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Comments on
Inflation, Appreciation, or Reform

A Structural and Institutional Perspective on RMB and China's External Imbalance"
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More to Agree than to Disagree

- The author correctly points out that:

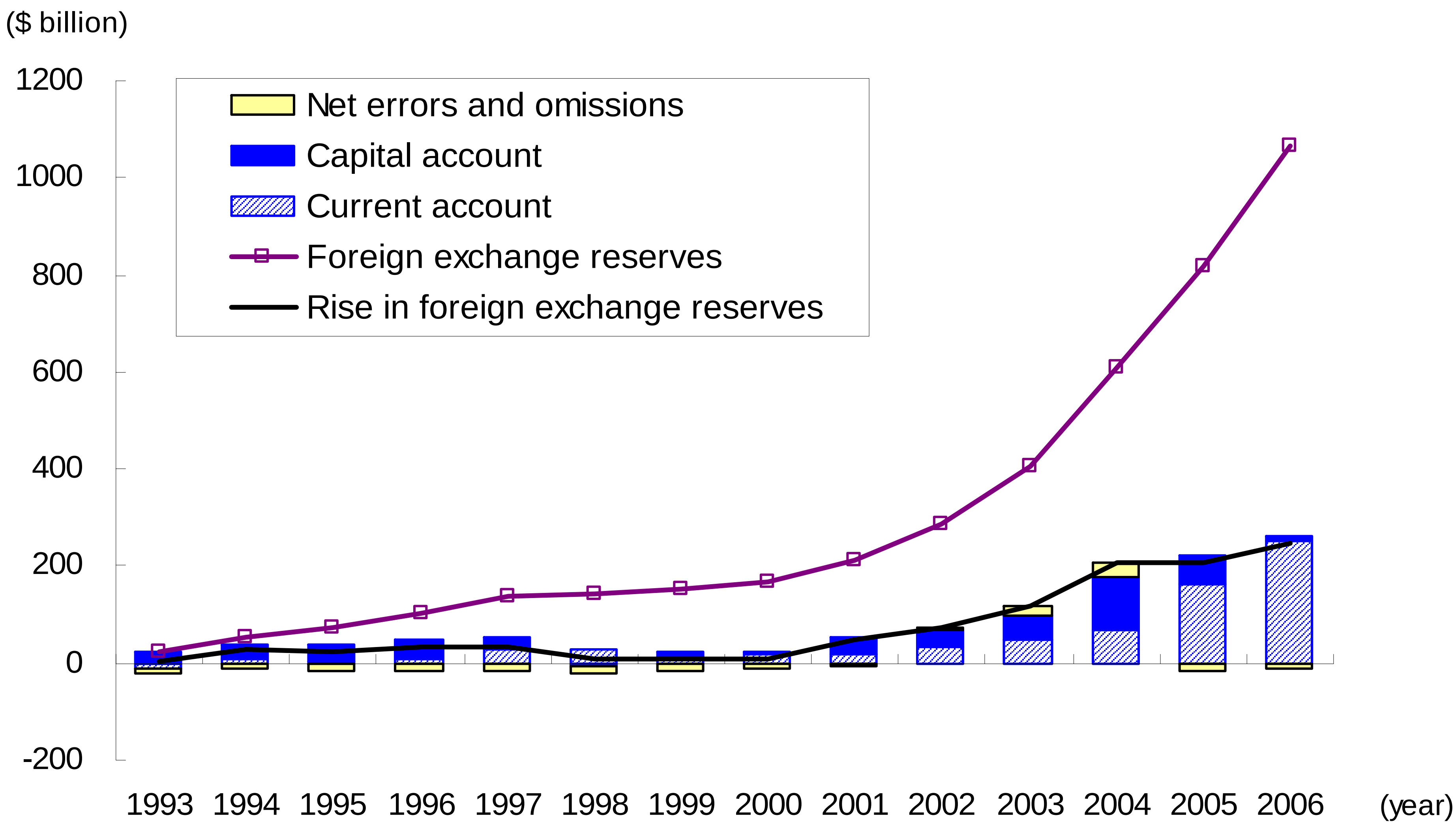
1. The reduction in transaction cost (together with rising productivity) is an important factor contributing to the improvement in the competitiveness of Chinese products.
2. In the long run, the government can at best control the nominal exchange rate, but not the real exchange rate. There is a tradeoff relation between price adjustment and exchange rate adjustment.
3. The Balassa-Samuelson hypothesis suggests that a fast growing country should see its exchange rate appreciating in real terms, but this had not been observed in China until recently because of the existence of an immense amount of surplus labor in the rural areas. However, the Balassa-Samuelson effect is becoming more apparent as China approaches full employment (Lewis turning point).
4. China needs to reform its financial sector as US Treasury Secretary Paulson suggested (Paulson Plan).

