epsom, L.
Teverson, L. (Chairman)

Witnesses: **Mr Moreno Bertoldi**, Head of Unit, and **Dr Ulrich Jochheim**, Desk Officer, Directorate-General for Economic and Financial Affairs, European Commission, examined.

Q426 Chairman: Good morning.

Mr Bertoldi: Good morning. Thank you for coming here which is a little outside the town of Brussels, almost in the countryside.

Q427 Chairman: I know this has been set up at very short notice, thank you very much. We are undertaking an inquiry into Europe-China relations and clearly the financial side is a very important area so that is why we were very keen to take evidence from you. Would it be worth me explaining how we work?

Mr Bertoldi: Yes, it is probably useful.

Q428 Chairman: What we normally do is take evidence from experts and people involved in this area, such as you. We take a transcript of the discussions on the record, which I hope will be okay with you. We then will give you a copy of the transcript so you can check it completely. If you wanted to go off the record, if you tell us that, that is also possible. We were rather hoping we could move forward on that basis. We normally pre-prepare questions but, given the short notice of the meeting, perhaps we could have it more as a conversation. We would be very interested if you are able to give us an introduction to your work and your reflections on the EU and the Chinese economy. That would be very useful to us. Then we

could come in after that. If you had one hour, that would be very useful. Would that work for you?

Mr Bertoldi: Yes. Let me introduce Ulrich Jochheim, who is the Desk Officer dealing with China. I am the Head of the Unit in charge of Economies of America and Asia, and IMF and G7/G8. In the Unit and China has an important role, we have a number of dialogues with them, plus we follow all the things concerning China happening in fora like the G20 or in discussions with the IMF. I will add for your information a little bit on my background. I started to work in the Commission in 1990. Initially I worked in the Japan desk and after that I went to Japan as economic and political counsellor to Tokyo. From Tokyo I moved to Washington, where I was the economic and financial counsellor. In 2006 I came back and took over this Unit. Ulrich has an international experience too and was one of my successors in Tokyo a couple of years ago. I will start with the Chinese economy and give you our reading of the current situation. We have just published our forecast on the European economy but there is also a part on the international economy and we have made a forecast for China also. Our growth forecast for China is a little bit below consensus. We forecast for this year growth just above six per cent GDP growth, growing close to eight per cent next year. The IMF has 6.5 per cent and the Asian Development Bank has seven. There is a question mark over that. There are two issues. One is the reliability of the first estimates of China's GDP. You know that there are continuous revisions, so whether our figure is right or not, whether the economy will grow faster or slower, we will only know in a couple of years. Our impression is that China cannot completely decouple from the global slowdown, so they will be affected on exports, which are about 40 per cent of GDP. However, there is also a strong component of imports that will decline. We expect the Chinese economy will be affected by the slowdown of international trade as the Asia region is affected, part of it more heavily than China. You have seen the figures concerning most of developed Asia. Japan,

Korea, Singapore, Hong Kong, Taiwan have all shown very sharp declines in the last quarter of last year and the first quarter of this year. Since there is an Asian supply chain, of which China is the final assembler of goods, we expect that, with a lag, the deceleration will also affect the growth of the Chinese economy. On the other hand, it is true that the Chinese have reacted quite rapidly to the slowdown by putting in place a big stimulus package. The headline figure of about 15 per cent of GDP is not credible but we can expect a package of about two to three per cent of GDP as has been put in place and rapidly implemented. We had a meeting with the NDRC - National Development Reform Commission - last week, where we discussed the Chinese and European economies. The representative from the NDRC was pretty proud of the accomplishments of the Chinese stimulus package and said, "We decided to build a bridge in a certain part of the country and three days later we had already started the work to build it". In a way, you can have such an outcome from a government that can over-rule some procedures, or that environmental standards are fully respected and so on. This allows to speed up the process, but, on the other hand, probably in ten years, they may regret building the bridge there because it was not the best location and there were environmental problems. What has clearly appeared in the last couple of weeks is that the stimulus package is already becoming effective. Although it translated in growth figures that are much lower than the growth figures to which we were accustomed before the crisis but are still positive and robust. Growth year-on-year in the first quarter of 2009 was 6.1 per cent. On Chinese standards over the last decade that is the lowest, but it is plus 6.1 per cent and other countries in the world would like to have such a growth rate. I got back yesterday from the meeting of the Asian Development Bank that took place in Indonesia and I have to say the Chinese looked pretty confident. I am sure that they are weathering the storm quite well. This means that it is likely that next year they will go back to a rate of growth that is close to their target of eight per cent but, again, it depends on how the crisis unfolds. In our

