



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

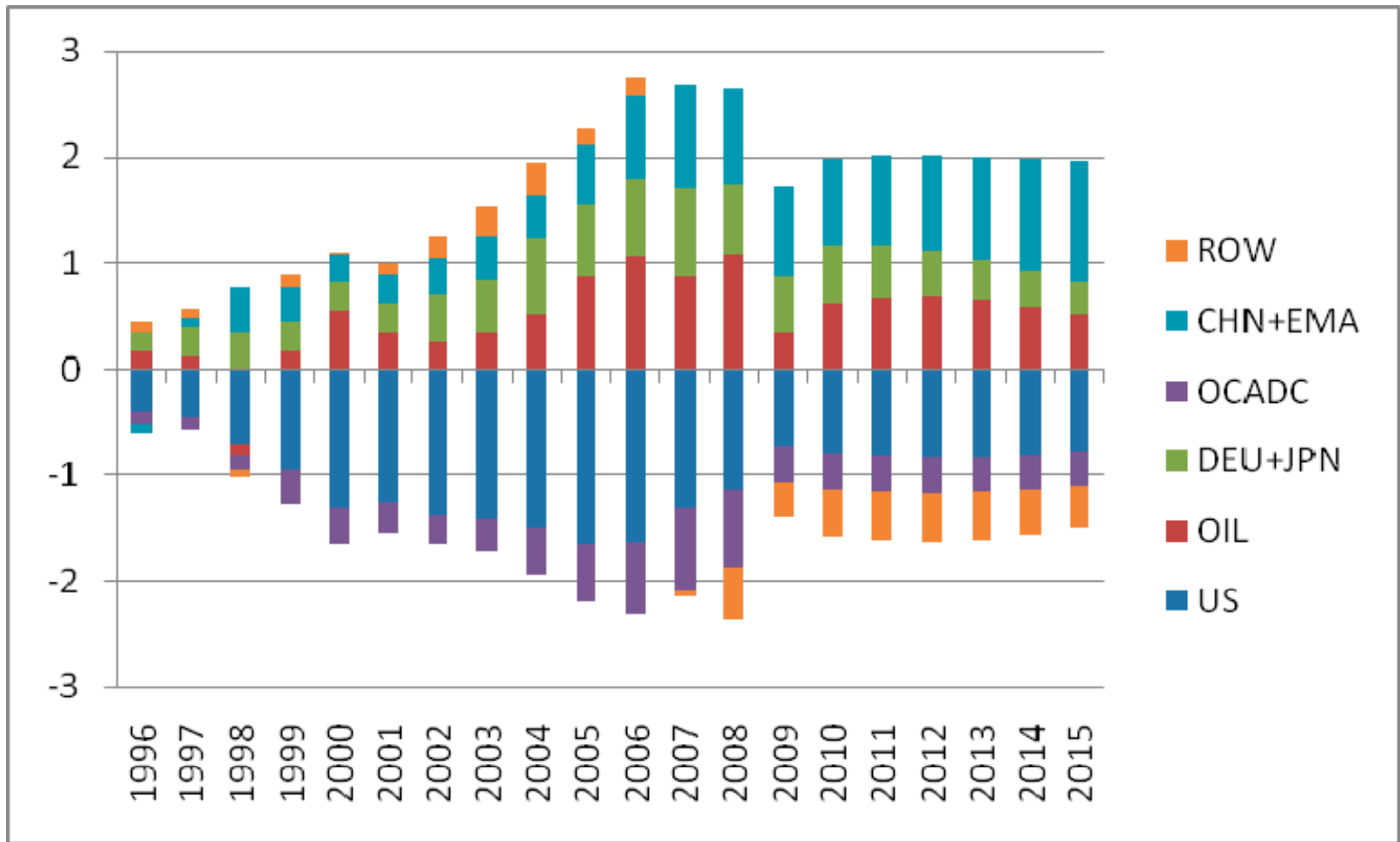
- At times, a weak currency
- An open door to FDI to encourage exports and technology transfer
- Movement of factors of production from low productivity to high productivity sectors
- A repressed financial system to direct capital to the manufacturing and export sectors.



