

“China’s Exchange Rate Policy Dilemma”

by

Morris Goldstein and Nicholas Lardy

Institute for International Economics

This paper summarizes key aspects of China’s exchange rate policy, outlines the problems it creates for both China and the global economy, and proposes a feasible policy compromise.

China’s Currency Regime

On July 21, 2005, China announced a 2.1 percent appreciation of the Renminbi (RMB) against the US dollar, a move to a managed float, and a number of other “reforms.” Most of these “reforms” simply reiterated long-standing arrangements: since 1994 China has identified its currency regime as a managed float and has set a 0.3 percent per day fluctuation limit (in either direction) for the RMB against the dollar (vis-à-vis the central parity).

The July 21st announcement, however, did pledge two potentially important alterations: (i) the RMB was henceforth to be managed “with reference to a basket of currencies” rather than being pegged to the dollar; and (ii) the exchange rate was to become “more flexible,” with its value based more on “market supply and demand.”

In practice, the July 21st reforms have so far had little visible effect. As of mid-December 2005, the RMB dollar rate was 8.07, a further appreciation of only 0.5 percent. There is also little evidence of pegging to a basket; rather, the RMB continues to closely track the US dollar. And the central bank’s monthly intervention in the foreign exchange market in August and September remained huge at \$18 billion per month --only slightly smaller than the \$19 billion per month in the first half of 2005. In short, China’s

exchange rate system remains a heavily managed peg to the dollar – and at a dollar exchange rate very close to the level prevailing before the July reform.

Is the RMB Under-valued?

There are several approaches to evaluating the misalignment of the RMB. The “underlying balance” approach asks what level of the real, effective (trade-weighted) exchange rate would produce an equilibrium in which the “underlying” current-account position is approximately equal and opposite in sign to “normal” net capital flows.¹

During the 1999-2002 period, before there was any expectation of a currency appreciation, China ran an average capital-account surplus equal to 1 ½ percent of GDP. Take this as our measure of normal net capital flows.

Next, define the “underlying” current-account as the actual current-account position adjusted for both cyclical movements that make the demand for imports unusually high or low and the lagged trade-balance effects of recent exchange rate changes.

China’s current-account surplus in 2005 will probably be in the neighborhood of 7-9 percent of GDP. The underlying current-account surplus should be somewhat lower – say 5-7 percent of GDP – because (buoyant GDP growth rate notwithstanding) domestic demand growth has slowed and because the RMB has appreciated in 2005 in real trade-weighted terms.

If China’s underlying current-account surplus is now in the 5-7 percent of GDP range while what is required to offset normal capital flows is an underlying current-

¹ Goldstein [2004] provides fuller discussion of this approach. There could be cases where some increase in reserves was desirable, or where only some share of the external imbalance was to be eliminated within a given time period. Nevertheless, the basic premise is that a large discrepancy between normal capital flows and the underlying current-account position signifies a misalignment of the real equilibrium exchange rate.

account deficit equal to 1 ½ percent of GDP, then China's current account needs to deteriorate by a whopping 6 ½-8 ½ percent of GDP to restore (strict) balance-of-payments equilibrium. If one does a set of simulations with a small trade model to calculate what size real, effective appreciation of the RMB would be necessary to produce such a large turnaround in the current account – taking account of the high import content of China's exports, using a plausible range for price elasticities of demand and supply, and making alternative assumptions about the second round effects of income changes on the demand for imports – the answers congregate in the upper part of the 20-40 percent range. This is somewhat larger than the estimated under-valuation for 2003-2004.²

We would not want to go to the stake for the precision of our estimates of RMB under-valuation: after all, there is uncertainty about the underlying parameters, other methodologies yield somewhat different estimates, and China is in the midst of a nontrivial revision of its GDP accounts. Still, with huge reserve accumulation in each of the past three years, with persistent surpluses on both the current and capital accounts, with the real, trade-weighted RMB showing a cumulative depreciation since the dollar peak in February 2002, with the Chinese economy running at full steam or close to it for most of the past three years, and with Asian currency appreciation needed to reduce the excessively large US current-account deficit, we submit that it is difficult to arrive at a credible estimate that shows anything but a sizeable under-valuation for the RMB.³

² Goldstein [2004] and Lardy [2004]. To estimate the under-valuation of the RMB with respect to individual currencies, one needs a multi-country model. Cline [2005] does such an exercise and estimates that as of November 2005, the RMB was under-valued with respect to the US dollar by 43 percent.

