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China's Great Transition: What It Means for Canada

Introduction

If I were to ask everyone here what the value of the Canadian dollar is these days, I expect you'd assume I meant relative to the US dollar. And you'd probably get the value bang on. This is understandable: the United States is our biggest trading partner, and most Canadians, especially business people like you, are well aware of the links between our two economies.

Now, if I were to ask you about the exchange rate between the Canadian dollar and the Chinese renminbi, the answers probably wouldn't be as accurate. This makes sense too: it's not a number you often come across, even if you're reading news stories about China's slowing growth and financial volatility.

Yet, China is Canada's second-largest trading partner and accounts for 17 per cent of the world economy.[1] More than 400 Canadian companies have a foothold there. They are in sectors as diverse as life sciences, aerospace and information technology. China's currency is on the way to becoming a global reserve currency. A decade from now, our children may convert Canadian dollars into renminbi as easily as we do now for US dollars.

We pay very close attention to China at the Bank of Canada because of its growing importance to our country's economic and financial well-being. Today, I want to share with you some of what we've learned by studying how China's

[1] On a purchasing-power-parity basis

I'd like to thank Mark Kruger and Gurnain Pasricha for their help in preparing this speech.

economy and financial system have evolved, and to discuss the opportunities and challenges that lie ahead.

This is relevant to all regions of Canada, especially here in Vancouver, our gateway to Asia. It's a real pleasure to be here, and I'd like to thank the Greater Vancouver Board of Trade for the invitation.

In my remarks, I will walk you through four points that frame our thinking on China:

(i) China's rise on the world stage has been exceptional, even disruptive, and beneficial for the global economy and Canada.

(ii) The slowing of China's growth to a more sustainable pace is not only inevitable, it's also desirable.

(iii) History teaches us that this type of transition is difficult to manage, takes time and is very likely to be uneven.

(iv) Canada is not immune to the risks China poses to the global economy, but we're well positioned to manage them.

A Giant Awakens

China's market reforms of the 1980s and its accession to the World Trade Organization (WTO) in 2001 marked the beginning of a remarkable transformation that has been felt around the world.

For China, the process has been overwhelmingly positive, even though it has entailed some stresses, particularly environmental ones. Its economy has more than tripled in size. More than a quarter of a billion Chinese people have been lifted out of poverty, in what has been the largest migration of rural workers to cities in history.[2] Life expectancy has increased by nearly three years. And China is hosting the G20 this year, just one example of its growing presence on the world stage.

China's transformation has also yielded benefits for the global economy. It's true that China and other emerging markets have presented stiff competition to exporters around the globe, including in Canada. We see the result in the declining proportion of people working in manufacturing industries in advanced economies, which has been difficult for many. And it likely contributed to the buildup of imbalances in the global financial system ahead of the financial crisis in 2008.[3] Yet, China's expansion also helped drive global trade to record highs. This means that exporters have been selling into a bigger market. At the same

[2] R. Garnaut, L. Song and C. Fang, "Reform and China's Long-Term Growth and Development," in *Deepening Reform for China's Long-Term Growth and Development* (Canberra: ANU Press, 2014): 3–25.

[3] B. S. Bernanke, "International Capital Flows and the Returns to Safe Assets in the United States 2003–2007," Banque de France, *Financial Stability Review,* no. 15 (February 2011): 13–26.

time, businesses and households have benefited from lower prices for many goods.[4]

China's growth has also meant better prices for the resources Canada sells. China has become the world's second-largest consumer of oil, with its demand doubling over the past 15 years.[5] It now buys half of the world's output of base metals, compared with less than 20 per cent in 2001.

This has helped make Canada richer. China's increased demand for commodities contributed to the big improvement in Canada's terms of trade—the price of our exports relative to that of our imports—between 2001 and 2008. Our terms of trade has fallen over the past couple of years, in part because of slowing growth in China, but it remains just over 10 per cent higher than it was when China joined the WTO.

It's hard to overstate how quickly the economic links between our two countries have developed. Two-way trade between Canada and China increased more than fivefold over the past decade and a half, and our exports to that country now exceed $20 billion a year. British Columbia has seized this opportunity; for example, China bought just under one-third of the province's exports of forestry products last year, compared with only 4 per cent in 2001.

Our governments have also worked to encourage trade and investment through accords, trade missions and other agreements with China.[6] And the growth in foreign direct investment in both directions speaks to the deep links that have been formed.[7]

On the financial side, the Bank of Canada signed a $30 billion Canadian dollar/renminbi bilateral swap arrangement with the People's Bank of China in 2014. This paved the way for the opening last year of the Canadian Renminbi Trading Hub, which will make it easier for our companies to use renminbi in business transactions. Canadian financial institutions are active in China, and, just a few months ago, British Columbia became one of the first governments to issue Panda bonds in China.

