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Hamlet Without the Pri(n)ce or Getting the Relative Price Right*

Comments on
"China's Rise, Twin Surplus and the Change of China's Development Strategy"
by Yongding Yu

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Tokyo Club Conference "The Future Structure of International Capital Flows"

Kyoto, November 2005

**** Hamlet appears on page 24 of a 26 page paper***

Recapitulation of the Paper

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Source of Great Performance

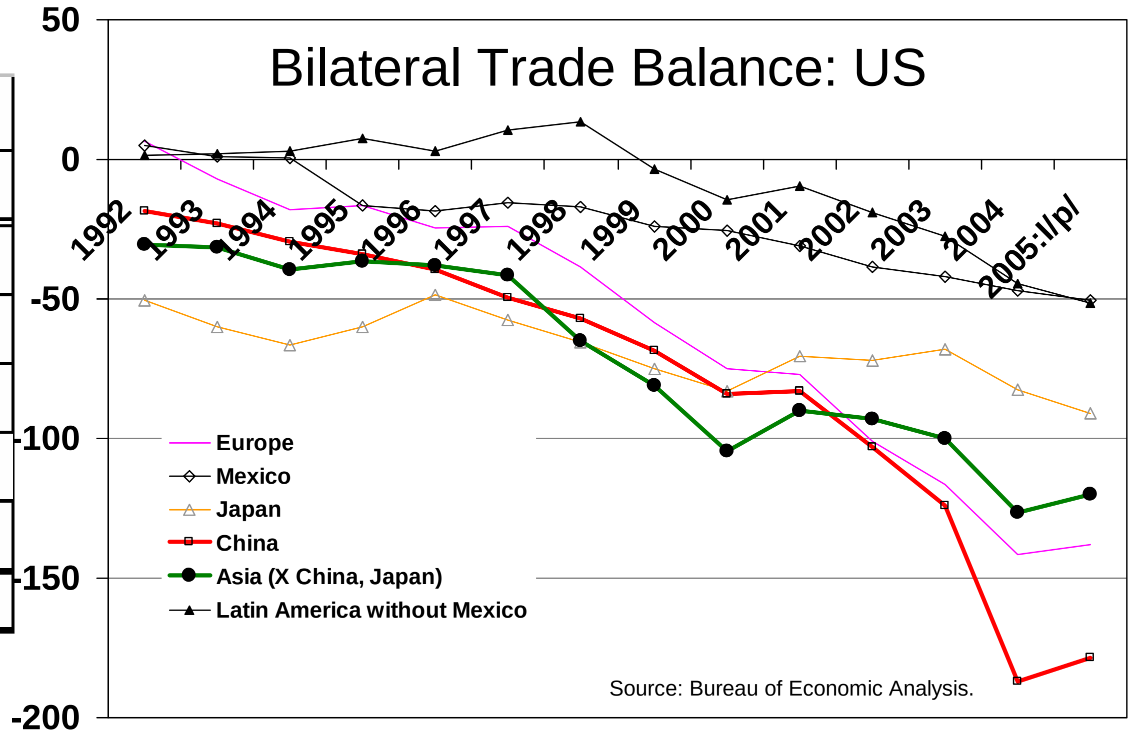
- Investment rate
  - Infrastructure
  - Educated labor
  - Good efficiency
- Global integration
  - FDI inflow and allocation
  - Tech transfer

Problems with Strategy

- Investment rate
  - Too high, inefficient, not mindful of pollution
  - Too much energy-intensive mfg vs. services
  - Rural-urban migration is not seen as a problem
- Global integration
  - Only a workshop
  - Not developing own R&D
  - Exposed to global cycles
- **'Twin surpluses'**
  - **Current account surplus**
  - **FX reserves**

Twin Surplus, Real: Trade & CA

Current Account/GDP					
	1990	1995	1998	2004	2005p
China	3.1	0.2	3.3	4.2	6.1
Japan	1.4	2.1	3	3.7	3.3
Dev.Asia	-1.3	-2.4	2.6	2.9	3.0
WestHemi	-0.1	-2.2	-4.5	0.9	0.9
EU	-0.6	0.4	0.5	0.1	-0.1
IMF,WEO database 9/2005					



Bilateral trade deficits with US is globally widespread—as a counterpart to US buying. But, rising CA/GDP surpluses, esp. China, implies increasing dependence on net exports for GDP growth, rather than own domestic demand