forecast we see a very subdued recovery of the world economy and therefore China will also have a problem. We have a forecast of 7.8 per cent growth for next year which is slightly below (but still in the margin of error) of the eight per cent target, but that is because of the unfolding of the global economic situation. If we want to take a medium to long-term perspective, China and the Asian region, but China in particular, will come out of the crisis relatively stronger than they went in. They will have a bigger weight in the world economy and I have the impression that Chinese policymakers will make use of the increased weight to push not only for the economic objectives but political objectives and to raise their profile at the international level. The last part of my presentation is on the medium to long-term challenges. Clearly the world economy that went into the crisis was very different from the world economy that we will see after the crisis. There is a need to rebalance global growth. This is now a key theme. It was also the key theme in the meeting of the Asian Development Bank and they wrote done a big report on that. Everybody admits that if we continue to have the global imbalances that we had before the crisis this is a recipe for disaster and we will have another crisis. Things will have to change in countries with large current foreign account deficits, like the United States, and countries with large current account surpluses, which is the case in China. One of the things that we do see, and you can look at the forecast, is that, despite the slowdown in the world economy and the negative impact of the crisis on Chinese exports, the current account deficit decline is very small. The current account surplus will probably still be above ten per cent this year, but even if it goes below ten per cent, it will still remain at nine point something, which means unsustainably high. This cannot go on forever. It is not good for a sound working of the Chinese economy because it could go against the wall and create a bubble somewhere given the size of the China's current account surplus. On the other hand, it is not good for the general welfare of the Chinese population. These are figures from 2006, but, despite the fact the income per capita in China is more than

the double of that of India, the consumption per capita was only two-thirds higher. Consumption is about 35 per cent of GDP. This figure is interesting since at this meeting of the Asian Development Bank Japan's Finance Ministersaid, "We have to rebalance growth and in particular measures have to be taken by the countries that have consumption of GDP lower than 50 per cent". Possibly Singapore has also a low consumption on GDP, but there is only one country I can think with consumption below 50 per cent and it is China. Why is China's consumption so low? In part this is not so surprising. In the case of Korea and Taiwan in the late 1950s, early 1960s, and after in the other South-East Asian economies in the 1970s and 1980s, consumption was low because there was a lot of capital accumulation and export driven growth This Asian model spread to China. In a way, China brought to the extreme, since the social safety net that was in place before the reform practically collapsed. The social safety net was not terminated but the system changed dramatically. The result has been that people have to save because most of them do not have a pension scheme, they do not have health insurance and so on. They have huge savings that are kept aside for precautionary reasons. If you get sick you have to go to the hospital and pay and the hospital charge at a very high fee. In a way, healthcare reform is a key issue and if they are able to create a social safety net there, there is the possibility of increasing consumption significantly. An example is the introduction of universal healthcare insurance in Taiwan. After the reform, Taiwan's consumption on GDP grew by about two per cent. In China there is an even bigger potential. Of course, an expanded social safety net that is needs to be sustainable because China's population is ageing rapidly and, therefore, quite soon the country will face ageing problems. Some economists say that China will become old before becoming rich. The current system needs important adjustment.

Q429 Chairman: Can I perhaps come in there? What you are talking about is absolutely key and, as you say, if we do not get this right this time it will all happen again in another few years. What is the method of adjustment, whether it is exchange rates or consumption levels? On the currency someone can just decide in Beijing presumably to change the exchange rate, but they are not very happy necessarily to do that. How can we start to get those adjustments, get that change? What influence would Europe have on that?

