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Introduction

It is our great pleasure to deliver another volume of Research Papers on Asia-Pacific economic issues. Each year we present you multiple points of view on that topic, trying to show how much the processes in Asia & Pacific affect the world economy. After nine years of hosting international scientific conference dealing with that region's affairs, we are still confident that these issues are important not only for the countries of the region, but also for economies worldwide.

This year we have chosen for you 15 articles. All of them where submitted for this year's conference entitled "Asian Economies in the Context of Globalization". Seeing that some authors describe the issues of countrywide importance and others of those having regional or global meaning, we have decided to group them according to the criterion of impact range.

The first chapter – Asian Economies in the Global Context – is a collection of papers on general regionalization or globalization issues. T. Sporek is trying to refresh the view of the globalization processes occurring at the crossroads of economy and politics. M. Bartosik-Purgat is analyzing sources of information about products and services in the light of cross-cultural research. E. Majchrowska is using Regional Comprehensive Economic Partnership case to show the importance of mega-regional blocks in global trade. In addition, we decided to add to this part the articles the subject of which is not so general, but it applies to trade relationships of a global nature. This will be the EU-India trade and investment agreement (G. Mazur), Poland-ASEAN agri-food products trade (K. Kita) or anti-dumping procedures against China under WTO rules (J. Skrzypczyńska).

Articles in the second chapter are – as the title implies – embedded in a regional context. P. Pasierbiak deals with trade regionalization in East Asia. S. Bobowski offers an insight into ASEAN-Japan Economic Partnership. A. Kuropka and A.H. Jankowiak analyse the impact of natural disasters on production networks in the region. As the last in this section we have placed the article about Singaporean Competitiveness Model applied in European economies (M. Żmuda). It may be not strictly connected with Asia & Pacific, but its concept is to transfer Asian experience to Europe at the regional level.

The last chapter – Asian Economies in the Local Context – is mostly about domestic matters of Asian countries. You will find there three articles about China (J. Bogołębska writing about Chinese monetary policy, A. Klimek describing cross-border mergers and acquisitions by Chinese state-controlled enterprises, S. Stępień and A. Sapa showing Chinese pork sector), one about Indonesia (*Development of Islamic banking in Indonesia* by I. Sobol) and one about North Korea (M. Kightley applying game theory in prediction of political changes in that state).

We think it is an interesting set of papers you will find valuable in your studies. We also hope that your scientific interests will continue to be associated with Asia and that is why we invite you to the 10th anniversary conference which will be held at the Wrocław University of Economics in November 2017.

We appreciate your time and consideration, as also time and effort of our peer reviewers. We look forward to the further submissions of interesting papers on Asia & Pacific. Thank you!

Bogusława Drelich-Skulska, Anna H. Jankowiak, Szymon Mazurek

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CHINA AS AN IMMATURE CREDITOR COUNTRY – THE DILEMMAS FOR ITS MONETARY POLICY

CHINY JAKO NIEDOJRZAŁY KREDYTODAWCA – DYLEMATY ICH POLITYKI MONETARNEJ

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Summary: China as a surplus country is an interesting example of emerging markets economy possessing the status of immature creditor, that is, a creditor which cannot lend in its own currency. Its surplus is financed by net claims on foreigners, mainly in the form of foreign exchange reserves. The central bank becomes a financial intermediary in place of private sector due to the fear of exchange rate risk. At the same time, due to its exchange rate arrangement it is subdued to so called conflicted virtue syndrome (term given by R.I. McKinnon), which is the mirror image of the concept of original sin hypothesis depicted in relation to experiences of emerging market debtor countries. This situation poses dilemma for monetary policy: the choice of appropriate exchange rate regime, capital account liberalization sequences, formulating objectives for monetary policy. The article concludes that the process of changing the exchange rate should be gradual, parallel to financial sector development, liberalization of capital account and the process of internationalization of domestic currency.

Keywords: immature creditor, conflicted virtue syndrome, exchange rate options.

