As Dollar Falls, China Seeks National Economic Security, Internal Development

by Mary Burdman

The annual meeting of China's national congress became the setting for the Chinese government to assert its policy on two critical issues of national economic security: Stopping big international speculative operations trying to force an upvaluation of the renminbi (RMB); and dealing with the problems of poverty and infrastructure shortfalls in China's developing economy of 1.3 billion human beings.

In his opening speech at the National People's Congress March 5, Prime Minister Wen Jiabao said his government wants to slow down the rate of "GDP-measured" growth, to 7% this year. In 2003, it was 9.1%. China is concerned not only about the risk of inflation, but also about too much unbalanced and "low level" investment, Wen Jiabao said. The focus on "GDP" had not succeeded in resolving the long-standing problems of China's economy, especially the disparity between the rapidly growing eastern coast, and the vast interior. These disparities are growing, and this is a big risk for China's welfare.

China must continue its national investment policy, Wen Jiabao said, for "expanding domestic demand." It will keep up the "pro-active fiscal policy"—the program of special construction treasury bonds—although the government contribution will be somewhat reduced. At the same time, China "will work to basically balance international payments and keep the exchange rate for the renminbi basically stable at a proper and balanced level."

The Chinese government is striving to introduce an idea of "common wealth" in its policy, as the well-known economist Hu Angang has just said. But this is a challenge. In trying to improve conditions for China's 800 million farmers, the government will be losing revenue, and increasing its deficit. Economic bottlenecks, especially in infrastructure, are making development extremely difficult; the challenges are enormous.

And the international situation is making the challenges much greater. Since last year, extremist factions in Washington and Tokyo have been trying to force China to break the RMB's fixed exchange rate with the dollar, which has existed since 1994. During the international turmoil of that fateful year 1998, China, despite heavy pressure, kept its capital controls and fixed exchange rates intact—and was able to win its fight, in the famous "battle of Hong Kong" that year, against the attacks by international currency speculators which were devastating every other nation in Asia.

Now, with cries of "It's 1998 all over again" echoing on every side—as the dollar, hedge funds, and markets all tremble on the edge of the abyss—China is responding to renewed pressures, this time from *inflows* of an estimated \$30-50 billion in "hot money." (Some sources point to as much as \$85 billion.) This would account for about *half* of the highly controversial ballooning of China's dollar holdings in the past year.

At a press conference March 11, Zhou Xiaochuan, governor of the central People's Bank of China (PBOC) affirmed, as every leading official had done before him, that China will keep the exchange rate of the RMB "basically stable." China will also "strengthen coordination of its domestic and foreign currency policies, and better monitor and manage short-term capital flows," *People's Daily* reported from the press conference. The PBOC pledged to "improve" how it determines the RMB exchange rate—as ever—in the interests of China's national economy.

Last week, at a bimonthly meeting of "G-10" and "emerging" central bank governors in Basle, PBOC deputy governor in charge of international affairs Li Ruogu, had told the world's financial officials and bankers the same thing. "We have always stated that the RMB will be maintained at a reasonable level of stability," Li said. "Unless we can have satisfactory results on all these [financial sector] reforms, we don't think we can move fast on the exchange rate." Asked if he thought the yuan was correctly valued now, he replied "Certainly I do."

As a well-informed Beijing banker told *EIR* March 10, China has very closely studied, and learned the lessons of what happened to Japan after the 1985 Plaza Accord, when the United States forced Japan to let the yen rise sharply against the dollar, to save the badly threatened U.S. currency and eliminate huge U.S. deficits to Japan. Germany was given similar treatment.

Last September, after the Dubai G-7 meeting demanded "more flexibility in exchange rates," the *People's Daily* published a commentary stating that in 1985, "the U.S. forced the

The disparities between the rapidly growing eastern coast, and the vast interior, is still a big risk for China. With 800 million of its 1.3 billion population living in less-developed rural areas, the government intends to maintain its program of special construction treasury bonds. To facilitate this development perspective in the face of pressures due to the falling dollar, China wants to keep its capital controls and fixed exchange rates intact.

Japanese yen to revalue," in order to artificially eliminate the huge U.S. financial and trade deficits with Japan. Postwar Japanese economic growth, "which depended heavily on foreign resources," was thrown into a "yen revaluation depression." Now, Japan is bankrupting itself, weekly investing billions to maintain the yen against the dollar.

Beijing is also fully aware, that were it to give in to "market pressure" to revalue the RMB, that pressure would only get much worse.

It must be emphasized that many U.S. and European officials and economists also completely reject the demands for RMB revaluation, acknowledging that it would have devastating effects, especially on the fate of the U.S. dollar.

The Income Gap

Amidst the international turmoil, China is also facing an economic challenge on a scale only approached by that of India—how to bring a nation of 1.3 billion people, which, only 50 years ago, was among the poorest on earth, to general prosperity. Nothing like this has ever been done before, and China's new generation of leaders, who came to power only a year ago, is certainly aware of that. Two decades of "reform and opening up to the world," launched by the great reformer Deng Xiaoping, have brought enormous growth to China. But a huge problem remains. Some 800 million Chinese live and work in the rural economy, where living standards are barely *one-third* the level of urban living standards. For some 285 million people in interior China's "poverty belt," conditions are far worse.

