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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*Hamlet appears on page 24 of a 26 page paper
## Recapitulation of the Paper

### 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
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.
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

Derived Official Holdings of UST Securities
May 2005 (est. $1.24 T) vs. March 2000 (inside boxes) (est. $636B)

- **Japan**: 34%
- **Mainland China**: 22%
- **United States**: 17%
- **Other**: 30%
- **Hong Kong**: 6%
- **Taiwan**: 3%
- **Korea**: 3%

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Industrialization process usually associated with real XR appreciation. 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