Streszczenie: Chiny jako kraj nadwyżkowy są ciekawym przykładem gospodarki wschodzącej, posiadającej status niedojrzałego kredytodawcy, czyli takiego, który nie może pożyczać we własnej walucie. Nadwyżka jest finansowana przez roszczenia wobec zagranicy, głównie w formie rezerw walutowych. Bank centralny staje się pośrednikiem finansowym w miejsce sektora prywatnego, w obawie przed ryzykiem kursowym. Jednocześnie reżim kursowy kraju jest uwikłany tzw. syndromem *conflicted virtue* (pojęcie nadane przez R.I. McKinnona), który jest lustrzanym odbiciem tzw. hipotezy grzechu pierworodnego, dotyczącego dłużniczych krajów *emerging markets*. Sytuacja ta tworzy dylematy dla polityki monetarnej, związane z wyborem adekwatnego reżimu kursowego, liberalizacji przepływów kapitału, formułowania celów polityki pieniężnej. W artykule przedstawiona jest teza, że proces zmiany reżimu kursowego powinien być stopniowy, w połączeniu z rozwojem sektora finansowego, liberalizacją przepływów kapitałowych i internacjonalizacją waluty krajowej.

Słowa kluczowe: niedojrzały kredytodawca, syndrom *conflicted virtue*, opcje kursów walut.

1. Introduction

High-saving countries lend to foreigners in the form of current account surpluses (CAS). China's large net foreign assets and current account surplus reflect a persistent excess of domestic savings over domestic investment. China's gross domestic savings stood at 52% of GDP in 2008, and are among the world's highest saving rates. It should be stressed, however, that until the recent financial crisis, saving in China were not generated only by the household sector, but were even more generated by the business sector.

China's trade surplus has been growing rapidly since 2000, reaching $359 billion in 2007, which was equivalent to about 10% of GDP. It has narrowed substantially since the global financial crisis, to 2.3% of GDP in 2012, mostly due to the shrinking import demand. However, until present, the Chinese current account surplus has shown signs of reversal, so China's role as an immature creditor is likely to persist. The aim of the article is to emphasise the problem of having a status of an immature country and ways of overcoming its shortcomings. This is not only a problem of implementing proper economic policies but also of important political consequences.

2. The international debt cycle theory and China as an external creditor

Traditionally, based on net international asset position and on whether the external balance is positive or negative, economists have identified four phases of debt of the country:

1) young debtor – has net external liability position, and also is building up this debt further by running annual current account deficits (CAD),

2) mature debtor – runs current account surpluses and is in the process of repaying external debt

3) young creditor – has net external asset position and is continuing to build its creditor position by running current account surpluses

4) mature creditor – is still in a net asset position, but is running down its assets by running a current account deficit.

The main idea is that in the process of economic growth, the country goes through the normal clockwise debt cycle.

Table 1. The international debt cycle

	CA < 0	CA > 0
Foreign assets < liabilities	Young debtor	Mature debtor
Foreign assets > liabilities	Mature creditor	Young creditor

Source: [Cline 2005].

Paradoxically, in the current global economy, the United States is in the position of a young debtor country rather than being a mature creditor as might have been expected from its high levels of income and wealth [Cline 2005].

Another paradox of the current global economy tackles China which instead of being in a position of debtor country is in a position of a creditor one.

Historically, creditor countries have been able to lend in their own currencies. This happened because they had open capital markets and provided international currency. The main examples of historical mature countries are:

- Great Britain in the 19th century. During Goldstandard its huge net capital outflows were denominated in pound sterling, sometimes with gold clauses.
- United States in the 20th century. During the first phase of the Bretton Wood system it had large current account surpluses that were financed by making dollar loans to foreigners. In 1965 C. Kindleberger [1965] countered that the US was serving as banker to the world, exchanging short-term liabilities for long term assets.
- Germany in the 21st century, which finances its large current account surpluses by lending abroad in euro. Germany was beginning to move from immature creditor to mature creditor when the Berlin Wall fell [Ma, McCauley 2013]. According to D. Gros and T. Mayer, the creation of the euro area meant that German surpluses could be deployed within the euro area without requiring banks or investors to take foreign exchange risk. They took credit risk by recycling surpluses within the euro area, but not currency risk. The result was that the German surplus could reach almost 80% of GDP in 2007 [Gros, Mayer 2012].

3. The syndrome of a *conflicted virtue*

As R.I. McKinnon and G. Schnabl point out, China's large current account surpluses result in a currency mismatch because it is an immature creditor that cannot lend in its own currency. Aside from relatively illiquid foreign direct investment outflows, an immature creditor continually accumulates liquid claims on foreigners denominated in international currencies, such as the dollar or euro. It is certainly an abnormality in the global economy: the world's largest creditor cannot finance foreign investments in its own currency.

