

Concluding Speech
Yu Yongding

Delivered at a February 2007 Workshop on Global Imbalances
Peterson Institute for International Economics
Washington, DC

Ladies and gentlemen, thank you very much for inviting me to attend this important conference on global imbalances.

I wish to point out that to maintain large current account and capital account surpluses is not in the interest of China. For its own sake, China should correct these imbalances as fast as possible. China's persistent twin surpluses are symptom of misallocation of resources at an enormous scale. First, the situation that the 128th poorest country in the world to hold a position of the third largest capital export country in the world is rather bizarre. China should use its resources for domestic investment and consumption rather than buying the US treasury bills. Second, the 3rd largest FDI attracting country should translate capital inflows into current account deficit. To channel this huge amount FDI inflows back to the US capital market is unreasonable. Currently, with \$ 2.5 trillion net debt, the US receives some \$ 50 billion net investment income a year. In contrast, with \$100-300 billion net worth, China has been running investment income account deficit for decades (except for 2005 and you know why). Without anti-dark matter in China, there would not be dark matter in the US. The USD1.2 trillion foreign exchange reserves China is holding represent a huge subsidy to the US. Without getting any appreciation in return, why should China continue to do so?

I think America's proclaimed long-term objective of restoring internal and external balances is in parallel with China's long-term objective. If you really do not wish China to continue subsidizing the US economy, very well, we should stop doing it. I proposed a 15

point-program aimed at reducing China's external imbalances, which includes policies such as improving China's social safety net, RMB revaluation, deepening financial reforms and so on. I discussed this program with many American officials and scholars. I found that we can agree on almost all the points in the program. Then what are the differences? I agree with Dr. Paulson. Perhaps you don't like him, because you think he is too soft to China. He said that there are no fundamental differences between China and the US. The difference is all about timing. Chinese are patient people. I hope Americans are more patient.

Personally, I think the exchange rate is an important factor in correcting imbalances. I believe that trade will respond to changes in exchange rates more or less. If export and import are entirely inelastic with respect to changes in the exchange rates, why should anyone worry about appreciation or devaluation? Among instruments aimed at correcting imbalances, I believe, as a price signal the exchange rate is the most effective and least market-distorting. I prefer China to use this signal rather than sending delegations to Seattle to purchase Jumbo jets to balance Sino-American trade. Of course, there should be other instruments that may or may not as important as the exchange rate. Exchange rate adjustment is indispensable. That said, I should say that at least in the initial stage, one-off jump by 25 percent is too risky. American government and congress should appreciate what China has done since July 2005 rather than try to bash China. China is no Japan. China will not bow to any political campaign and be pressurized into appreciation.

In 2003, 2004, even until 2005, to talk about appreciation was taboo in China. But now almost everybody agrees that there should be appreciation. Popular opinion is five percent revaluation a year. Americans think five percent a year is too slow. But the Chinese authorities and the public fear that a faster speed of appreciation will create disastrous consequences on China's export sectors. For example, in the textile industry, which is one of the most important export sectors in China, there are 19 million people employed. At the same time, the average profitability of the sector is just 3.5 percent. If the RMB appreciates by 25 percent in one go, who can guarantee that there will be no massive unemployment? Personally, China's export sector is much more resilient than people suggested. However, a

cautious approach should be understandable. Unemployment is equally as painful for a Chinese worker as for an American worker.

The pace of RMB appreciation may speed up in future. It depends on

- Development of current account surplus
- Development of inflation and assets bubble
- Growth of fixed assets investment
- Sustainability of sterilization operation
- Effectiveness of the management of capital account

By how much has the RMB been undervalued? How long will it take for the RMB to reach its equilibrium level? I do not know, and do not believe there is anyone who really knows. But I know that more and more Chinese realize -- are realizing there should be a faster pace of appreciation.