³ Taking a broad view at the evidence across several methodologies, it looks to us like the RMB is under-valued in real, trade-weighted terms by 20-35 percent.

Problems with the Current Regime

China's current exchange rate regime has created problems for China and the global economy.

First, the (de facto) fixed dollar exchange rate limits the independence of China's monetary policy and has contributed thereby to the pronounced macroeconomic fluctuations of recent years. In 2003- 2004 when investment was booming and the rate of price inflation accelerating, the central bank was reluctant to raise domestic lending rates in part because it feared that, despite controls, higher rates would attract capital inflows. As a result, the real rate of interest to corporate borrowers (proxied by the one-year bank-lending rate minus the change in the corporate goods price index), fell from 8 percent in 2002Q3 on the eve of the investment boom to negative 4 percent during April-September 2004; that, in turn, contributed to an excess demand for loans.

Second, China's undervalued currency has contributed to growing trade surpluses and, at least in some years, also to very large portfolio capital inflows, which appear motivated by an expectation of appreciation. Mammoth exchange market intervention, amounting to 11, 12, and 14 percent of GDP in 2003, 2004, and the first half of 2005, respectively, has been necessary to prevent currency appreciation..

The central bank sterilized much of this reserve accumulation through increases in reserve requirements and open market operations. Since mid-2004 the central bank also has used administrative controls to limit bank credit creation. This approach is costly in several respects. There have been episodes when the barn door was locked only after the horses had left. In 2003 and the first half of 2004, there was a bank credit blowout, with the ratio of the increase in bank credit to GDP hitting an all-time high. This led to an

investment boom, with long-term consequences for excess capacity in a number of sectors, for downward pressure on operating margins in these sectors, and potentially for non-performing loans in banks that lent heavily to support such projects. 2005 again witnessed a substantial build-up of bank liquidity, reflected in growing excess reserves and declining money market rates.

Increased use of administrative controls on lending is inconsistent with the government's long-term policy of requiring state-owned banks to operate on commercial principles. When the central bank specifies lending ceilings and sectoral lending priorities, the development of a credit culture is slowed. And when money market interest rates are depressed by excess liquidity, bank profitability suffers since banks are net lenders in the money market.

Third, a highly under-valued RMB encourages excess investment in tradable goods. Eventually, the real exchange rate will appreciate and will lower profitability in tradable goods industries, again with adverse implications for banks.

Fourth, China is accumulating a large exposure to potential capital losses. China's foreign exchange reserves will at year-end 2005 be in the neighborhood of 40 percent of GDP. A 20 percent revaluation of the RMB against the major reserve currencies would thus impose a capital loss equivalent to 8 percent of GDP.

Finally, China's prolonged, large scale, one way intervention in the foreign exchange market – along with its large and growing global current account surplus -- fuels protectionist pressure in the United States and elsewhere. One reflection is the Schumer-Graham bill in the US Senate, which could lead to a uniform 27.5 percent tariff on all Chinese imports. Another is the ill-considered congressional action subjecting a

potential China National Offshore Oil Corporation (CNOOC) purchase of Unocal to a special congressional review. Since over half of China's exports go to the United States, Euroland, and Japan and since China has a long-term interest in investing abroad, such protectionist threats ought not to be taken lightly.

In sum, the costs to China of maintaining an undervalued currency are already significant and are likely to rise over time. Moreover, unlike some others (e.g., Dooley, Folkers-Landau, and Garber [2003]), we do not see the growth and employment benefits of an under-valued RMB as exceeding its costs (Goldstein [2006], Goldstein and Lardy [2005]).