This yawning "income gap" is a challenge to the current stability, and entire future, of China. In his NPC speech, Prime Minister Wen Jiabao emphasized that China must solve these "long-standing and deep-seated problems."

"Rural incomes have grown too slowly, the task of increasing employment and improving social security is arduous, development in different regions of the country is not balanced, the income gap is too wide among some members of society, and pressure on resources and the environment is mounting," Wen Jiabao said. The rural economy will be the "top priority of all our work."

Fighting Speculators

Already last Summer, leading Chinese officials and economists rejected any "shock therapy" (i.e, Plaza Accord-style) exchange rate "reform." This would, they warned, allow speculative "hot money" to rush in, sending the RMB into gyrations, which China's economy cannot handle.

As early as August 2003, the State Administration of Foreign Exchange (SAFE) announced that hot money was "sneaking" into China, speculating on a sharp up-valuation of the exchange rate, as U.S. Treasury Secretary John Snow was demanding. China's foreign exchange, overall, shot up by $116.8 billion last year, to $403.3 billion. The speculative funds got into China through trade, foreign direct investment, borrowings by foreign banks now operating under China's agreement with the World Trade Organization, and from overseas Chinese.

Last Autumn, the SAFE began a special investigation. The results were announced Feb. 26 in a special interview to the official news service *Xinhau*, given in Beijing by Guo Shuqing, who is both vice-governor of the PBOC—the central bank—and director-general of SAFE. Those who would bet on a rise of the RMB rate, he warned, should "be on the alert against risks in order to prevent unnecessary losses. [They] are likely to pay enormous prices."

It is notable that recently, the central bank of Russia has also been warning of hot money flows. In contrast to 1998, these are flows into the country, not capital flight, and the pressure is to force currencies up against the dollar. But the results would be just as dangerous. The Russian central bank warned of the rising exposure of big Russian corporations to foreign debt, and upward pressure on the ruble, which has actually been rising against the dollar.

On March 9, the China Banking Regulatory Commission (CBRC) announced a crackdown on foreign banks operating in China. It will now demand twice-yearly operations reports from the branches in China. Before, the foreign banks only had to report on their global operations. As of October 2003, there were 62 foreign-invested banks in China; as of December, about 40% of branches could provide Chinese currency services, increasing their economic influence.

"This has posed a challenge to continued effective supervision, and requires regulators to be clear about every foreign bank's overall operations and risk levels, and properly assess their business strategies and risk management capabilities," the CBRC spokesperson said. These foreign-owned banks have been heavily increasing foreign loans in China. They borrowed $58.6 billion in foreign loans in the first nine months of 2003, to lend to foreign companies in China, about 80% of China's total new foreign liabilities!

These were mostly short-term debts, making forex regulators suspicious that the foreign banks were speculating on a revaluation of the RMB. This process has been driving dollar inflows into China, pushing its foreign exchange reserves to unprecedented levels, and it fuelled monetary expansion last year, reported *Xinhua.*

The foreign banks will now have to account for lending activities, affiliated transactions, cross-border fund flows, bad loan provisions and capital adequacy ratios. The CBRC spokesman said that: "Implementing consolidated supervision on foreign-invested banks is of great significance."

Chinese firms are also implicated, some of them borrowing dollars abroad and selling them to Chinese banks for RMB. Higher domestic interest rates are also causing Chinese to dump dollars onto the central banking system in favor of RMB, all of which has increased China's dollar reserves.

Rational Trade Balance

As part of an effort to bring overall "exuberant" growth under control, China will also be slowing the expansion of its foreign trade this year, the Minister of the State Development and Reform Commission, Ma Kai, said in his annual report to the National People's Congress March 8. He emphasized that China had slowed down its foreign trade growth rate from 37%, to just 8% last year. Growth had been in double digits for many years.

Guo Shiqing had the same message. China will strive to balance its international payments this year, "before the negative impact of persistent surpluses comes into play," he told *Xinhua.* This would not be done via changing the exchange rate: the government will support higher value Chinese exports, increase quality imports into China, and tighten supervision of capital inflow.

China has been increasing imports since last year, and in addition, the soaring prices of commodities, including oil, has brought its previous trade surpluses into deficit in the first two months of 2004. The deficit was $682 million in January, and this rose sharply to $7.9 billion in February.

The trade policy has broader implications for China's national economic security, as a National People's Congress deputy from Guangdong province, Fu Hanxun, wrote in an article published in the *Peoples Daily* March 9. China, which is at a "turning period of strategic opportunity," should look at the fate of the nations of Latin America, he wrote.

Since the 1980s, countries such as Brazil and Argentina, striving to expand GDP, allowed all-out transfer of U.S. and EU processing industries into their countries, but did not have profit-and asset-transmission laws. Foreign capital now dominates 90% of Brazil's enterprises, Fu wrote. Many of these industries have been sent to China, leading to economic collapse in Latin America.