A New Approach Is *Not* Optional

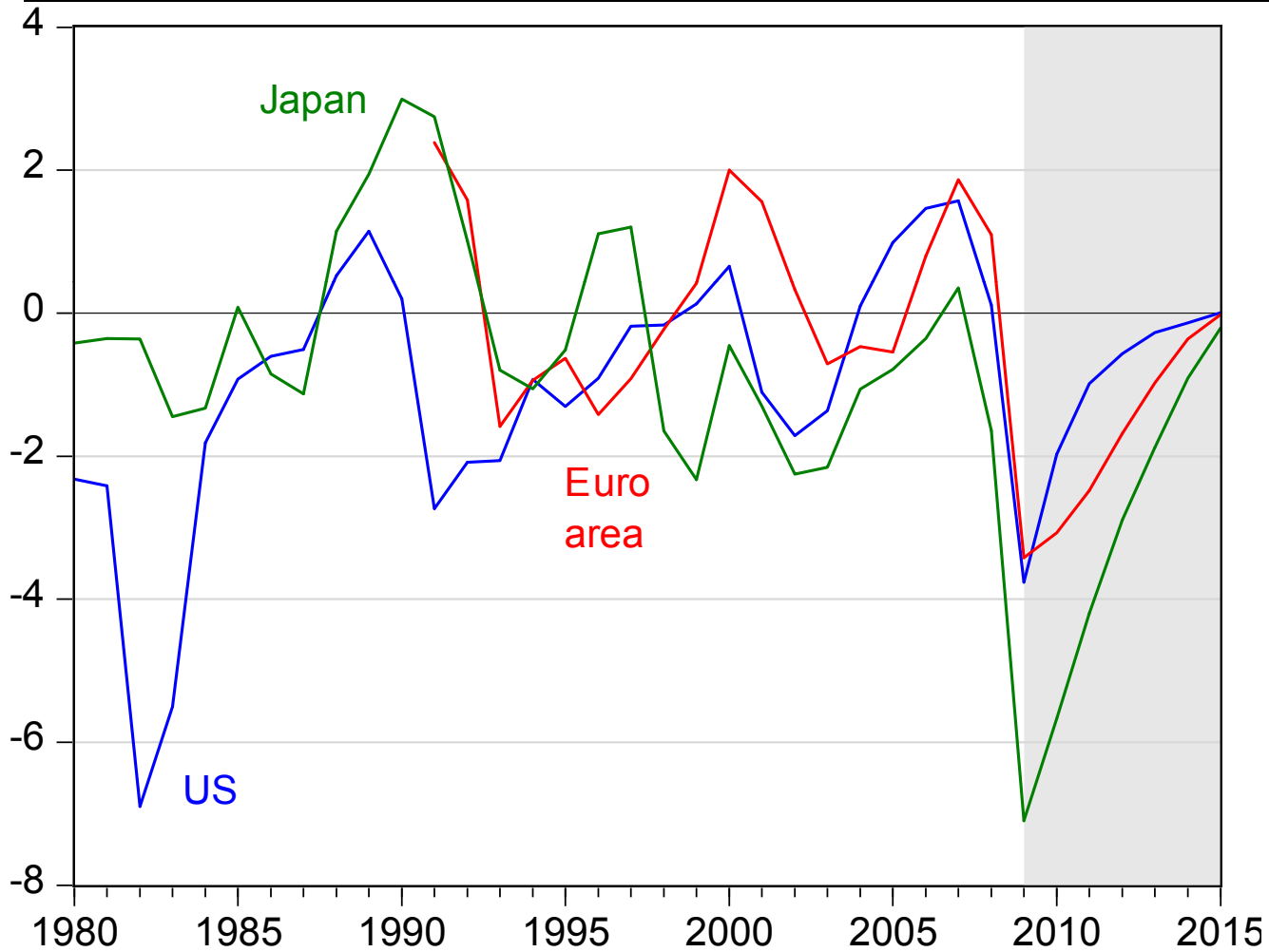
- Slower growth in the rest-of-world constrains the scope for export-led growth
- Reorientation of demand away from consumption in US adds to this effect
- The export sector cannot absorb labor as rapidly as before
- Declining productivity of capital