Mr Bertoldi: Our position is to say that the imbalances that China is producing are unsustainable and there is a need for adjustment. We think that the main adjustment has to take place in domestic policy. As I said, healthcare reform, the reform of the way in which profits of state-owned enterprises are retained and, therefore, used to create new productive capacity are key issues. With regard to the financial sector, in a way they have a rather backward and inefficient financial sector. Therefore they have been very prudent and have not bought the toxic assets that have impaired the advanced economies in Europe and the United States. But there is still a problem of inefficiency, of bad allocation of credit and accumulation of bad loans. Regularly through the use of the reserves they accumulate and the sound budgetary situation they have, they have been quite good in wiping them out in the last couple of years, but they continue to come back and produce distortions. We think that domestic reform would and should help produce the bulk of the adjustment. Exchange rates are part of the strategy. The fact that the Chinese authorities keep a stable exchange rate vis-à-vis the dollar has translated in periods of devaluation while in reality the currency should have continued to appreciate in effective terms and not only compared against one currency, the dollar. The appreciation of the Chinese currency would provide the right incentives. The companies that are less effective and cannot compete in international markets would decline and that would provide incentives to the service sector to develop. The middle class in China would be favoured by reform and that would increase its purchasing power. This was one of

the things that the Chinese policymakers who were present in Indonesia acknowledged. Their economy cannot remain forever the factory of the world. They have to move up the technological ladder in manufacturing but they also have to diversify and need a larger service sector, which at the moment is relatively small if compared to what it should be in a country that is now an emerging market economy. They have the ambition to become in the long term an advanced economy, therefore the service sector has to develop. If the exchange rate remains undervalued, as we consider it to be, that clearly provides incentives in the opposite direction: you increase the manufacturing sector in order to export more to grow. In the end, either the economy will become too diversified or too dependent on the world economy with the risks and effects that we have seen. Even Japan, which is a vast economy with a very large manufacturing sector, has suffered very heavily since October. If you look at our forecast for Japan, despite the fact that they have very few impaired assets and the banking sector is not in a bad shape in the current circumstances, economic growth will be lower than in Europe and the United States where we suffer from the joint effects of the real economic crisis and the financial crisis.

Q430 Lord Crickhowell: I find the whole thing puzzling because you have got these huge imbalances in trade with the United States and Europe, the history of the recent Asian and Japanese crises is that there was a very slow recovery from the initial collapse in getting trade going, and you say in your report that China is having a massive internal construction programme but very high investment rate, an extremely low share of private consumption in overall GDP, so I find it hard to see how the internal adjustment is going to very rapidly deal with the huge imbalances. I did not quite understand what you were saying about the

exchange rate. Unless there is a fairly substantial change in the exchange rate I do not quite see how the great adjustment is going to take place. There has got to be a big adjustment because they are not going to be able to do the same trade with the United States on the same basis, or indeed Europe, that has been the basis of the economy for the last few years. How is it going to happen? I do not quite understand how the adjustment is taking place.

Mr Bertoldi: There is a temporal dimension. We do not want the United States moving suddenly from a savings ratio that was zero per cent to ten per cent because we know that would bring the world economy to its knees. The same is true in the case of China. We cannot expect that it moves from a current account surplus of ten per cent to a current account balance, or close to balance, in two or three years. A big move in exchange rate with an one-off appreciation of the renminbi by 30 per cent would have a huge wealth effect and wealth loss for the Chinese themselves who hold such large amounts of dollars. The other thing that we do not want is to have a sudden and rather abrupt move in the exchange rate that would have the euro appreciating and the dollar depreciating because we want to reach a balanced position in the balance of payments quickly. After that, we would go back to a sort of semi-fixed exchange rate between the renminbi and dollar but in a way, given the productivity dynamics of the two countries, that would reproduce the same problems and would require abrupt changes in exchange rates with all the wealth effects that we know about. For these reasons reason we think that the structural reform in China can be helped by the use of the exchange rate and the progressive appreciation of the Renminbi. The exchange rate can be made more flexible, although theoretically already now it has a lot flexibility: it s the way in which the policy authorities intervene that reduces that flexibility. In order to have a sustainable and sound growth model you have to go to the root of the imbalances and in the case of China they are related to the way in which the domestic economic structure creates huge incentives to over-invest (I think the investment on GDP is currently above 50 per cent),