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[4] L. Morel, "The Direct Effect of China on Canadian Consumer Prices: An Empirical Assessment," Staff Discussion Paper No. 2007-10, Bank of Canada, 2007; M. Francis, "The Effect of China on Global Prices," *Bank of Canada Review* (Autumn 2007): 13–25.

[5] According to the International Energy Agency, China's oil consumption rose to 10.6 million barrels per day in 2014, from 4.6 million barrels per day in 2000.

[6] Examples include the Canada–China Foreign Investment Promotion and Protection Agreement, the Joint Declaration on Canada–China Clean Technology Cooperation, and the memorandum of understanding aimed at increasing British Columbia's lumber exports to China. For more information, see http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/fipa-apie/china-chine.aspx?lang=eng, http://news.gc.ca/web/article-en.do?nid=1036379, and https://news.gov.bc.ca/stories/china-and-bc-sign-wood-frame-mou.

[7] China's investments in Canada reached $25 billion in 2014, 115 times more than they were in 2001. Meanwhile, Canadian investments in China rose by a factor of 10 during the same period, to $7 billion.

Slower— but Steady—Wins the Race

Let me turn to my second point. While China's economic growth has had an overall positive impact on the Canadian economy, that growth is slowing. It's slowing to a more sustainable pace, and this is not only inevitable, it's desirable.

The Chinese economy expanded by a little less than 7 per cent last year. That sounds fast relative to advanced economies, but it's the slowest pace for China in 25 years and down from the double-digit numbers of a few years ago.

The slowdown is natural. The economic strategy that the Chinese have pursued over the past 15 years cannot continue indefinitely. The strategy is simple: add more workers and more capital to increase the economy's potential to produce goods, and then sell those goods in global markets.

This has run its course, for a couple of reasons. First, demographic forces are no longer in China's favour—the working-age population is projected to shrink by about 5 per cent by 2030.[8] Second, China's reliance on investment is not sustainable—it was 46 per cent of GDP in 2014, compared with 25 per cent for other emerging-market and developing economies and 20 per cent for advanced economies.[9]

The strong investment policy is increasingly creating redundant or unproductive capital in China, which may boost growth in the short run but also increases the odds of painful economic adjustments in the future.

A critical question is where growth in China is likely to settle if the transition is successful. Bank of Canada researchers judge that China has the potential to grow at an annual rate of around 6 per cent, on average, over the next 15 years.[10] At that pace, it takes less than 12 years for the economy to double in size.

To understand how such growth is possible, recall that China's GDP per capita is still only one-fifth of what it is in the United States. This means China still has a lot of room to catch up by adopting existing advanced technologies. As part of this process, the share of agricultural workers in China will continue to shrink, to the benefit of more productive sectors.

With Chinese incomes rising, education levels should follow suit and boost productivity. These improvements in human capital could potentially more than make up for the decline in the working-age population.[11]

One implication for Canada is that China's demand for commodities should remain high and grow from a higher base, even if the country's economic growth is slower and less reliant on natural resources.

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[8] According to United Nations population projections, China's working-age population is estimated to decline by 4.5 per cent between its 2014 peak and 2030.

[9] International Monetary Fund, *World Economic Outlook Database*, October 2015.

[10] These values are based on J. Bailliu, M. Kruger, A. Toktamyssov and W. Welbourn, "How Fast Can China Grow? The Middle Kingdom's Prospects to 2030," Staff Working Paper No. 2016-15, Bank of Canada, 2016.

[11] Ibid.

Solving the Chinese Puzzle

My third point is that history shows that the transition to the next stage of development is difficult to manage, takes time and is quite likely to be uneven.

If China is to achieve its potential to grow, it will have to avoid what economists call the "middle-income trap," in which developing countries that seem destined to join the club of advanced economies suddenly see their growth stagnate for many years.[12]

Chinese authorities recognize that their specific challenge is to shift from an economy fuelled by investment to one supported by domestic consumption. Another is to boost productivity. To meet these challenges and to achieve the economy's potential, Chinese authorities are working to fit a number of pieces together—much like a Chinese puzzle. There are many pieces, but let me mention three.

Comprehensive social safety net

The first one is outside the purview of central banking but crucial to achieving the rotation of demand toward consumption. I'm talking about a comprehensive social safety net. In advanced economies that have a public pension system, unemployment insurance and healthcare, risks are pooled, and people can spend more of their income because there is relatively less need to save for a rainy day. That's why people in developed countries save an average of around 5 cents of every dollar they earn. Contrast this with China, where urban households currently save nearly 40 cents out of every dollar earned.