Rebalancing



IMF, World Economic Outlook (April 2010)

Economic Slack in Advanced Economies



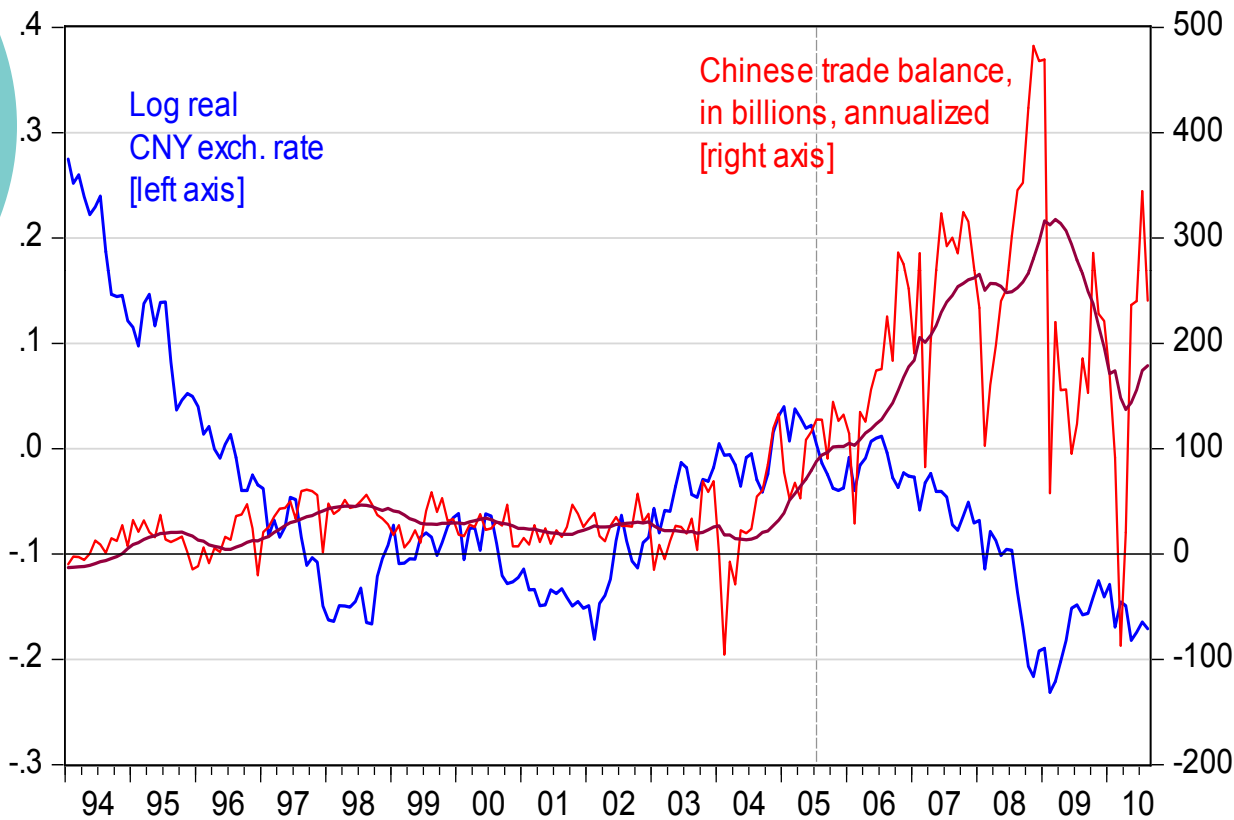
IMF, World Economic Outlook (April 2010)