One of the reasons for the inability to lend in its own currency is that domestic financial markets are immature – shallow and fragmented, with interest rate restrictions and foreign exchange capital controls. As the currency is not fully convertible, it is not accepted for international lending. It is worth mentioning that the Chinese authorities have just gingerly begun to open up their domestic bond market to selected foreign official investors.

Second, as stresses G. Schnabl, (as in the case of Japan), international capital markets have been pre-empted by major currencies from areas with highly developed financial markets due to network externalities [Schnabl 2010].

The inability to lend in own currency is also shared by other East-Asian creditor countries, such as Taiwan, Korea, Malaysia and Singapore, as well as by oil-exporting surplus countries such as the Gulf Coast states and Russia. Among immature creditors there is also one industrial country, namely Japan. Japan runs current account surpluses but does not lend much abroad in yen, thus creating currency mismatch (as liabilities are mainly in yen). But unlike China's and other emerging markets, liquid assets denominated in foreign currencies are accumulated mainly by private financial sector (domestic banks, insurance companies, pension funds). Apart from it, large Japanese corporations make overseas direct investments in many sectors. In Japan the government does not dominate the international intermediation of its saving as much as in China.

The resulting currency mismatch makes monetary management and security portfolio equilibrium in domestic financial markets more difficult. The main consequence of currency mismatch in immature creditor country is currency risk – the risk from potential exchange rate fluctuations, from buying dollar assets. The currency mismatch poses problem of risk management, creating an additional reason why China pegs its currency to the dollar. Because of this currency mismatch, private financial institutions may be reluctant to carry exchange rate risk. Thus, central bank becomes a financial intermediary and buys liquid dollar assets on a vast scale as the counterpart of China's saving surplus. In China, public-sector asset managers (mostly the State Administration of Foreign Exchange) invested in 2007 some two thirds of China's gross international assets. By contrast, in 2007 Germany's public-sector managers handled about 5% of Germany's international assets [Ma, McCauley 2013].

In fact, this leads to a sort of financial conundrum for China. According to R.I. McKinnon and G. Schnabl, China's financial conundrum arises from two sources:

1) building up foreign currency claims (largely dollars) within domestic financial institutions as a consequence of inability of financing its cumulating trade surplus with domestic currency,

2) attributing the surplus to an undervalued exchange rate.

The second source mentioned above leads to the syndrome of *conflicted virtue*. Foreigners accuse the Chinese government of manipulating the yuan/dollar exchange rate in order to have mercantile advantage and generate trade surplus, and threaten trade sanctions unless the currency appreciates. Intensive pressure to appreciate mostly stems from the IMF, the G-7, and the US Treasury. This is what P. Krugman and F. Bergsten call "China bashing" [Bergsten 2010; Krugman 2010].

At the same time, such a currency appreciation has many destabilizing properties. It could set in train serious deflation ending with a zero interest liquidity trap. It worsens the value of accumulated dollar assets. This argument is especially important if one keeps in mind that external assets of China are highly concentrated in dollar assets. Domestic holders of dollar assets worry about the possibility of appreciation and run into the domestic currency forcing an appreciation.

As runs into the domestic currency out of dollar assets begins, government is "conflicted". The greater the foreign mercantilist pressure for appreciation of the domestic currency, the greater is the concern of the domestic private holders of dollar assets.[1] This is quite different from the case of Japan – in Japan there is no anticipation of currency appreciation, thus currency mismatch does not pose such dilemmas for monetary authorities.

According to R.I. McKinnon, debtor countries have "original sin", and creditors have "conflicted virtue", making foreign exchange risks more difficult to hedge. In case of original sin hypothesis, there is both currency mismatch and maturity mismatch. Debtors cannot borrow in own currency nor can they hedge their net dollar indebtedness. In case of conflicted virtue there is currency mismatch but no necessary maturity mismatch.

What is interesting, emerging market economies, by changing instrument and currency structure of their international investment positions, have cast off their *original sin*. One may say it has transformed into a *conflicted virtue*. In the past, foreign currency-denominated external debt dominated the external liabilities of emerging markets. It has shifted, with foreign direct investment (FDI) and portfolio equity accounting for the majority of liabilities. This shift is consistent with greater international risk sharing. For example, in 2010 FDI and equity portfolio accounted for two-thirds of total external liabilities for China and Brazil, 51% for India, 56% for Russia [Prasad 2011]. Such a structure of liabilities is less risky for the country, as the threat posed by outflows of portfolio equity capital is less devastating than the rollover risk on short-term foreign currency debt that used to generate currency crisis. What is even more interesting, external debt issued by these countries is increasingly denominated in their own currencies. The asset side of the international investment position is dominated by foreign exchange reserves which are accumulated mostly in government bonds of advanced countries. Foreign exchange reserves account for a large share of total external assets – 47% for Brazil, 69% for China, 68% for India, 37% for Russia [Prasad 2011]. As the level of public debt in the major reserve currency economies is high and rising, it means that the risk on emerging market balance sheets has shifted – from liability to the asset side.