Some economists in China argue that China's trade is not sensitive to the changes in exchange rate and hence China's current account surplus cannot be eliminated by appreciation. This argument is flawed at least on two accounts. First, if China's trade does not respond to the changes in exchange rate, what harms will occur to the Chinese economy by allowing RMB to appreciate? If you can sell things more expensively without influencing the quantity of the things you can sell, why not raise the sale prices? Second, I agree that China will not be able to eliminate its current account surplus entirely in the short-run. But this does not mean that China cannot achieve equilibrium of international balance of payments. In the short-run, to achieve equilibrium dose not means to achieve a balanced current account, let alone a balanced trade account. After appreciation, Japan is still running current account surplus, many economies also are. The key is that the monetary authorities in those economies do not have to intervene in the foreign exchange markets constantly and at a large scale. The RMB exchange rate should be allowed to arrive at the equilibrium level gradually. By then Chinese monetary authority eventually will be able to stop intervening in the foreign exchange market and China will be able to stop accumulating foreign exchange

reserves.

China is one of the two most important engines for the economic growth of the world. So not only Chinese leadership but also the US government should try their best to allow China to maintain its growth momentum. Otherwise, other countries, especially East Asian countries including Korea and Japan, whose exports are highly dependent on the Chinese market, will suffer -- suffer greatly.

I think United States government is not very fair in dealing with its trade partners, as just mentioned by Professor Park. Until 2005, Japan's trade surplus vis-a-vis the United States was bigger than China's. Japan is a rich country; Japan's living standard is more than 20 times higher than China's. But nobody said a word to the Japanese trade surplus. Learned scholars would say that Japan did not intervene in the foreign exchange market. Yes, indeed. But Japan stops intervening only since Mr. Watanabe took over, that is, since March 2004. Furthermore, Japan has maintained a very low interest rate. As a result, the world has been flooded with excess liquidity via carry trade, which enables the Yen to be maintained at a very low level. By no means I am arguing for pressurizing the Japanese. What I am trying to say is that the US government should be fairer in treating its trade partners. You should treat China as carefully as you treat Japan, and so that Chinese will be more willing to cooperate.

I appreciate Morris' paper presented in 2005 in Dalian. This paper was very, very educational, and very helpful for Chinese economists at the time when they were grappling with question of appreciation. With all respect, I cannot take the risk to accept the suggestion that the RMB should appreciate by 25 percent immediately. I am not convinced that by doing so China can eliminate imbalances without harming its economy seriously.

I know that in 1986 - 1987, New Taiwanese dollar was revalued by something 30 percent in less than two years. I also know that in 1985-1986 Japan revalued by more than 60 percent. Despite the assets bubbles after the appreciation, the export sectors of those economies were

continued to do well. Therefore, the possible negative impact of appreciation on the export sector should not be exaggerated. On the other hand, China is an economy highly open and highly dependent on trade. China's export/GDP ratio is more than 35 percent. In contrast, that ratio in Japan is about 10 percent. Hence, China may be more vulnerable to exchange rate changes.

Morris Goldstein and Nicholas Lardy made a very good contribution to raising the Chinese people's awareness about the importance of reevaluation. I appreciate their efforts. But on the other hand, it seems to me that they should not appear so confident about their own suggestions on RMB appreciation. They say the RMB must appreciate by 25 percent. Why not 10 percent or 20 percent? How can they be so sure? Where are their models and statistics? Could you allow me to check their derivation? If you allow me, while recognizing that they are among the best in the area of China study in the world, I will say that their track record on the Chinese economy is not 100 percent perfect. According to their prediction made in 2004 (Institute for International Economics PB04-7), they did not forecast that the Chinese boom would continue with a growth rate of around 10 percent for another three years, as happened. I suspect that this time they are wrong again with their policy prescriptions.

Anyway, the most important objective for the United States and China is to reduce the trade imbalances between the two countries. We need a comprehensive policy package. Exchange rate is just one of the many important instruments for achieving this objective. Actually, China has been trying its best to use other methods, even though I don't quite agree with the use of many other methods-- I mean, methods that are not market-oriented. The irony is that appreciation perhaps is most beneficial to China and least beneficial to the United States. But China strenuously avoids appreciation, and the US stubbornly forces China to appreciate. What's wrong with both sides? My recommendation is to read an article entitled Yuan Solution? by P. Swagel, which still can be found on the website of AEI.

Finally, I think I should say I probably would agree with Fred's comments. That is, China

should do something to show that it is very serious about reducing the trade surplus against United States, starting from 2007. Something should be done to soothe the Congress to prevent the situation from spinning out of control. I think this is something Chinese government has started to do and will do more in the coming months.

Thank you.