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

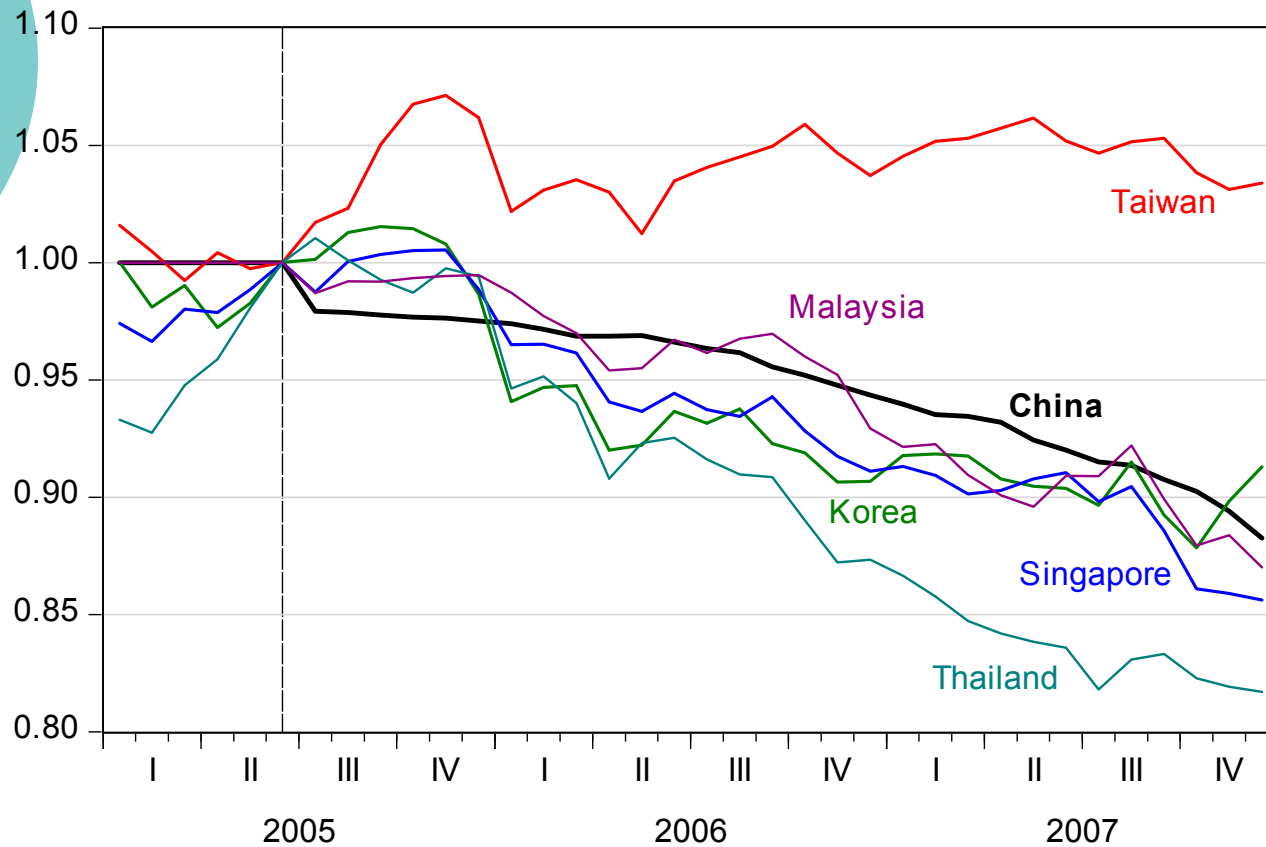
Impact of Currency Appreciation



Estimated
Price elast of
Exports = 0.75

Implies 10%
appreciation
leads to \$70 bn
reduction exports

The Yuan and Other Currencies

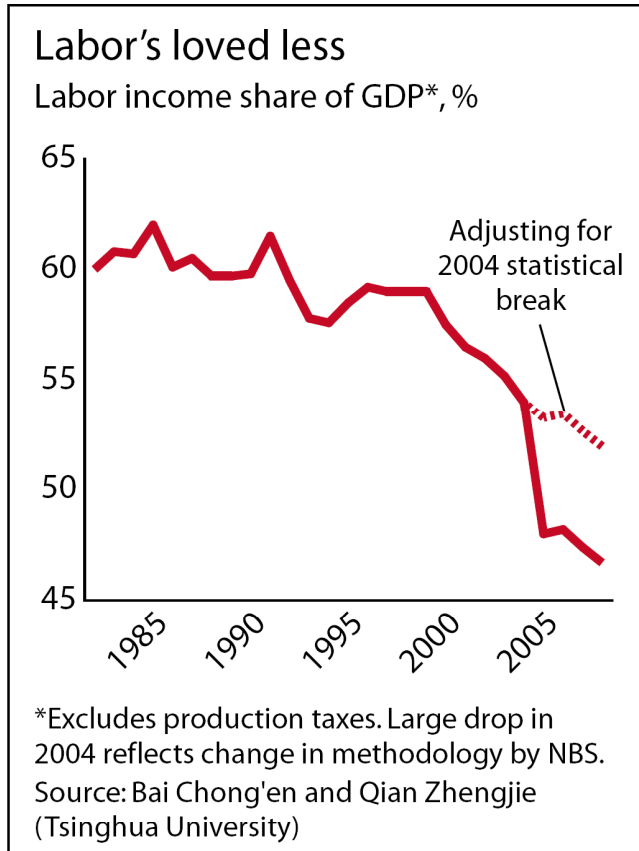


Thorbecke & Smith (2010):
10% regional