Imbalances evident throughout Asia

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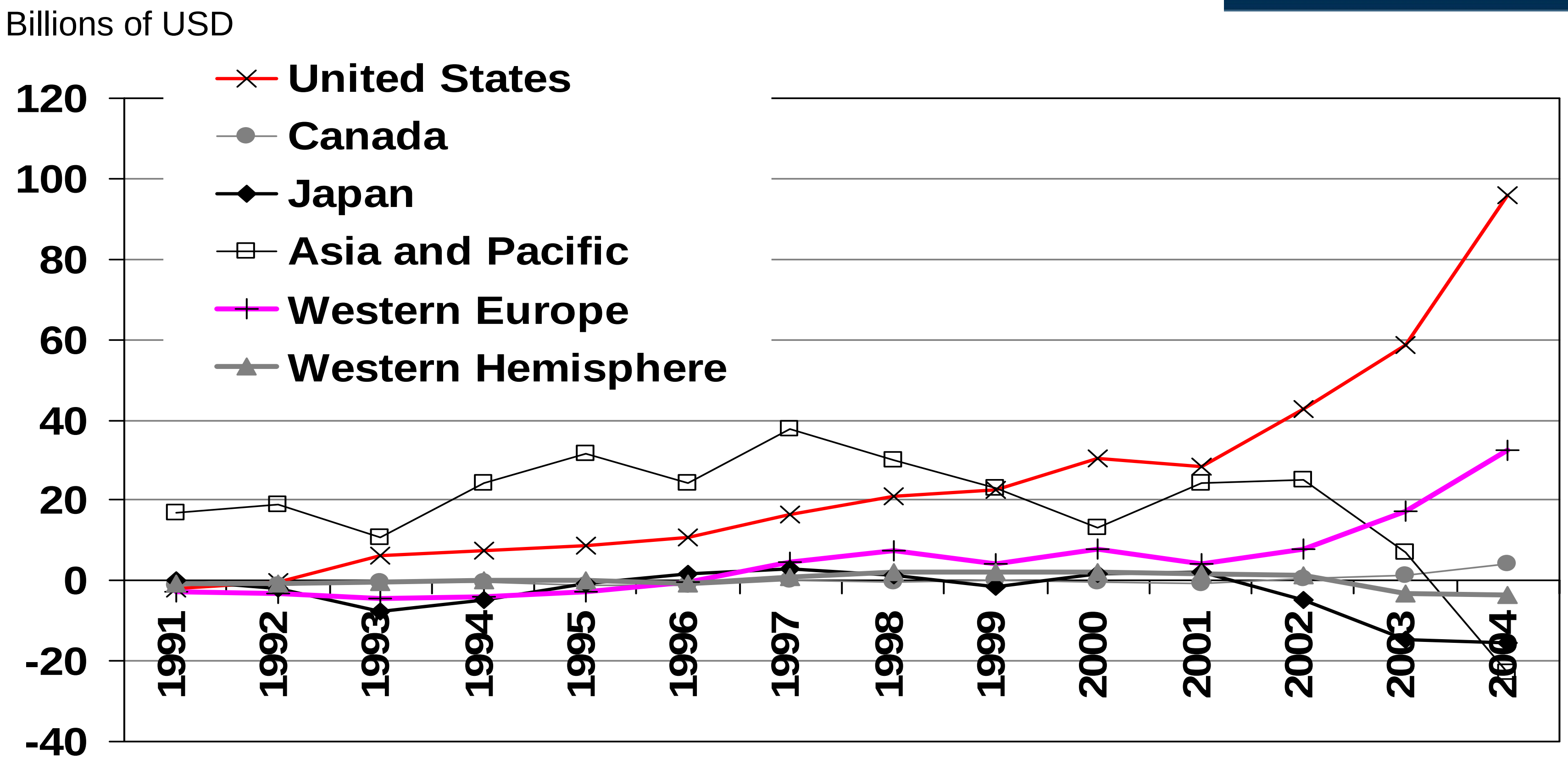
Bilateral Trade Balance: China



Source: UN COMTRADE Database.

Regional production depends on demand in US and Europe.

Asia is not its own engine of growth.

To what extent is China's strategy unbalancing the whole region?