Chinese workers and capital will also need to adjust as the composition of the economy shifts out of state-owned sectors like coal and steel, toward more productive sectors like high value-added services.[13] This will be a lengthy transition, in part because many people will need to relocate to different regions and perhaps even be retrained.

China has taken steps in the right direction, bringing in pension reforms, higher healthcare spending and reforms to the household registration system that will give migrant workers access to basic services in smaller Chinese cities. China also made raising the level of social protection a priority in its new Five-Year Plan.

Solid monetary policy framework

The second piece, which is very relevant to central bankers, is a solid monetary policy framework to provide the foundation for sustainable growth. China faces what is known in international economics as the "policy trilemma."[14] No country

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[12] S. Aiyar, R. Duval, D. Puy, Y. Wu and L. Zhang, "Growth Slowdowns and the Middle-Income Trap," IMF Working Paper WP/13/71, International Monetary Fund, 2013.

[13] The 13th Five-Year Plan promotes the development of industrial design, engineering, legal and accounting services, among others.

[14] The concept was developed by Canadian economist Robert A. Mundell and British economist Marcus Fleming. Mundell won the Nobel Prize for Economics in 1999.

can sustainably maintain all of the following three policies: (i) a fixed exchange rate, (ii) independent monetary policy and (iii) free international capital flows. It's the classic case of "you can't have it all."

Resolving this trilemma won't be easy, and it takes time. No one knows this better than Canada. We successfully confronted the trilemma and then later adopted inflation targeting in 1991, which was the perfect complement to a floating exchange rate and free capital flows. This monetary policy framework has served us well for the past quarter century.

But we should remember that it took us several decades, and a number of policy reversals and missteps, to reach this point. History buffs will recall that Canada let markets determine the value of the Canadian dollar in 1950, then went back to a fixed exchange rate in 1962 and finally adopted a floating exchange rate in 1970.[15] Yet we still lacked a robust monetary anchor and this contributed to a period of very high inflation that lasted through the early 1980s. The lesson for us is that orienting monetary policy toward achieving low and stable inflation can lead to better economic outcomes.[16]

China only recently moved from pegging the renminbi to the US dollar to maintaining its stability against a basket of currencies. This has increased the variability of the renminbi/US$ exchange rate and allows for exchange rate movements that could facilitate deep structural adjustments. Certainly, in Canada, we've seen that our floating exchange rate supports structural adjustments, like the reorientation toward the non-resource sector under way today. My colleague Deputy Governor Lynn Patterson gave a speech about this last week—I recommend it to anyone who wants to learn more about this transition.[17]

That said, if Chinese authorities gear monetary policy toward supporting the exchange rate, there may be trade-offs with pursuing domestic objectives. Moreover, the appropriate level of the basket itself changes over time, leading to speculative flows if the target level is not adjusted on a timely basis.

Chinese authorities have committed to further liberalizing the capital account. Loosening restrictions on international flows, if managed well and at the right time, could help China's transition.[18] Liberalizing the capital account would help to complete markets and expand access to market financing within China.

That said, liberalizing the capital account is one of the most difficult challenges that developing economies face. Take the Asian Crisis as an example: countries liberalized their capital accounts before their financial systems were ready and suffered a currency crisis in 1997 that set their development back a few years. One of the lessons is the need for well-developed and resilient financial markets to allow for the pricing of risks and to accommodate large financial flows. This

[15] J. Powell, *A History of the Canadian Dollar* (Ottawa: Bank of Canada, 2005).
[16] M. Parkin, "Mounting Evidence: Findings from Natural Experiments in Inflation Targeting," E-Brief, C.D. Howe Institute, 31 March 2016.
[17] L. Patterson, "Adjusting to the Fall in Commodity Prices: One Step at a Time" (speech to the Edmonton Chamber of Commerce, Edmonton, Alberta, 30 March 2016).
[18] These benefits are discussed in greater detail in Kruger and Pasricha (forthcoming).

episode also illustrates that a lack of market-determined exchange rate flexibility can encourage excessive unhedged foreign currency borrowing. Hedging raises the cost of foreign borrowing and would have limited excessive exposures.

Financial stability

Financial stability is the last piece of the puzzle I'll mention. There are some points of concern here. In the aftermath of the global financial crisis, China embarked on a massive expansion of credit to support domestic demand.[19] China's overall debt has grown much faster than the economy, now reaching some 285 per cent of GDP. Around 60 per cent of this is in the non-financial corporate sector, mainly state-owned enterprises. This sector is where a lot of the excess capital and non-performing loans may reside.[20]

There are other worries too, such as potential under-reporting of non-performing loans in the banking sector and the strong growth in lending and other financial activity by entities that may be lightly regulated.[21]

That is why Chinese authorities are working to strengthen regulation and oversight. For instance, they have improved the transparency of the country's debt, which should make it easier to spot problems before they spiral out of control. Local governments, for example, are now required to borrow by issuing bonds for new projects rather than by using opaque financing vehicles. Moreover, China is a net international creditor—of about US$1.7 trillion—which insulates it, to some extent, from the decisions of international investors.