China's inflexible currency regime and its under-valued RMB also handicap the adjustment of global imbalances and increase the risk of a hard landing for the dollar and the US economy, with adverse global spillovers.

The US current-account deficit is now running at about 6 ½ percent of GDP – an all-time high. If the US current-account deficit is not reduced, US net foreign debt relative to GDP will rise to a worrisome level and US assets will eventually lose their attractiveness relative to alternative investment opportunities – resulting in some combination of a fall in capital flows to the United States, higher interest rates on US liabilities, and a decline in the dollar. If these adjustments were large and disorderly, they would depress significantly US growth, with adverse spillovers for US trading partners.

As Mussa [2005] has emphasized, the inevitable correction of the US external imbalance will necessarily involve a depreciation of the dollar against most currencies, and domestic demand growing more slowly (faster) than domestic output in the United States (rest of the world). The first channel is the expenditure-switching channel, while

the second one is the expenditure-changing channel. Both are needed. That is why both a more ambitious program of fiscal consolidation and a tightening of US monetary conditions are essential – along with policies that stimulate domestic demand growth in major US trading partners.

The real, trade-weighted US dollar needs to fall by a further 15-25 percent from its current level to support external adjustment. The currencies of Japan, China, and the rest of emerging Asia have a combined weight of roughly 40 percent in the Fed's dollar index. If the Asian currencies do not participate, either the overall depreciation of the dollar will be too small, or the appreciation burden will fall too heavily on economies where a further large appreciation would not be warranted. In the wave of dollar depreciation starting in February 2002 the euro, the Canadian dollar, and the Australian dollar, among other market-determined currencies, experienced strong real appreciations, whereas the Asian currencies – with the notable exceptions of the Korean won and Singapore dollar—did not.

China remains a prime candidate for leading wider Asian currency appreciation because of its large external imbalance and because the RMB's behavior can influence – for better or worse --the attitude that other Asian economies have toward pressures for appreciation in their own currencies.⁴ In this sense, it is important that China be part of the international solution to the adjustment of large external imbalances – and not part of the problem.

⁴ In contrast, Eichengreen [2004] has argued that other Asian currencies would not necessarily follow the RMB upward if China revalued.

Policy Constraints and A Compromise Solution

China's willingness and ability to deal with the shortcomings in the current exchange rate regime are heavily constrained by at least three important factors.

First, China's banking system, although improving, remains fragile. Households, which have bank deposits equivalent to almost 100 percent of GDP, have had little opportunity to diversify the currency composition of their financial assets and could be susceptible to capital flight if they thought risks of repayment had worsened. Thus, any adjustment of China's exchange rate regime will have to maintain most existing capital controls until the domestic banks are further strengthened.

Second, the degree of under-valuation of the RMB is now so large that it would take a long time to correct it if it were done in a series of small steps. But this is apt to exhaust the patience of the international community. Also, the greater the expectation that each RMB appreciation will be followed by another, the larger the scale of capital inflows and the larger the sterilization problem.

And third, China's current leadership, even more than its predecessor, appears to prefer an incremental approach to dealing with the current exchange rate dilemma. They value highly growth and stability. They worry that letting market forces freely determine the exchange rate could result in too much RMB appreciation, slowing exports, employment, and growth and thereby contribute to increased social instability.

How then to square the circle? Absent the aforementioned constraints, the policy solution would be straightforward: China could simultaneously and immediately remove the restrictions on capital flows and let the market determine value of the RMB. The constraints mean the search is for second-best policy options.

All things considered, we believe the preferred course of action is a compromise along the following lines.⁵

China would make a credible down payment on removing the large undervaluation of the RMB by immediately revaluing it by 10-15 percent relative to the currency basket; it would widen the band to 5-7 percent on each side of the new parity; it would simultaneously implement fiscal expansion; and it would leave in place most capital controls. The 10-15 percent revaluation of the RMB would help to reduce China's very large current-account surplus and should persuade those in the US Congress and in other G-7 legislatures that China was finally getting serious about controlling its growing external imbalance. A 10-15 revaluation would be a much more tangible sign of progress than the meager 2 ½ percent revaluation registered thus far.