- I have some reservations, however, regarding the author's denial of the possible role that exchange rate policy can play in redressing BOP imbalances.

A Policy-mix Approach

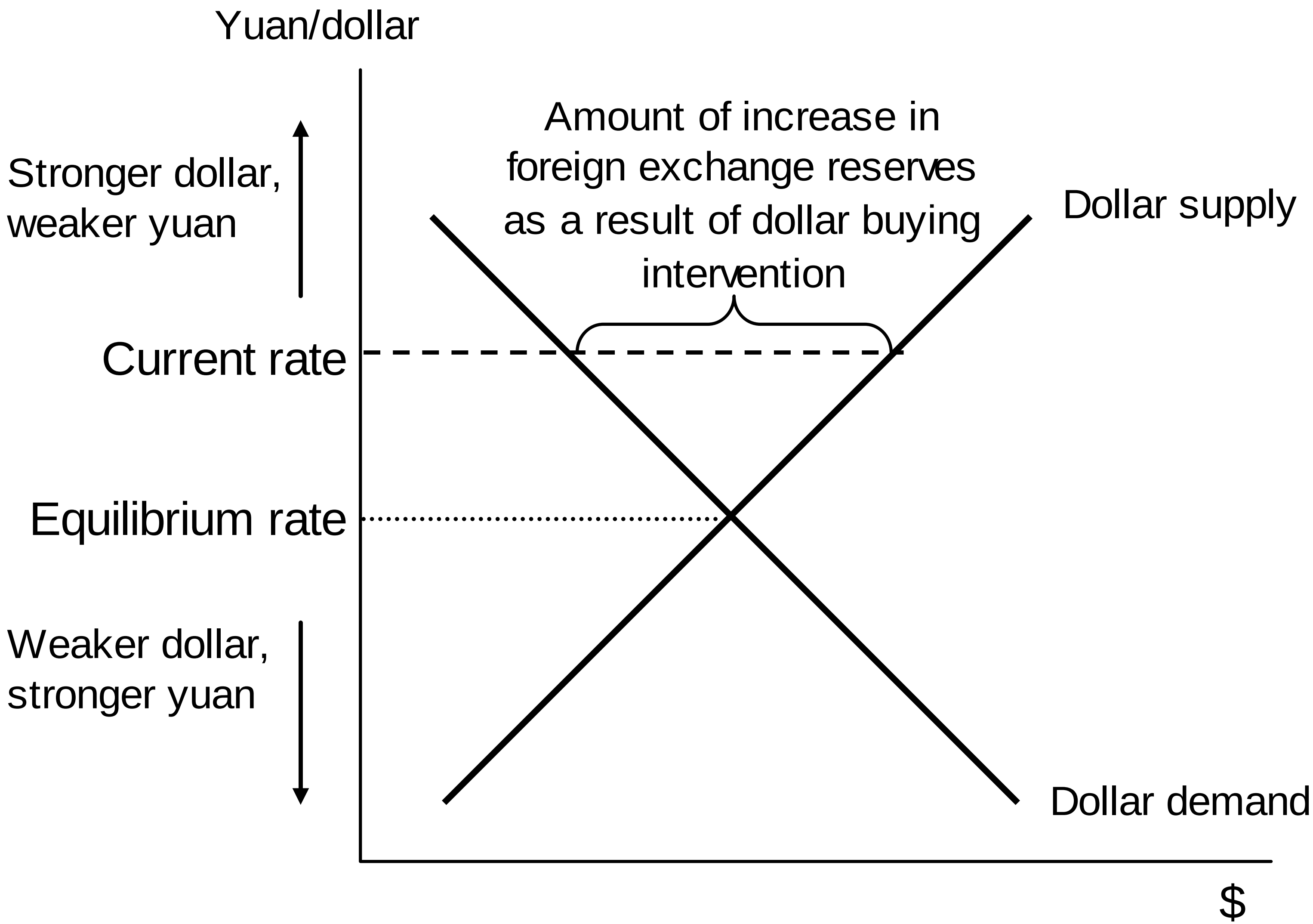
- Tinbergen's rule: Achieving a multiple number of independent policy targets requires an equal number of policy instruments.
- Mundell's rule: Each policy instrument should be assigned to a policy target on which it has the greatest relative effect.
- Exchange-rate policy cannot solve China’s structural problems (state-owned enterprises, banks, agriculture). It should be assigned to reduce China’s external imbalance.