4. The dilemma of monetary policy as a consequence of being an immature creditor

Being an immature international creditor is the principle source of the upward pressure on the yuan. Another source stems from the fact, that short interest rates in United States, United Kingdom European Union and Japan are extremely low, near-zero. With Chinese economy growing fast, having higher interest rates, hot money

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[1] As R. Kinnon and G. Schnabl depict the problem, "the virtuous country becomes conflicted. Whence conflicted virtue". The term "conflicted" connotes dilemma or impasse.

flows to China. Once the yuan begins to appreciate, carry traders see greater short-term profits from investing in yuan assets.

The main problem of immature country government facing *conflicted virtue* syndrome is whether to intervene to resist currency appreciation or not. The exchange rate regime of China has become the bone of contention among economist. The first group of economists point advantages of floating. Those from the opposite side point that there is no market solution for the exchange rate for a large immature creditor country.

The main arguments for intervening against appreciation are the following:

- It could crowd out exports which are the main source of economic growth (short-time effect).
- It could cause a fall in domestic prices relative to international levels (long-time effect). This argument is based in historical experiences of Japan. As R.I. McKinnon points out, when the yen rose from 360 to the dollar in 1971 to peak out at 80 to the dollar in 1995, eventually the Japanese price level fell relative to the American one and threw the Japanese economy into a deflationary slump in the 1990s replete with a near-zero interest liquidity trap [McKinnon 2007]. What is important, the repetitive appreciations of yen from 1970s to mid-90s under international pressure (especially from the United States) did not prevent trade surplus from growing.

G. Schnabl sees many benefits of pegging the renminbi to the dollar [Cheung, de Haan 2012]:

1. It stabilized the economy, which laid the foundation for increasing investment and boosting trade.

2. The dollar peg stabilizes financial markets. Without the peg, sustained appreciation expectations would depress interest rates below the interest rate of the anchor country thereby pushing China into a near-zero interest liquidity trap.

3. Peg as well as decisive countercyclical macroeconomic policies played also a crucial role in stabilizing the East-Asian region. The Chinese peg is the core of an informal dollar standard with the dollar as first (external) anchor and the Chinese yuan as the second one (internal), which is the (second) best solution to maintain the intraregional exchange rate stability and growth. In this way China has moved from regional to a global stabilizer. This argument is based on the fact that East Asian economies have become highly integrated economically, with more than 50% of trade with each other. They need stable cross rates of exchange [McKinnon, Schnabl 2004].

The destabilizing effect of strengthening the currency was experienced during China's upward crawling peg from July 2005 to August 2008, when one-way bets on the Chinese yuan led to an acceleration of speculative capital inflows and extensive sterilization operations by the Chinese central bank [Schnabl 2010].

In G. Schnabl's opinion, the most important drawback of appreciation is distortion caused by the fact that interventions are sterilized so that the real exchange rate does not increase.

R.I. McKinnon stresses another argument against appreciation of the yuan – that stable exchange rate yuan/dollar can encourage higher wage growth. From higher wage growth at a stable nominal exchange rate, China's real international competitiveness would be better calibrated by encouraging unit labour costs to converge to those in developed countries.

Other arguments in favour of stabilizing exchange rate are based on the assumption that exchange rate movements do not necessarily correct trade imbalances between open economics, but they can increase hot money flows.

The economist emphasizes that the private sector unwillingness to hold dollar assets makes a free float impossible.

The main argument in favour of floating is that this exchange rate regime would permit conduct independent monetary policy. As A.A. Hossain points out, this is particularly appropriate for a relatively large economy, such as China's, with a commensurately large non-tradable goods sector [Hossain 2015]. A flexible exchange rate would have the added advantage of helping to absorb shocks, both domestic and external. On the other hand, as China does not have deep foreign exchange markets, there is the fear that flexible exchange rate may be volatile.

Stabilizing the exchange rate means costs associated with accumulation of foreign reserves. The accumulation of foreign reserves increases domestic base money supply, risking inflation and asset – price bubbles. Sterilization of the purchases of reserves also has adverse consequences. Raising reserve requirements, which is often used by Chinese central bank, reduces the effectiveness of the banking sector as financial intermediaries, while encouraging the rise of shadow banking to circumvent the restrictions.