The key question for China is, "Do Chinese or foreign enterprises dominate its economy?" For the past 25 years, foreign enterprises have been given "super-national treatment" in China, unlike domestic enterprises. Some 60% of China's foreign trade was from foreign-controlled processing industries last year, and over 50% of manufacturing exports are from joint ventures. Such foreign dependence could well threaten China's economic security, Fu Hanxun warned.

Financial Risks

However, while asserting control, warned Guo Shuqing, China should not "overshoot" the goal, lowering its forex reserves too far. It must be prepared for speculative attacks, and "there is the possibility of a turnaround in the international balance of payment situation," were there to be a shift in U.S. interest rate policy. China maintains its foreign reserves primarily to guard against international financial risks, he emphasized.

During the Asian financial crisis, there was a hot debate in China, on whether it was the capital and currency controls, or its large forex reserves, which was most critical in protecting the national economy. Former Prime Minister Zhu Rongji was committed to expanding foreign exchange, and Guo Shuqing would appear to support this view, by citing the statements of Republic of Korea officials, that the more the forex reserve a country held, the better. This does not, however, mean any softness on the currency and capital controls front!

"Provided China was in a serious financial crisis," Guo said, "the country would need perhaps several hundred billion U.S. dollars, as tens of billions of U.S. dollars (in emergency aid) is not adequate, as its economic scale is very big." There is no lender under the current international financial system that can provide such a huge amount of money, and China must depend upon its own self-reliant efforts, he said.

LaRouche's Policy

China, like the rest of the world, is caught in the crashing U.S. dollar system. This creates more pressure in Asia than Europe: most European trade is within the EU, and is conducted in euros, but China has to use dollars. Its currency and capital controls are a vital line of defense for its national economic sovereignty, but this is not enough.

Amidst all the other financial pressures, certain institutions, including the likes of Goldman Sachs and HSBC, the current manifestation of Hongkong-Shanghai Bank, have been promoting the view that China will make a "small" revaluation of the RMB, and then peg it to a "basket of currencies." When this view was published in the *Chinese Business Post,* it was immediately denied by the PBOC.

The Beijing banker affirmed that China had no intention to re-peg the RMB to a "currency basket"—for very good reason. In the daily financial turmoil, world currencies are frantically gyrating against each other, making any "currency basket" unworkable.

There is *no* solution possible, other than that proposed by Lyndon LaRouche—a new Bretton Woods system. In August 1998, as the "Asia" crisis was careening towards its second, and worst phase, LaRouche warned that China should not yield to pressure, then, to *devalue* the RMB in the wake of the collapsing yen.

There is only one option: that "China, the U.S.A., and other relevant nations, . . . establish, as early as possible, a new international monetary order, eliminating the present 'floating exchange-rate' system, and establishing a set of adjustable, but approximately fixed parities, similar to the pre-1959 form of the Bretton Woods agreements," LaRouche wrote. Financial and trade relations must be based on fostering "development of basic economic infrastructure and advanced technologies of agriculture and industry from the already industrialized to the so-called developing nations." Here lies the answer for China.

Austerity Hits Hungary On Eve of Entry to EU

by Birgit Vitt

Hungary will, on May 1, become a member of the European Union (EU), along with Poland, the Czech Republic, Slovakia, Slovenia, the three Baltic states, Malta, and Cyprus. But a Schiller Institute delegation that visited Budapest in February received the impression that the country has not been well prepared for this step by its political leadership: People are facing a kind of reality-shock.

Two years ago, the Socialist/Liberal government coalition under Prime Minister Peter Megyessy came to power, having made many electoral promises to the effect that the new government would improve living standards. They increased the wages of 800,000 state employees, and raised pensions. This led to a short-term improvement for the people, but it also increased the state's expenses and inflation. The government tried to get its money back through other means. In 2003, inflation was at 5.3%; but, according to official statistics, the cost of living in January 2004 had increased by 6.6% in comparison to the year before. From December 2003 to January 2004, basic living costs rose by 2.1%. This must be seen in the context of the increased value added tax and consumer taxes. Hungarians had to pay 3% more for food, while costs for public transport, waste disposal, energy, alcohol, and tobacco also increased. Given the 5% value added tax, Hungarians had to pay 16% more for medicine.

This is only the beginning. On Feb. 11, Tibor Draskovics was nominated as the new Finance Minister. He has assured EU headquarters in Brussels that he will do everything he can to consolidate the budget, and announced a draconian austerity program of 570 million euros in cuts for 2004. This still means a budget deficit of 4.6%, and is far from fulfilling the criteria of the EU's Maastricht criteria, which limit the deficit to 3%. Hungary's entry into the Eurozone will therefore most probably not occur before 2010.

In the second half of 2003, there was a speculative run against the Hungarian currency, the forint, as a consequence of which, the central bank had to increase interest rates to 12%. The areas in which cuts will be made are the follwing: Economics Ministry Eu138 million; Defense Eu46 million; Education and Culture, each Eu32 million; Information Technology and Telecommunications Eu30 million. According to Interfax, subsidies for the health-insurance fund will be cut