China's Rising External Imbalance and Foreign Exchange Reserves（2006）

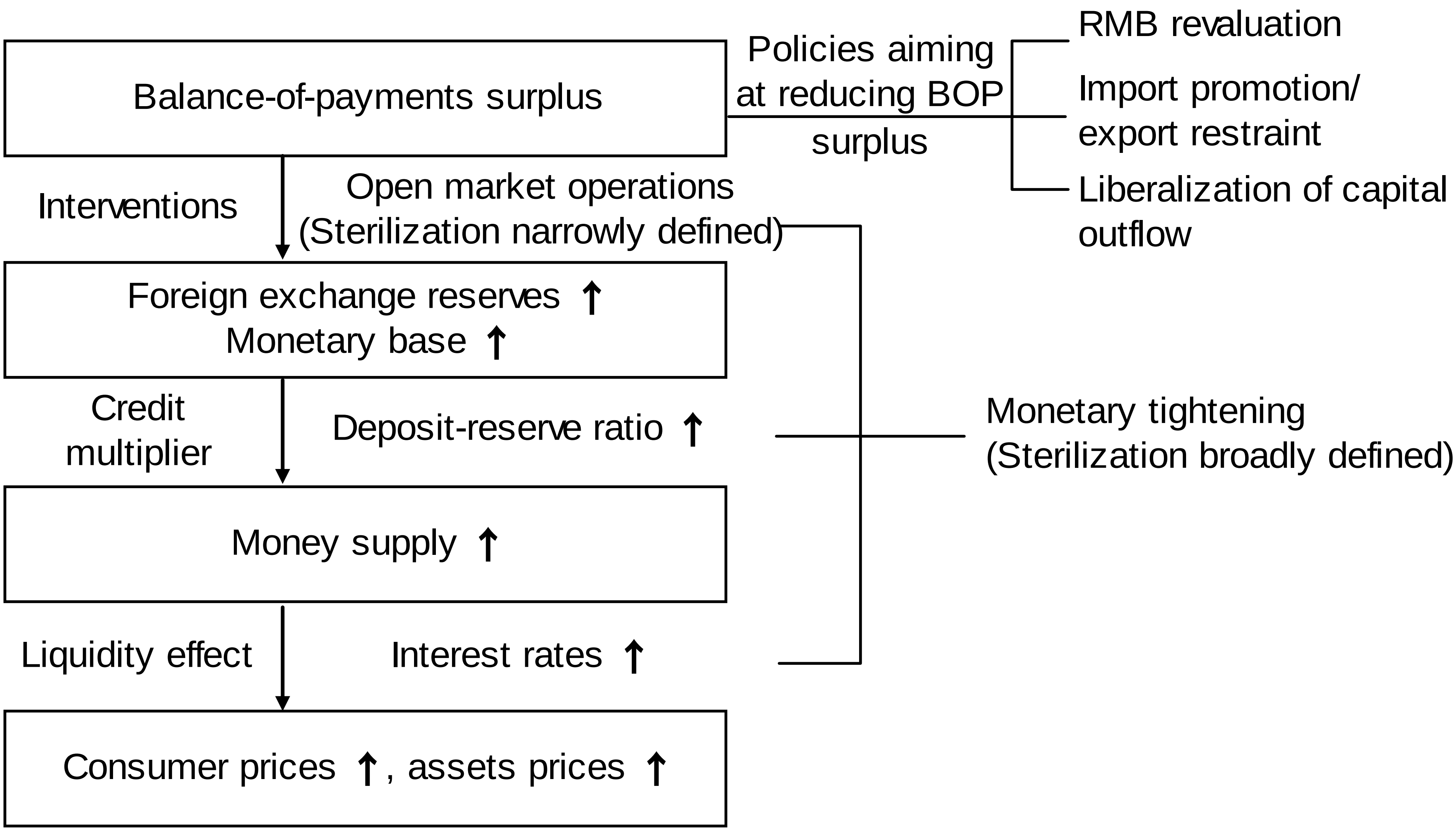


Note: Increase in foreign exchange reserves = current account balance + capital account balance + errors and omissions.
Source: State Administration of Foreign Exchange http://www.safe.gov.cn/