A rapid accumulation of foreign reserves in China has expanded the money supply despite partial sterilization of foreign capital inflows. Chinese inflation is very volatile, albeit on a low average rate, and mainly monetary in nature. It arises from multiple objectives of monetary policy (exchange rate stabilization, price level stabilization) and the central bank's limited control over instruments (although, empirical studies show important role of various supply shocks in influencing volatility of inflation). Budget deficit is not considered a source of inflation. High-inflation volatility in China leads to high volatility in both the real interest rate and real exchange rate.[2]

Empirical studies show that the inflation rates in China and the United States may have a short-term relation but they do not establish a cointegral – casual linkage despite China's fixed peg to the US dollar. The same empirical studies suggest no significant cointegral-causal relation between the US Treasury bill rate and the

[2] There is a debate whether China operated a real exchange rate targeting policy to promote economic growth by keeping its real exchange rate depreciated or undervalued. According to empirical studies presented by A.A. Hossain, since the mid-1990s, the real exchange rate has remained relatively stable.

deposit rate of interest in China. These interest rates are not causally related although they appear to show similar trends since the late 1980s. That implies that China possesses some monetary policy independence and that changes in monetary policy in the United States do not necessarily lead to a corresponding change in monetary policy in China [Hossain 2015]. One may draw the conclusion that despite the fixed peg exchange rate system, capital controls have allowed China to conduct monetary policy in a somewhat independent manner. However, fixed peg has created high volatilities in the rate of inflation, real interest rates and real exchange rates. These volatilities, in turn, have caused adverse impact on real output or its growth, by carrying the danger of creating or exacerbating boom-bust cycles.

5. Solutions to conflicted virtue syndrome of immature creditor country

Because of the currency risk associated with the status of immature creditor, the intermediation of China's saving surplus is left to the public sector, instead of the private one. As R.I. McKinnon points out, the central bank and the government have three tools available:

1. The creation of sovereign wealth funds, like China Investment Corporation (CIC) to invest overseas.
2. Encouraging state-owned enterprises to invest.
3. Promoting aid programs in developing countries, which would generate a return flow of raw materials.

The main advantage of these ways of intermediating China's saving surplus internationally is that they minimize the possibility of hot money inflows back into China.

In the discussions on international financial intermediation by an immature creditor country while preserving monetary control, R.I. McKinnon recalls the "Singapore Solution". To prevent hot money inflows, the Singapore government nationalizes the internal flow of saving by requiring all Singaporeans to deposit into the Singapore Provident Fund: a state-run defined-contribution pension scheme. Then Provident Fund capital is lent to two giant sovereign wealth funds: the Government Overseas Investment Corporation (GIC) which invests in liquid foreign assets, and Temasek which invests in more risky foreign assets as equities and real estate.

Again, one may see the experiences of Japan as an immature creditor country with its overseas investments which are vulnerable to hot money flows. Over the last 20 years, carry trades out of low yield yen assets have been commonplace with a weakening yen. These can suddenly reverse as in 2008, leaving Japanese economy vulnerable to runs from dollars to yen [McKinnon 2010].

6. Conclusions

The working of the international monetary system allows big countries to run big surpluses. According to this statement, China is going to run surpluses in the long run. This means the necessity of overcoming dilemma stemming from *conflicted virtue* syndrome and status of immature creditor.

As has been stated, China's external assets are concentrated in dollars, reflecting the historical anchoring of the renminbi to the US dollar, but this concentration is not backstopped by parallel monetary or political structures of integration. Thus in the long run the de-linking with the dollar is plausible, which would also render monetary policy in China less dependent on US monetary parameters.

In the short run, the solution is to liberalize the Chinese domestic financial markets by eliminating interest rates restrictions as well as liberalize capital account restrictions. In this way China could become a mature international creditor with natural outflows of financial capital to finance its trade surplus.

In the long run, the process of internationalization of yuan can become the solution to the China's financial conundrum and dilemmas for monetary policy depicted above.

This process should be accompanied by a gradual revaluation of yuan together with the process of remodelling of the development pattern of the country – enhancing the consumption. Adopting a flexible exchange rate should allow China to gain monetary policy independence and improve the quality of its monetary policy. Provided that monetary policy is credible, the pass-through if the exchange rate on prices would fall.

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