and huge incentives to export. You have to change the system and have it rebalanced. The exchange rate in itself can be an instrument, but the appreciation of the exchange rate alone will not produce the rebalancing. Either you go for a fully flexible exchange rate that could bring rapid appreciation of the renminbi and you could have overshooting with a banking sector that is still fragile (many economists admit that the structure of the financial sector is not sophisticated and developed enough to move to a completely flexible exchange rate), or you go for huge appreciations or movements in the exchange rate in order to try to reduce the imbalances but then, as I say, there are problems. In political economy terms, a drastic appreciation of the renminbi would mean from one day to the other hundreds of thousands of companies would have to close.

Q431 Chairman: I want to bring Lord Hamilton in in just a minute, but I just want to press you slightly on that area. Does the European Union have its own view as to how that adjustment should take place? In the bilateral relations we have are we trying to influence that or are we just observers?

Mr Bertoldi: We have dialogues. They are not negotiations in terms of macroeconomic policy. Furthermore, there are also the international financial institutions that produce reports and so on. In general, on the exchange rate we follow the line that was agreed by the G7 finance ministers that takes the line that the G7 countries and the Commission and Union signed. What we are saying is that the Chinese currency should be made more flexible and be left to appreciate accordingly. With regard to the dialogues, in those dialogues we insist on the importance of domestic reform and point out that it is in the interests not only of the world economy but also of China itself to move to a more balanced growth order because it increases the welfare of its citizens, avoids unpleasant surprises down the road and has a positive spill-over on the world economy. The Chinese authorities recognise that they have to move. The big difference we have is on the speed of the move. They are extremely cautious

and the word “gradual” is the key word. We say gradual is fine, but with their graduality they have created something that is not gradual, namely huge surpluses. Something more vigorous is needed. Clearly we can flag the problem up and stress that it is important for them to adjust because with the current account surplus they have there is the risk of protectionist backlash both in the United States and Europe. They have to do more. In the 1990s I was involved in a similar discussion with Japan and we found that even the strong pressure the US was generating towards the Japanese did not produce much. The important thing is to raise awareness that this is creating a problem and if the policymakers have the ambition to play a more active role in the world, they have to be a responsible partner (which in the official communiqué China indicates as one of the main objectives of its foreign policy). Ultimately the final decision is most of the time domestically.

Q432 Lord Hamilton of Epsom: You have given a forecast of six per cent growth for this year, which seems to be highly likely, and Goldman Sachs came out with a figure of eight point something, in excess of eight per cent. Where did that figure come from, do you think?

Mr Bertoldi: They revised it up. They had seven point something.

Dr Jochheim: they had six.

Mr Bertoldi: They consider there is much more attraction from the stimulus package. If I remember correctly, they have a reading of the crisis in the world economy that is different from ours. They see a stronger recovery in 2010 and in the second half of 2009, plus there is the attraction of the stimulus package.

Dr Jochheim: If I may add one thing. The real difficulty for me is to forecast the behaviour of sub-national levels of government. Below the national or central government the Chinese have five levels of authority, starting with the provinces. You might know that some provinces in terms of size are more important than both Germany and the UK, like Sichuan, for example, which has more than 84 million inhabitants. The difficulty is that the stimulus

programme foresees spending of four trillion renminbi, of which 1.18 trillion would come from the central government. It relies a lot both on banks and lower levels of government. It is extremely difficult to predict. To be frank, I am sitting here and even if you go to Hong Kong, to Beijing, you feel you are not on-site. It is very difficult to predict how the lower levels of government are going to behave. In the past they were more expansionary than the central government wanted. In 2007 China had a growth rate of 13 per cent compared to an objective in the five-year plan of annual growth of eight per cent. This was driven by provincial governments and provincial leaders. The Chinese leadership tried to exert a lot of pressure on them. For example, they had a kind of credit limiting and in giving orders you must only expand your credit balance sheet by ten per cent or something. They have now abolished this and this is one of the reasons why, for example, loan growth in the first quarter was extremely high because all of a sudden there was pent-up demand, pent-up projects. Depending on what you assume as to the behaviour of these levels of government you can justify anything between four and ten per cent for the current year.