The Mechanism behind the Rise in Foreign Exchange Reserves



Liquidity Expansion - Mechanism, Effects and Policy Responses



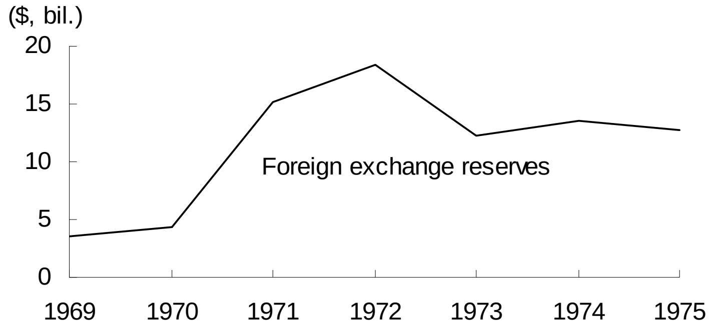
Is Exchange Rate Stability More Desirable than Price Stability?

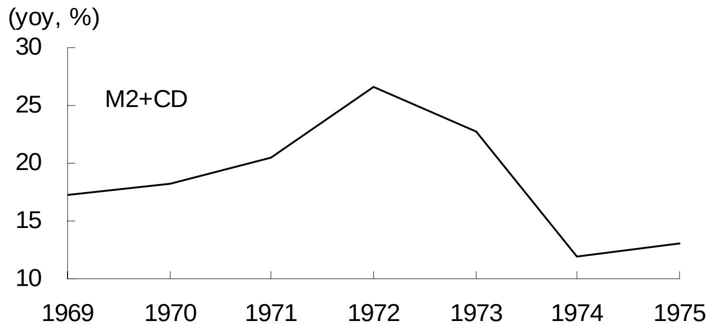
- Japan's experience in the late 1980s
  - McKinnon's hypothesis of "ever higher-yen syndrome" is irrelevant for China, because China's major concern now is expansion of an asset bubble rather than deflation.
  - It was not a strong yen per se, but attempts by the monetary authorities to suppress the yen's appreciation through intervention in the foreign exchange market and monetary easing (by keeping interest rates low) that led to the bubble economy in the late 1980s.
- Hong Kong's experience following the Asian Crisis (1997-98)
  - Hong Kong suffered negative GDP growth and negative inflation as a result of the Asian Crisis
  - Overvalued HK dollar (relative to other Asian currencies which had depreciated sharply), together with the need to maintain high interest rates in line with the United States, delayed Hong Kong's recovery.

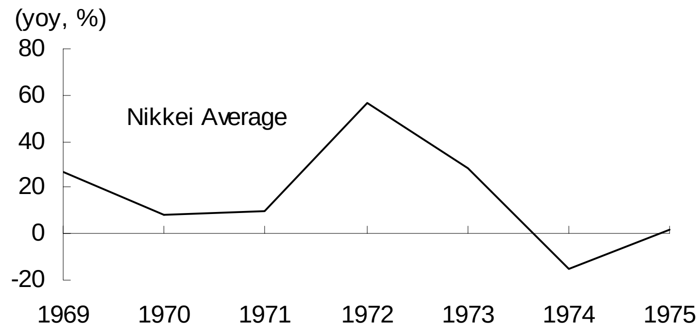
The "Impossible Trinity" in International Finance

	Free Capital Mobility	Independent Monetary Policy	Fixed Exchange Rate	Examples
Capital Controls	No	Yes	Yes	China (before July 2005)
Monetary Union	Yes	No	Yes	Hong Kong, EU
Free Floating	Yes	Yes	No	Japan, Australia

Japan's Financial Situation at the Time of Transition to a Floating Exchange-rate System







Source: Bank of Japan and Tokyo Stock Exchange.