Twin Surplus, Finance: UST Build-up

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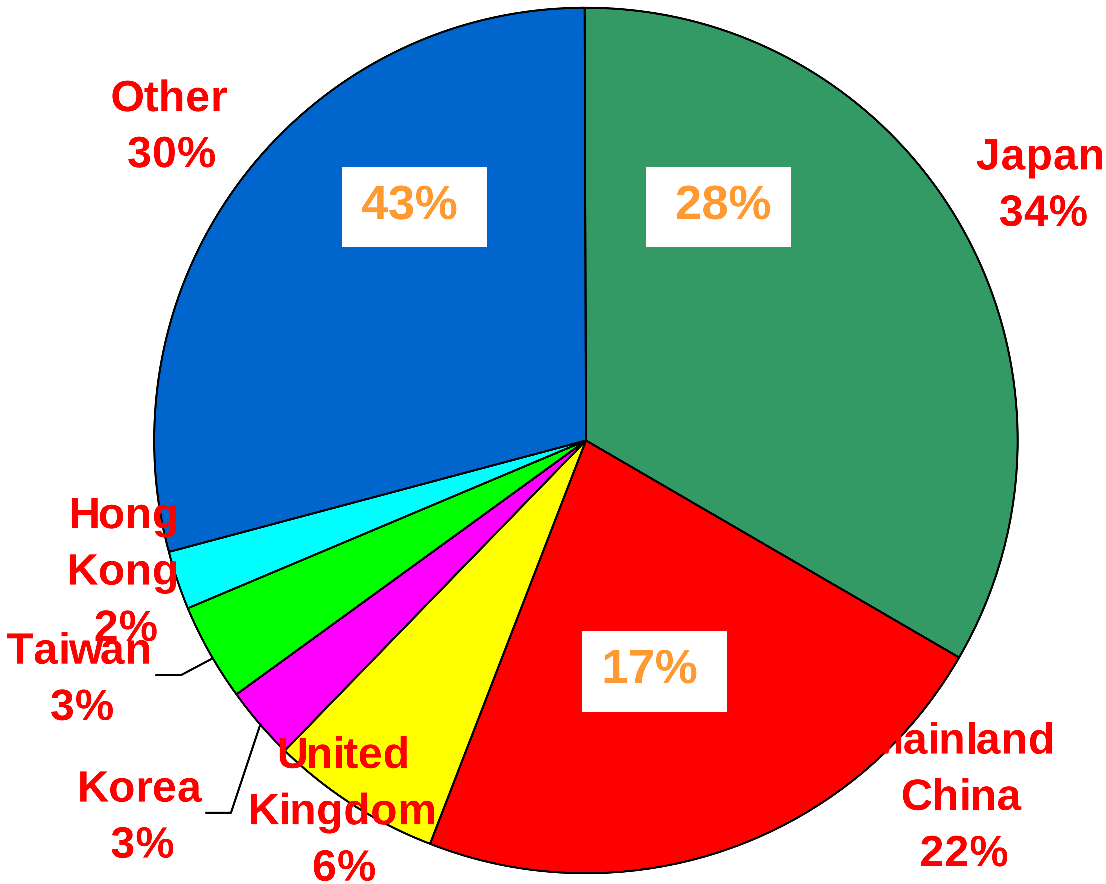
Derived Official Holdings of UST Securities

May 2005 (est. $1.24 T) vs. March 2000 (inside boxes) (est. $636B)



The Key Relative Price? Real Exchange Rate

Real Effective Exchange Rates, Time T (beginning year of economic integration)

