The Challenges and Opportunities of Transition

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Transforming the Chinese Economic Development Model
IMF, Washington, D.C., October 7, 2010
Stein’s Law

If something cannot go on forever, it will stop.

- The Chinese development model has proven wildly successful.
- But the current approach has reached the point of diminishing returns in the current global macro environment.
The Previous Approach

- At times, a weak currency
- An open door to FDI to encourage exports and technology transfer
- Movement of factors of production from low productivity to high productivity sectors
- A repressed financial system to direct capital to the manufacturing and export sectors.
A New Approach Is Not Optional

- Slower growth in the rest-of-world constrains the scope for export-led growth
- Reorientation of demand away from consumption in US adds to this effect
- The export sector cannot absorb labor as rapidly as before
- Declining productivity of capital
Rebalancing

IMF, World Economic Outlook (April 2010)
Economic Slack in Advanced Economies

IMF, World Economic Outlook (April 2010)
What Is to Be Done?

- Currency appreciation
- Re-orientation to domestic consumption (including services) - (e.g., Feenstra and Hong, 2010)
- Development of the social safety net
- Increasing labor’s share of income
- Fiscal reform, at the local level
Impact of Currency Appreciation

Estimated Price elast of Exports = 0.75

Implies 10% appreciation leads to $70 bn reduction exports
The Yuan and Other Currencies

Thorbecke & Smith (2010): 10% regional appreciation induces 10% export reduction

Notes: Down is appreciation; all rescaled to 2005M06=1

Yuan weakly exogenous for most currency pairs over this sample
Re-orienting the Economy

**Labor’s loved less**
Labor income share of GDP*, %

*Excludes production taxes. Large drop in 2004 reflects change in methodology by NBS. Source: Bai Chong’en and Qian Zhengjie (Tsinghua University)

**China’s gross national saving**

Source: Kroeber, *CEQ*, Mar ‘10

Source: Ma & Yi, BIS WP 312 (Jun ‘10)
Goals versus Timing

- Despite high-visibility debates over the policy direction, there is substantial agreement.
- The conflict is over extent and timing.
- Policymakers tend to err on the side of caution, with slow and calibrated moves.
- In the current environment, to be cautious is to be incautious.
Evidence that Time Is Short

- Currency manipulation legislation
- A Chicken war?
- Competitive depreciation: Japan, Korea
- Warnings of competitive depreciation: Brazil
Implications

- A new development strategy will be years in the making
  - Solidifying social safety net
  - Integrating domestic labor markets
  - Developing secondary securities markets
- But some measures can be implemented fairly rapidly
  - Currency appreciation
  - Liberalizing services sector