“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

Mr. Yu first reviewed China’s stellar macroeconomic performance, but then pointed to some concerns related to domestic investment and FDI, particularly that China was investing too much in energy-intensive manufacturing and was not developing its own R&D capacity. He saw a problem developing with the ‘twin surpluses’ in the current account and foreign-exchange reserves.
In my comments, I focused on the price signal of the real exchange rate—that is the relative price of ‘traded’ goods to ‘non-traded’ services. This price signal is central to the balanced development process. There is evidence, in China and in the Asian region as a whole, that this price signal is not operating so as to promote balanced development.

The consequences of the relative price distortion include: Excessive investment (both domestic and foreign) in the same export sectors, which drives down margins, reduces efficiency in resource use, and reduces the incentives to upgrade technology; excessive investment in related structures (plant and residential), which sets up a real estate bubble; an undermining of the financial sector, which is inherently costly to development; a widening of the rural-urban disparity, which leads to migration and unrest; a rising current account surplus and build-up of foreign exchange reserves, which exposes the central bank to capital losses.

The longer the relative price/real exchange rate is distorted, the more challenging the adjustment path, not just for China, but for the whole region.