Q433 Lord Crickhowell: Can I reverse the question in a sense. Here you are saying very high continuing growth, external imbalances likely to decline only very slightly in real terms and current account surplus broadly unaltered. What are the implications for the European economy? What is the effect if there is this great imbalance? If China is going to continue to have this imbalance, what are the consequences for Europe?

Dr Jochheim: It depends on the point of view you are adopting. The Chinese say, and I tend to agree, that the first priority issue is to save China's economy. From our point of view it is better that the Chinese keep on growing than that they collapse. That is my personal opinion. From that point of view, they have a point. The second issue is that the programme is not very conducive to imports from the US and EU. . (Off the record) The impact of the

programme even on the EU will depend very much on the export structures of our Member States.

Mr Bertoldi: The Chinese are not trying to export their way out of the crisis, so in a way that does not change much the effect of the large current account surplus right now. It has more or less the same effect that they had before the crisis. There is not an acceleration of the process. What the Chinese authorities are doing is that they are committing to keep their exchange rate stable vis-à-vis the dollar, so that depends on how the dollar evolves. Should the dollar depreciate significantly in the coming months we would have a problem. Should the dollar appreciate then the renminbi would appreciate against our currency. In the current situation what we do not want is to have very high volatility in exchange rates. We have sufficient uncertainty to deal with already. Of course, in our view it would be much more helpful if instead of having more activity we had a steady appreciation of the renminbi in real terms in a gradual manner. That is the message that we are sending. One of the risks of this crisis and was partly a result of what we had in the crisis of 1997-98 was that for a country it is better to have a current account surplus, because if ever there is a crisis it is more able to weather the storm than a country that has a current account deficit, particularly in the case of an emerging economy. That was the case in the Asian financial crisis of 1997-98 and in part it is also the case now. We see the problems in Central and Eastern Europe. Some countries have a current account deficit. It is what economic textbooks would say. If you are catching up, the best way is to invest and to consume. You have a current account deficit because you are creating productive capacity and in future that will allow you to have a balanced position. In order to grow rapidly and increase the welfare of your population, this is the best way to proceed. The risk is that everybody after the crisis will try to follow this path,, while, on the other hand, there will not be the United States as the consumer of last resort.

Q434 Lord Hamilton of Epsom: Can we look at the Chinese banking system? Quite clearly they are not suffering from the problems of Western banks, but there is a view that they have been lending to anybody who would basically create jobs without asking too many questions beyond that. How strong do you think their banking system is and is there a crisis in the making there or will that not be a problem?

Mr Bertoldi: There is a risk that they will build up a lot of non-performing loans that will not appear immediately but will appear down the road. It is still a very unsophisticated system that struggles to modernise. In a way, the Chinese policymakers move very cautiously and they still tend to use the banking sector to orientate investment and to have political drive on that. Down the road the banking sector is a problem. There were some timid moves to open it to the foreign banks, to have cooperation and so on, but at the moment all of this seems to have been frozen by mutual consent. Clearly worldwide European and American banks are withdrawing, so they are not asking for entry or investing more, but also the Chinese seem much less keen to have the presence of foreign banks in their financial sector. Changes in the financial sector are essential. What we have seen in the other economies of East Asia, and the Chinese are looking at them, is that growth will start to slow and they cannot rely forever on manufacturing. They have to diversify. They have to allocate their financial resources more efficiently and have to introduce a market mechanism. They have to do that in a gradual way. Either they can do that in a gradual way or through a big bang. The gradual way that was followed by the Japanese produced a big bang and in some other countries also. They know they cannot stay where they are, they have to move, and in this respect the crisis has made them more wary about moving towards liberalisation. That will be a problem down the road. This huge expansion of credit could create a large amount of non-performing loans. In a way, they are swapping the long-term with the short-term and that will be a problem. What I would not like is that the Chinese authorities, since they know they are creating a problem

down the road, will continue to run large current account surpluses in order to be able to clean up the banking sector. This would be the wrong policy lesson from the crisis.

