

China's Exchange Rate and Monetary Policy

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1. Introduction

Recently there have been several efforts by officials of the U.S. government¹ to persuade the government of China to adopt a floating exchange rate for the renminbi (RMB).² According to most accounts, the U.S. motivation stems in large part from a belief that the RMB's value would rise relative to the dollar, thereby making Chinese goods temporarily more expensive in the United States and leading, presumably, to a temporary reduction in China's bilateral trade surplus with the United States. Thus it is likely that what these government officials actually desire is a RMB appreciation, not a floating rate.³ Such a movement would perhaps be popular with U.S. manufacturers of export goods and with some trade unions. For the U.S. government to base its position regarding Chinese policy on such domestically-motivated and short-term considerations is, however, antithetical to free market principles that stem from economic analysis and which our government usually promotes (at least nominally).

It is also the case that this general type of international bullying (euphemistically termed "international cooperation") has turned out badly in the past. In 1986, for example, the United States pressured Japan into a bilateral agreement whereby the Bank of Japan would be more expansionary in return for which the U.S. government would "continue to

¹ See, for example, Andrews (2003) and Blustein (2003) for reports on government efforts and attitudes.

² Renminbi is the name of the currency, "ren min bi" meaning something like "the peoples' money," whereas the yuan is the unit of account. Thus the RMB exchange rate is about 8.277 yuan/dollar.

³ For additional discussion, see Hutzler (2004), Ip (2004), and O'Driscoll and Hoskins (2004).

fight protectionism” (Fischer, 1988). Also, the U.S. agreed that the current dollar-yen exchange rate (154 yen per dollar) was appropriate—in context meaning that the dollar did not need to fall further. A multilateral agreement regarding the U.S. exchange rate was soon afterwards adopted by the G-7 governments in February 1987 at a meeting in Paris usually referred to as the Louvre Accord. At that time, both Germany and Japan agreed to small fiscal stimuli while the United States would attempt to reduce its budget deficit. How did these agreements turn out? Some observers have argued that the expansionary stance promised and adopted by Japan was a significant contributing factor in the dramatic asset price “bubble” of 1987-1989, during which land and stock market prices soared to extraordinary heights. Largely as a result, arguably, the Bank of Japan was induced eventually to take deflationary measures, after which Japan entered a historic slump lasting more than a decade—and creating difficulties not only in Japan but around the world.⁴

For these reasons, it is difficult not to disapprove of the U.S. government’s recent efforts with respect to Chinese exchange rate policy. That does not mean, however, that a floating exchange rate for the RMB would be unwise for China. Let us consider that issue from a more proper perspective, based on monetary theory and experience—i.e., the relevant economic analysis.⁵

2. Exchange Rate Regimes

A useful starting point for the discussion is to recall that exchange rate policy and monetary policy are not two independent entities. In an economy without direct controls on

⁴ This account is adapted from McCallum (1996, p. 257).

⁵ Emphasis on any bilateral trade balance is widely regarded by economists as entirely inappropriate. From the perspective of the benefits of exchange, to desire “balanced” trade with each nation is analogous to desiring that an individual household’s payments are required to balance with its employer’s and with each of the businesses from which it purchases goods. Such a requirement would obviously lead to extremely inefficient patterns of production.

foreign transactions, the two amount to virtually the same thing, as I have argued in a previous SOMC paper (McCallum, 2001). Even with a considerable amount of direct controls, the two policies cannot differ substantially from a long-run perspective, since the rate of change of the exchange rate is identically equal to the nation's inflation rate, minus the average (trade-weighted) foreign inflation rate and plus the rate of change of the real exchange rate (whose behavior is, from a long run perspective, basically independent of monetary policy).

With that observation as background, let us now turn to the economics of the choice of an exchange rate regime. We must compare the costs and benefits of having a truly fixed exchange rate. The fundamental disadvantage (cost) is that a fixed rate requires monetary policy to be devoted to keeping the exchange rate at the specified value, instead of being devoted to the control of inflation (and, to a limited extent, output) domestically. With fixed rates, that is, nations cannot tailor their monetary policies to domestic macroeconomic conditions. Looking in the other direction, what is the fundamental advantage (benefit) of a fixed rate system? It is that, in the pure case, this system extends the area over which a single currency is utilized and thereby increases the scope of transaction efficiencies provided by a common money. Such efficiencies can be extremely important. It would, for example, be disastrously inefficient for any economy not to have an asset that serves as money, i.e., a common medium of exchange, and thus to have to rely heavily on barter for making market exchanges. Indeed, it would be highly inefficient to have different moneys for (e.g.) the different cities in Pennsylvania or Virginia, or even among the states of the United States. But the larger and more self-contained is the area considered, the smaller are the gains at the margin from further extensions of a single currency from region to region—

and also the greater is the need for monetary policy occasionally to be different in different regions of that area.

So for small open economies fixed rates are relatively attractive and for large economies floating rates tend to be more appropriate. The exact comparison is so complicated and delicate that no one can conduct a quantitative analysis that shows conclusively whether an actual economy should (or should not) join a common-currency arrangement—except for extreme examples such as Belgium and Luxembourg. No one, for example, can truly demonstrate on purely economic grounds whether the current euro area is too large or too small.