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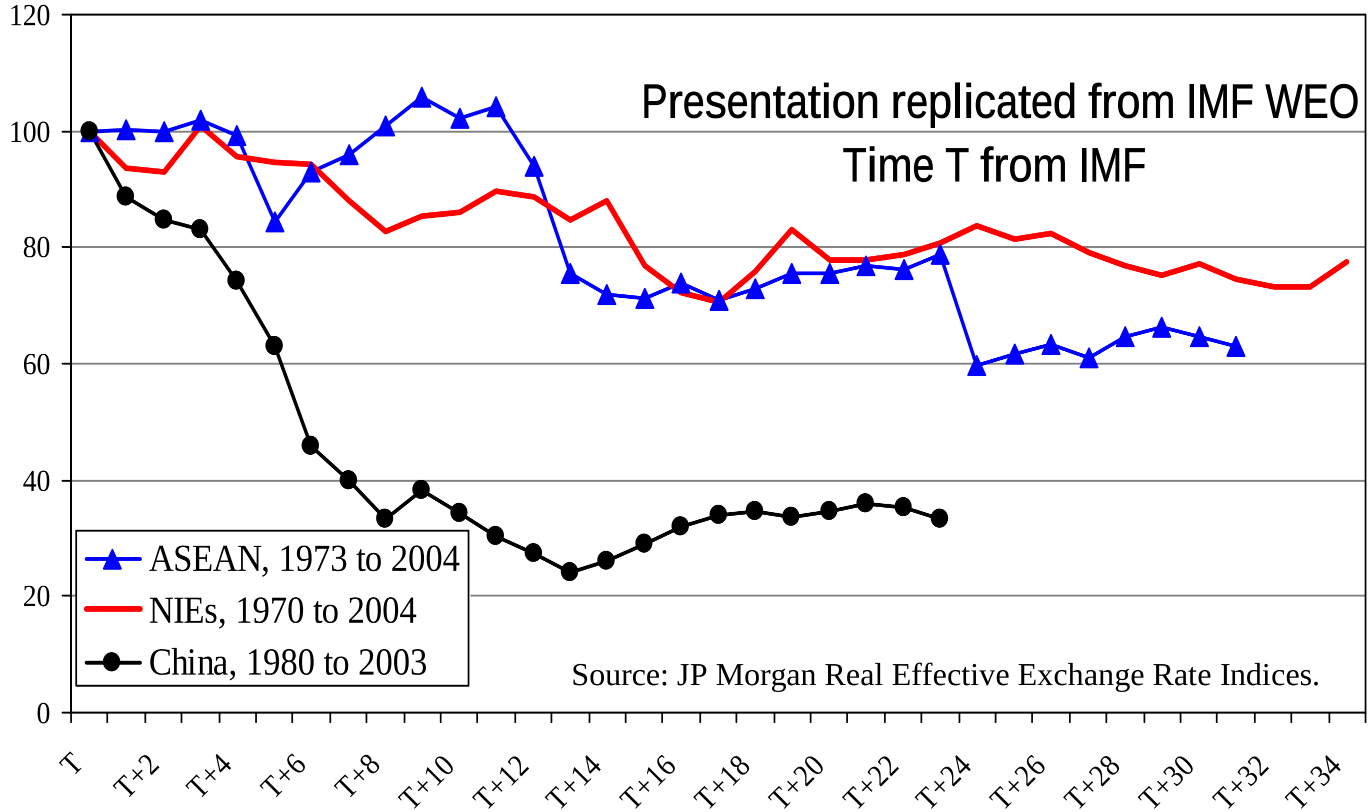

Industrialization process usually associated with real XR <u>appreciation</u>.
Real exchange rate is also the relative price of traded/non-traded.
The real exchange rate is central to development; need to ‘get it right’

Consequences of Persistent Undervaluation

- More FDI into same export sectors,
  - reducing profitability, efficiency in resource use, & tech upgrading.
- Too much complementary investment in related structures,
  - setting up real estate bubble.
- Undermines financial system,
  - since price and credit signals are wrong or unused.
- Leads to urban-rural disparities,
  - encouraging more migration and potential unrest.
- Generates CA surplus and build-up of FX reserves,
  - Exposes central bank to capital losses & country to protectionism.

➢ *The longer this goes on, the more challenging the adjustment path, not just for China, but for the region!*

Conclusions

- The exchange rate is relative price central to the development challenges addressed in the paper.
- Hamlet does not appear until page 24, of a 26 page paper!
- Mr. Yu is understated when he says,
  - "The market distortion is also related to the undervaluation of the exchange rate."
- Can he really answer,
  - "I do not know how China can get of of the mess unscathed." ?

References

- “Globalization and the US Trade Deficit: Domestic Sources, Foreign Sources, and Policy Challenges,” Testimony prepared for U.S.-China Economic and Security Review Commission Hearing May 19-20, 2005 .
- Breaking Up Is Hard To Do: Global Co-Dependency, Collective Action, and the Challenges of Global Adjustment,” CESifo, Summer 2005.
- Managing Exchange Rates: To Achieve Global Re-balancing or As Evidence of Global Co-Dependency?” *Business Economics,* June 2004.