Q435 Chairman: Coming back particularly to the European relationship, you have outlined very well the problems that there are and the slowness of any adjustment in the future, but one thing we would like to try to get at is whether the European Union has any leverage or influence, either bilaterally or within institutions like the G20, to actually make a difference. We are China's largest market, we have 500 million consumers in a single market, we have the second largest reserve currency, but is China so internally focused or as the European Union are we not in a position to influence policymaking in China to mutual benefit or even to our own benefit? Why not? Are we performing better than we seem to be?

Mr Bertoldi: Part of that is a question that you should address to our colleagues in DG Trade. I do not know if you have met them already or are going to meet them. I do not know whether we would welcome knowing that the Chinese are effectively putting pressure on us to change our policies or with the Americans. What we can have is a dialogue. The Chinese could claim that the Americans are now raising the savings ratio because they pressed them. I do not think that this would go down very well in the US. What we have is a dialogue and what we can do, and we are doing, is to make them aware that without adjustment down the road there will be problems. Sometimes we are able to defuse the problem but this means that actions need to be taken. I will give you a concrete example that I know quite well because I was involved in the process: sovereign wealth funds. They are somewhat a spin-off from the global imbalances. Sovereign wealth funds have been around for 50 years but they became a problem in early 2007. The Chinese created their own sovereign wealth fund and the Russians, although it was not through a sovereign wealth fund, but state-owned companies, announced investments in the EU energy sector. There were two possibilities. One was to respond through legislation and there were discussions, as you will probably remember,

whether there should be a golden share or we should set up our defensive sovereign wealth fund and so on, or, and this was the second possibility, to go through a multilateral solution where the Chinese would engage, but not only the Chinese, the Kuwaitis, the Abu Dhabis, the Russians, to agree on clear governance rules for their sovereign wealth funds and to disclose a certain amount of information so that we could be reassured as much as possible that the investment that comes from sovereign wealth funds is not done for strategic purposes but rather for commercial purposes. The IMF and OECD were involved through the G7, and very rapidly we had the code of conduct for sovereign wealth funds and the Santiago principles. Initially there was nothing, but now the Chinese have set up their own website and they disclose information, who the managers are, financial information, etc.. It is not yet an entire implementation of the principles but they tell us they are doing more than other sovereign wealth funds. We agree, but we add that, this is not a beauty contest, the principles are there to be applied. However, the positive fact is that we found a solution that in the meantime was pushing sovereign wealth funds, not only the Chinese one, but all the sovereign wealth funds to disclose a certain amount of information, to give assurances on the types of investments they were doing. For the moment this defused the protectionist risk that would have negatively affected our economies, not least because in the current climate we need capital from the sources that have capital. There was recognition by the two sides that there was a problem, although the nature of the problem was seen in different ways from the two sides, and they moved to create a global public good.

Q436 Chairman: So a policy success in that area?

Mr Bertoldi: In that area. The problem has been defused. Whether it has been solved, it will take more time before reaching a conclusion. There has been disclosure of information and assurances that make clear the other side recognise the legitimacy of our concerns. The worst scenario would have been that we would have introduced restrictive legislation and they

would have reacted by introducing domestic retaliatory legislation in a number of sectors in order to make our exports more difficult. This sort of retaliation is something you want definitively to avoid in general and even more so during a financial crisis.

Q437 Chairman: Thank you very much for that. Mr Bertoldi, I think we have taken up enough of your time. We very much appreciate you having found time to speak to us this morning. Can I thank you very much indeed for having taken us through these areas, it will be very useful to the inquiry.

Mr Bertoldi: Thank you for coming. I hope I answered your questions. I do not know whether I was convincing in all my answers, probably not. If you have any further questions please do not hesitate to come back to me or Ulrich.

Chairman: Thank you very much indeed.