

**Book Review on**  
***China and Asia: Economic and Financial Interactions,***  
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Not a single day passes by without an economist mentioning China. Its economy has been growing at an impressive 9.9% on average since 1980, which the current worldwide recession has only slightly dented: its growth rate fell to 8.7% in 2009 from 13.0% in 2007, while the G7 economies contracted by 3.4%.

The current interest in China is driven not just by its might, but also by ambivalence about its role in the current crisis. Some economists, notably the previous and current chairmen of the Federal Reserve, have argued that China is partially responsible for the crisis; its excess savings – i.e., a current account surplus at 11% of GDP in 2007 – fed the insatiable profligacy of several industrialized countries, most notably the U.S. and the U.K. These “global imbalances”, they argue, gave rise to asset bubbles that eventually burst, leading to the crisis.

Whether China is partially responsible for this crisis is not just an academic question. For if recovery of the world economy must rely on a resumption of consumption in the advanced economies, will we see a resurgence of the global imbalances that caused the crisis? This book helps us to answer these questions by examining international macroeconomic and financial issues regarding China and Asia.

To grasp China's contribution to global imbalances, one needs to start by looking at China's savings and investment, which Lin and Schramm (Ch. 2) analyze at both the national and sectoral levels. They show that the corporate and household sectors have provided more savings than the economy can use as investment. Interestingly, they also show that one third of domestic savings are transformed into investment outside the formal financial system, indicating the country's lack of financial development which Fed Chairman Ben Bernanke has pointed out cause China's excess savings to flee to the highly developed financial markets in the U.S.

In addition to being shallow, Chinese financial markets' lack of openness has been cited as one factor contributing to the global imbalances. As Hung (Ch. 3) illustrates, the speed of China's financial liberalization has not kept up with the recent phenomenal rise in exports, resulting in the pileup of the country's international reserves (IR) holdings; it now holds \$2.4 trillion, or more than one third of the world's total IR. Other East Asian economies hold another one-third.

Ironically, while one of the major motives for China and other East Asian economies to hold massive amounts of IR was to insure themselves against another Asian financial crisis, this exact behavior may have contributed to the current crisis through the export of liquidity. Li et al. (Ch. 12) look at why countries accumulate more IR than the optimal level. According to them, countries can fall into a "zone of optimal inaction" in which they have no incentive to change their level of IR holdings even if they exceed the optimal level.

It has been argued that more than two-thirds of global IR holdings are held in U.S. dollar assets. Cavoli and Rajan (Ch. 7) as well as Schnabl (Ch. 8) show that the U.S. dollar has been the most dominant reserve currency in Asia, though the yen has marginally enlarged its role since the Asian crisis.

For China, the dollar's depreciation means more appreciation pressure on its currency. Fung et al. join the ongoing debate on the undervaluation of the Chinese currency by questioning the way the effective exchange rate – an important yardstick to estimate the equilibrium rate – is usually calculated. The authors argue that the U.S. dollar is overweighted in the currency basket used to determine the effective exchange rate because it does not adjust for China's trade via Hong Kong, given China's reliance on Hong Kong as its intermediary for international trade, and given that Hong Kong's currency is pegged to the U.S. dollar. This results in misleading estimates of the Renminbi's equilibrium value.

The Renminbi's undervaluation has become highly politicized in the U.S. However, Lee (Ch. 6) shows that a large part of the current account surpluses of East Asia is of a permanent nature; therefore exchange rate movements would not have much impact on current account balances. Even if China allowed its currency to appreciate, many argue that imports from China would merely be replaced by those from other countries with cheap labor, possibly leaving U.S. current account deficits intact. Ahearne et al. (Ch. 1) show that the development of Asian countries' industrial structure can be explained by

the “flying geese paradigm”; thus, even if China moves toward higher-value-added industries, it would probably be displaced by other less developed economies in Asia.

This book illustrates how intricately woven China is with the current global recession. While we want China to be the “demander of last resort” – as the U.S. was during the Asian crisis – that growth must be both sustainable and balanced. Chen et al. show that there is still much room for China to move toward higher-value-added, non-processing types of industries, which will significantly impact both output growth and employment.

But don’t expect China to take drastic actions. History shows that Beijing policymakers tend to be risk-averse gradualists. They must worry about widening income gaps and the risk of societal and political instability, all brought about by rapid development. As Chinese policymakers learn from their own and others’ experiences, we need to educate ourselves about the circumstances that China faces. This book provides us with the key to not only China’s economy but also the world economy.