

## **Comments on "Real Exchange Rates and Manufacturing Industry in China"**

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- Very good paper on effects of REER on manufacturing value added from 1983 to 2016.
- Careful computation of REER from 1983 to 1994 as weighted average of official rates and swap rates
- Computed 3 types of REERs for manufacturing: at macro level (economy-wide consumer price index), at product level (188 products at HS4), and sector level (18 manufacturing sectors, ISIC revision 4).



- Main result: Appreciation (depreciation) of REER is bad (good) for manufacturing value added
- Effects of appreciation: Indirect effects vs. Direct effects (residual)
- Indirect effects: Effects via X (manufacturing exports, a proxy for size of tradable sector), FDI, PRIV, L (manufacturing employment) and K/L (capital intensity).
- Indirect effects on X, FDI, PRIV, and L are negative, but the effect on K/L is positive (appreciation cheapens imported machinery).
- Direct effects are positive (pressure to increase efficiency & innovate).
- Net effects are still negative (expected result).



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- The paper distinguishes between 2 periods: 1984 93 (depreciation of 51%), and 1994 2016 (appreciation of 50%).
- More useful to distinguishes between 4 periods, as most observers do:
- 1. 1984 93 (depreciation for export promotion)
- 2. 1994 to early 2001/2 (appreciation; RMB fixed against USD but majority of E Asian currencies depreciated due to the Asian Financial Crisis)
- 3. 2002 to 2005 (depreciation as USD weakened against major currencies)
- 4. 2006 2015 (appreciation as China changes its exchange-rate policy



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- The paper switches frequently between depreciation (appreciation) and under-valuation (over-valuation), but the two concepts (one positive and the other normative) need to be distinguished.
- In the early reform era of 1983 85, it can be argued that the depreciation only rectified the over-valued REER of a command economy to an appropriate level. Similarly, it can be argued that the appreciation since 2005 only rectified the under-valuation of RMB to an appropriate level.



- As the paper has suggested, given market failures in developing countries, under-valuation to capture the dynamic benefits of manufacturing exports may be good for overall growth and development (literature on export-oriented development).
- However, China has reached a stage of development where under-valuation may harm overall economic growth (though it still promotes growth of manufacturing).
- For upper-middle income economies, China's manufacturing sector is too large (32% of GDP in 2010 vs. 22% average) and its service sector is too small.
- To switch from extensive growth to intensive growth, China's needs financial reforms with realistic interest rates (instead of negative real rates in the Hu-Wen era) to improve the efficiency of capital allocation. Undervaluation hampers financial reforms.



- In a regime of financial repression with negative real interest rates (Hu-Wen era), it is difficult to raise interest rates with an undervalued exchange rate.
- First, raising interest rates would aggravate capital inflow anticipating appreciation.
- Second, the central bank needs to sell bonds to banks to sterilize the increase in forex reserves. Low interest rates allow China to sterilize on the cheap.
- Third, as China cannot raise interest rates adequately, China needs to control loans through administrative decrees, hampering financial reforms.
- Fourth, Chinese banks have to hold a high level of low-yield bonds, which hampers banking reforms.
- Mundell trilemma: Monetary autonomy and exchange rate stability implies capital controls.



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- The paper postulates that appreciation should lower the price of imported machinery and raise the capital-intensity of manufacturing.
- However, appreciation (from an undervalued level) facilitates interest-rate liberalization. The rise in interest rate (from a state of financial repression) tends to lower overall capital-intensity.
- In theory, the effect of appreciation on manufacturing K/L is ambiguous.



- In a situation of undervaluation cum financial repression (China in the Hu-Wen era), appreciation and financial liberalization would help China to switch from manufacturing/investment – led growth to service/consumption – led growth.
- It would help China to rebalance its economy (though it lowers the growth of manufacturing).
- For China, depreciation to promote manufacturing exports is an obsolete strategy.
- Emphasis on 'fair trade' in ROW strengthens the argument against undervaluation to promote exports.



- Paper computed 3 types of REERs for manufacturing: At macro level (economy-wide consumer price index), at product level (188 products at HS4), and at sector level (18 manufacturing sectors, ISIC revision 4).
- The REER at macro level reflects the prices of tradables as well as home goods (both prices are included in the consumer price index), but the latter two REERs only reflect the prices of tradables.
- Under stable exchange rates, if the prices of Chinese nontradables rise relative to those of ROW (due to higher inflation in China), but the prices of Chinese tradables are stable relative to those of ROW (due to higher productivity gain in tradable production in China), China's REER at the product and sector levels would be stable (China in first half of Hu-Wen era ?).
- However, China's REER at macro level would rise. China's manufacturing exports would suffer as more resources would be allocated to production of nontradables.



- For China, depreciation to promote manufacturing exports is an obsolete strategy.
- My suggestions pertain to interpretation & general equilibrium considerations rather than validity of empirical results of the paper for the manufacturing sector.

## Minor points:

- "foreign trade societies" & "export societies" (p. 9 & elsewhere) should be "foreign trade corporations" & "export corporations".
- The statement, "In China, as in other developing countries, foreign investments are concentrated in the tradable goods sector" (p. 13) is no longer true. Since 2010, FDI has concentrated on nontradables, mostly services. FDI in China's tradable goods (manufacturing plus agriculture) has declined rapidly from a peak of 73% in 2005 to 49% in 2010, and has declined further to less than 30% in 2016.

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