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.