A significant widening of the band would give China some increased independence for monetary policy, would allow scope for some further appreciation of the RMB, and would give China some practical experience in managed increased flexibility. It would also give some substance to China's repeated claim that "market supply and demand" would increasingly determine the RMB's value.

Fiscal expansion is needed to offset some of the contractionary effect of the RMB revaluation. The fiscal expansion needs to be expenditure based because direct tax receipts in China – like the agricultural tax and the income tax -- are currently far too small to provide a meaningful boost from a tax reduction. Increased government expenditures should strengthen the social safety net because one of the main factors

⁵ This is close to our original formulation of the "two-stage" approach to China's currency reform; Goldstein and Lardy [2004].

behind China's very high household savings rate is precautionary savings against potentially high out-of-pocket expenses for health care, education, and retirement.⁶

Keeping in place the bulk of existing controls on capital flows is a prudent measure against potential capital flight should there be bad news about the state of the still fragile banking system.

True, this would still leave a sizeable real appreciation of the RMB to be done later, over say, the next two years, with all the expectations-cum-capital flow problems that such a phased adjustment entails. Indeed, that is why we pushed for China to remove in one step the under-valuation in 2003-2004.⁷ But that window of opportunity has passed – now that the under-valuation of the RMB is larger and now that domestic demand growth has slowed. While speculative inflows have recently declined from the record pace of 2003-2004, one cannot be confident that they would not revive; in such a case, the authorities would need to choose between an acceleration of the RMB appreciation and a temporary recourse to tighter controls on capital inflow.

In the final stage of currency reform – when China's banking system is on a firmer footing – China would float the RMB and remove the remaining controls on capital flows. Appropriate sequencing of capital-account liberalization would prevent currency reform from undermining the continued strengthening of the banking system.

Admittedly, this is not such an elegant plan. But if it avoids the international train wreck that would otherwise take place, it merits consideration.

⁶ Blanchard and Giavazzi [2005].

⁷ Goldstein and Lardy [2004].

References

- Blanchard, Olivier and Francesco Giavazzi, 2005, "Rebalancing Growth in China: A Three-Handed Approach," unpublished manuscript, MIT and Bocconi Universities, November.
- Cline, William, 2005, "The Case for a New Plaza Agreement," IIE Policy Brief, Institute for International Economics, Wash DC, December.
- Dooley, Michael, David Folkerts-Landau, and Peter Garber, 2003, "An Essay on the Revived Bretton Woods System," NBER working paper 9971, NBER, Cambridge, September.
- Eichengreen, Barry, 2004, "Chinese Currency Controversies," Paper prepared for Economic Panel, Hong Kong, April.
- Goldstein, Morris, 2006, "RMB Controversies," Cato Journal, vol. 26, no. 2, Forthcoming.
- Goldstein, Morris, 2004, "Adjusting China's Exchange Rate Policies," IIE Working Paper 04-1, IIE, Wash DC, June.
- Goldstein, Morris and Nicholas Lardy, 2005, "China's Role in the Revived Bretton Woods System: A Case of Mistaken Identity," IIE Working Paper 05-2, IIE, Wash DC, March.
- Goldstein, Morris and Nicholas Lardy, 2004, "Two-Stage Currency Reform for China," Asian Wall Street Journal, September 12.
- Lardy, Nicholas, 2004, "Exchange Rate and Monetary Policy in China," Cato Journal, vol. 25, no. 1.
- Mussa, Michael, 2005, "Sustaining Global Growth While Reducing External Imbalances," in C. Fred Bergsten (ed.), The United States and the World Economy: Foreign Economic Policy for the Next Decade, IIE, Wash DC.