Nevertheless, the basic reasoning suggests that most economies should probably opt for a floating exchange rate unless it is prepared to share have a single currency with its principal trading partner(s). Otherwise, it is trying to gain the benefits of a fixed rate without any true, long-lasting commitment to that arrangement. And that type of intermediate case is from a long-run perspective illusory, as it implies a self-destructive invitation to speculative attacks. As Milton Friedman argued so effectively in 1953, a truly fixed rate or a true float are both preferable to the intermediate case of a fixed but adjustable rate.⁶ So, to repeat the conclusion, a country should in most cases have a floating rate unless it is prepared to join a single currency area (which would then have a floating rate against a few other such areas).

It is my impression that the actual reason why fixed rates have been attractive to the governments of many developing countries is that these governments believe that such an

⁶ Friedman's words are worth quoting: "Because the exchange rate is changed infrequently and only to meet substantial difficulties, a change tends to come well after the onset of difficulty, to be postponed as long as possible, and to be made only after substantial pressure on the exchange rate has accumulated. In consequence, there is seldom any doubt about the direction in which an exchange rate will be changed, if it is changed. In the interim between the suspicion of a possible change in the rate and its actual change, there is every incentive to sell the country's currency if a devaluation is expected... or to buy it if an appreciation is expected. (1953, p. 164).

arrangement is conducive to an enhanced volume of “capital inflows,” i.e., borrowing from (or selling claims to) the rest of the world. Having net capital inflows to nations in which the marginal product of physical capital is high is, of course, good for world-wide resource allocation. But many of these countries get themselves into serious trouble by relying too heavily on borrowing from abroad—think of Argentina—and their real motivation for having a fixed exchange rate is to make a larger amount of such borrowing possible.

Now, to me it seems that the prospects for foreign investment in China are so favorable that China does not need a fixed exchange rate to attract a large quantity of capital inflows (i.e., sales of claims on Chinese assets). Furthermore, it is a large economy that does not need to join a currency union for medium-of-exchange efficiency reasons. Therefore, while there may be severe transitional problems, the long-run fundamentals would seem to point to a floating exchange rate as the best ultimate arrangement for China—one which would permit it to use its monetary policy to stabilize domestic demand in a manner that is called for by prospects concerning inflation and business cycle conditions.

3. Current Difficulties

Most of the previous arguments are undoubtedly familiar to many Chinese economists and to officials of the central bank, the People’s Bank of China (PBC). Nevertheless, there is great reluctance on the part of Chinese officials to move to a floating exchange rate. This seems to be true even of PBC officials, although they are at present eager to impose monetary restraint on the Chinese economy, which is currently giving strong indications of “overheating.” Let us continue, accordingly, with a brief discussion of the current monetary policy situation in China.

Over the past few weeks, there have been many indications that the PBC is now attempting to dampen demand, because of signs of incipient inflation and a belief that much recent investment spending has been highly speculative in nature. At the prevailing exchange rate and with existing capital controls that prevent Chinese residents from purchasing foreign assets, there has been a high rate of capital inflow. Chinese firms convert the incoming dollars into RMB, so the exchange value of the latter would rise if the PBC did not purchase dollars to prevent this appreciation. These purchases increase the Chinese monetary base, in the absence of offsetting actions. Accordingly, the monetary base has been growing quite rapidly—at rates of 12-16 percent (per annum) recently. To tighten monetary conditions, the PBC needs to reduce this rate of monetary growth. They have attempted to restrain the growth rate by selling interest-bearing central bank liabilities, but there is a limited demand at the prevailing rate of interest, which is below a realistic market value.

In order to reduce base growth, it will evidently be necessary for the dollar value of the RMB to be increased, one way or another. One possibility is a pure float with no capital controls; another would be a one-time revaluation; a third would be a modified float in the presence of controls on the ability of Chinese residents to hold foreign assets. The latter is mentioned because a float without such controls would almost surely have to be accompanied by an increase in the rate of interest paid on deposits in Chinese banks (in order to prevent a major outflow of funds). But such an increase would be a severe shock to the Chinese banking industry, which comprises almost the entire financial sector, and the banking sector is not healthy. Specifically, the four largest banks are state-owned banks that channel funds from depositors to state-owned enterprises (SOEs) at loan rates that are well below market rates. Over half of all industrial workers, moreover, are employed by these

SOEs. So a sharp cutoff of funds to them would be enormously unpopular, but an increase in effective bank lending rates to the SOEs would put even more strains on the state banks, which already have such a high proportion of non-performing loans that they would be considered insolvent under realistic accounting practices.⁷

One point of this brief description is that it is not clear exactly how the Chinese authorities should proceed at present. Another is that there are numerous economic and political problems created by the continued presence in China of departures from free-market institutions.⁸ In that regard, it seems clear that the Chinese are better placed than American officials or economists to decide how to proceed in freeing their monetary policy from the constraint of a fixed exchange rate; but it also seems clear that to dampen demand some method will have to be chosen. In sum, the Chinese must decide how to proceed and advice from the U.S. should be limited to the encouragement of progress toward free market arrangements in all aspects of society.

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⁷ For this reason, Alan Greenspan has recently expressed discomfort with the idea – Ip (2004).

⁸ In addition to those mentioned previously, legal constraints on labor mobility are significant.

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