appreciation
induces 10%
export reduction

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

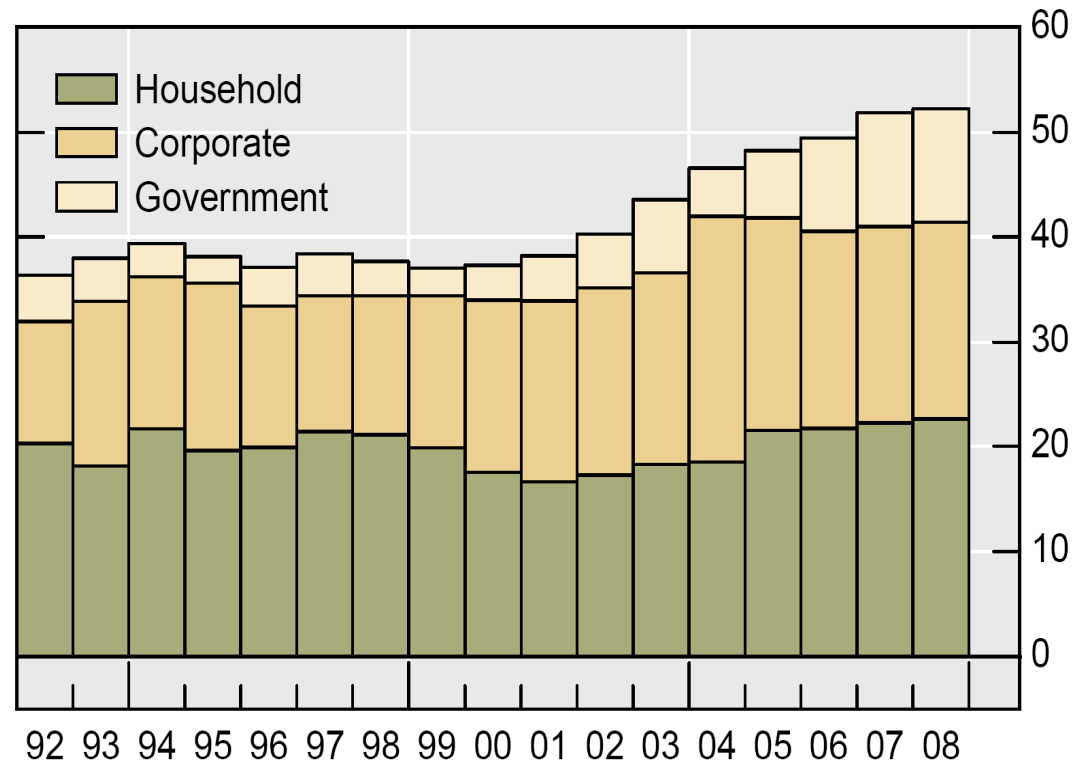
Yuan weakly exogenous for most currency pairs over this sample

Re-orienting the Economy



Source: Kroeber, *CEQ*, Mar '10

China's gross national saving



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