The People's Bank of China has so far been able to manage downward pressures on the renminbi that have come with capital outflows. An estimated US$600 billion left China last year.[22] Some of the capital outflows have been Chinese corporations paying down foreign currency debt, which is a good thing. The People's Bank of China still has around US$3 trillion in reserves. There is concern in markets that, if capital account pressures were to continue, the central bank may have to either lower its target range for the currency or introduce more-stringent capital controls. Chinese authorities are focusing on more proactive communications and reforms to foster trust in their financial system.

Canada Has a Stake in China's Future

This brings me to my final point. Canada is not immune to the risks that China's transition poses to the global economy. It is nonetheless well positioned to manage them.

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[19] The Bank for International Settlements (BIS), which conducts a worldwide assessment of financial sectors every quarter, identified China as a vulnerable financial system, as measured by three out of the four early warning indicators used. See Bank for International Settlements, *BIS Quarterly Review*, September 2015.

[20] Data are from the Institute of International Finance's *Emerging Market Debt Monitor*.

[21] Financial Stability Board, *Global Shadow Banking Monitoring Report 2015*, 12 November 2015.

[22] See the Institute of International Finance's Annual EM Capital Flows Database.

At the Bank of Canada, we've been thinking through what a shock from China would mean for our economy.[23]

Canada would be affected mainly through lower commodity prices and slower trade. Direct financial spillovers would likely be relatively small because our banks have little direct exposure to China. What's more, the US and European banks that our banks do business with have strengthened their balance sheets since the financial crisis. That said, uncertainty about China's prospects has had a surprisingly large effect on investor confidence in recent months, so this could be an important channel.

To get a rough idea of how important the trade and commodity price channels could be, our staff conducted simulations using our economic models. They looked at what would be the effect on the Canadian economy if GDP growth in China were 1 percentage point lower than our baseline projection. They found that Canadian GDP would be 0.1 percentage point lower than it would have been otherwise. To give some perspective, if the same shock occurred in the US, the effect on our GDP would be six times greater.

The effects of a shock from China would also depend on a number of other factors our models don't capture well, such as what parts of the Chinese economy were growing more slowly and how severely global financial markets were impaired. A significant depreciation of the renminbi, especially if it were sudden, could be disruptive to the global financial system, with implications for Canada. It would also depend on the progress the Canadian economy has made in its own adjustment to the drop in commodity prices that we've seen in the past two years.

Canadian financial institutions have the capital and liquidity in place to handle adverse shocks like this. Stress tests conducted by the International Monetary Fund and Canadian authorities in 2013 showed that our banks can withstand a larger shock than even those we saw during the 2008 financial crisis or the recessions of the 1990s and 1980s.[24]

Conclusion

Ladies and gentlemen, let me conclude with a quote that dates back two centuries and that is attributed to Napoleon. He is reported to have said about China: « Ici repose un géant endormi, laissez-le dormir, car quand il s'éveillera, il étonnera le monde. » It means, "Here lies a sleeping giant, let him sleep, for when he wakes, he will shake up the world."

This was prescient. China's integration into the world economy has been nothing short of extraordinary.

As China's economy continues to mature, its growth is slowing to a more sustainable pace. This is desirable. China has the potential to grow at a healthy pace over the longer run, but the transition will take time and there is uncertainty

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[23] Bank of Canada, *Financial System Review* (December 2015); Bank of Canada, *Monetary Policy Report* (January 2016).

[24] K. Anand, G. Bédard-Pagé and V. Traclet, "Stress Testing the Canadian Banking System: A System-Wide Approach," Bank of Canada *Financial System Review* (June 2014): 61–68.

about whether this potential will be fully achieved. That means China may go through some periods of economic and financial volatility.

The Bank of Canada will continue to watch developments in China closely, given its importance to the global economy and Canada. China's transition poses risks, and Canada is well positioned to manage them. At the same time, lower prices for oil and other commodities mean that Canada is going through its own complex adjustment.

In March, the Bank of Canada left the policy interest rate unchanged, since the economy was evolving broadly in line with our expectations set out in our January *Monetary Policy Report*. Next week, we will update our projection and take into account all that has happened since January, including the measures announced in the federal budget.

And if you're still wondering about the exchange rate and have resisted googling it, the answer is around five renminbi per Canadian dollar.