Tamás Gábor

*Conceptions or misconceptions about China's exchange rate policy**

Is the undervalued yuan indeed detrimental to the global economy as a whole?

The international economic literature makes primarily China responsible for the evolution of a global disequilibrium. According to this view, China's current account surplus and the growth of the resulting Chinese official exchange reserves to almost two thousand billion dollars were rendered possible by holding the yuan at a low exchange rate. In this paper, I intend to highlight that the appreciation of the yuan, which began through American government pressure, did not push world economic processes to the direction of global correction. Appreciation, in the short run, leads to unleashing inflation and to further build-up of official exchange reserves. I shall demonstrate the above with the example of the Japanese economy in the 1970s. The appreciation, so often referred to, can only exert its effect in the long run. I shall also point out that foreign exchange rates have a direct impact on the balance of trade. Current account surplus merely reflects the extent of domestic saving exceeding domestic investments. How a discrete appreciation of China's currency will affect its current account surplus is neither obvious nor unambiguous. To sum up, I arrive at the conclusion that there is a need to put a stop to the crawling appreciation of the Chinese currency and to develop an exchange rate with a narrow currency band in order to ease world economic tensions.

China's current account surplus (net saving surplus) has spiralled up since the turn of the millennium, its overall current account surplus rose to USD 371 billion by 2007.[1] This almost covers half of the US current account deficit of USD 731 billion.[2] Looking at recent years' trends, if this continues, it could cover more than half of the US deficit. The imbalances in the financial system of the world economy basically originate from the above-mentioned imbalance. The tension could be lessened in the long run, if the net saving of China falls, and the inverse occurs in the United States.

Because of political pressure from the United States, since 21 January 2005, the exchange rate of the Chinese currency, the renminbi,[3] has been steadily appreciated unilaterally against the US dollar by about 6 per cent a year.

At the same time, China's *exponentially rising official exchange reserves* are in contrast with other large surplus-saving countries, such as Japan and Germany. The reason behind this is presumably that these countries' surpluses on current account are matched by private short-

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term and long-term capital outflows. Could foreign exchange restrictions that are still in place in China cause the discrepancies? By 2007, China had eliminated foreign exchange controls on capital outflows by industrial corporations and financial institutions, while individuals have generous allowances for foreign travel. Although the "gates" are gradually opening up to investments outside of the country, nevertheless, the private (non-state) sector refuses to do so. On the contrary, the State Administration of Foreign Exchange of China (SAFE) is still struggling with "hot" money inflows.

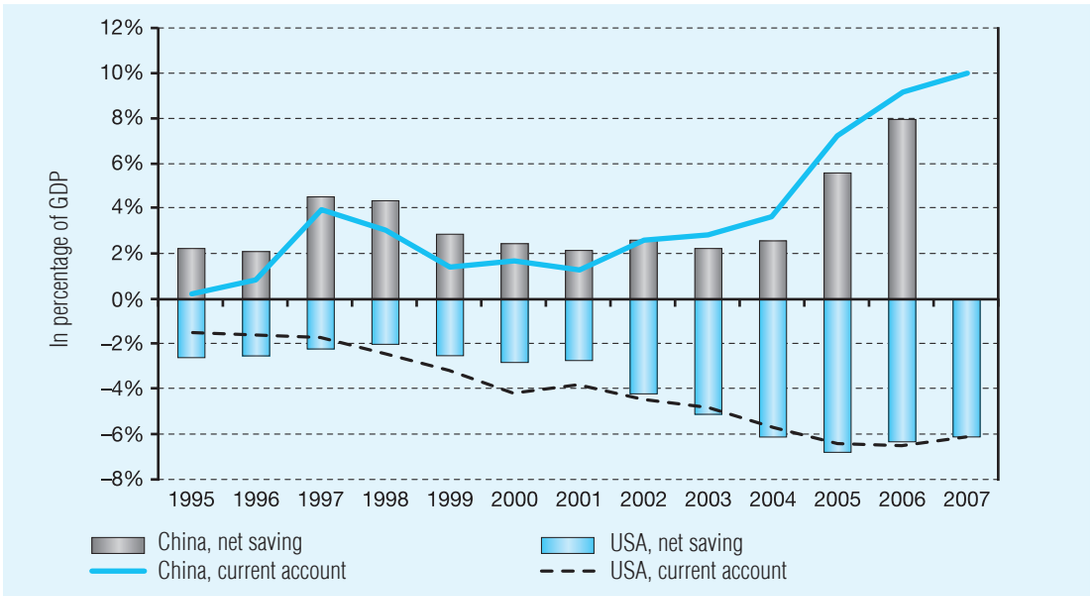
What can be behind such an abnormality? Since all participants now expect that the renminbi will continue appreciating against the dollar, there is a *declining trend to hold dollar assets*. This declining trend is accentuated even more when American interest rates continue to fall, as the base rate of the dollar was decreased to 0.25 per cent by the FED Open Market Committee in December 2008, referring to fears of a world economic recession. In this international financial environment, *McKinnon* and *Schnabl* (2008) distinguish between two different interpretations of the concept of global imbalance. According to the first interpretation, global imbalances are caused by the great saving imbalances across countries that are reflected in the trade deficits generated by saving imbalances across countries that result from the great current account deficit (negative net saving) of the United States and large trade (saving) surpluses of China, Japan, Germany, oil exporters. Second, the further massive imbalance in the financial relationship between China and the United States is the explanation behind global imbalances. *As opposed to other creditor countries, financing China's trade surplus is not matched by private capital outflows.* Instead, we witness processes as a result of which China's central bank accumulates vast amounts of foreign exchange – some of which is invested in American treasury bonds and further increases the current account deficit and debts of the world's largest debtor, the United States.

In the past decade, saving and investment imbalances grew especially between two large economic powers: the USA and China. *Chart 1* shows that by 2007, China's current account surplus exceeded 10 per cent of its GDP, reaching 11.4 per cent by the end of the year. In the same year, the USA's current account deficit was 5.1 per cent of its GDP, but due to size differences it was also in contrast with the trade surplus of several other countries. By 2006, the financing of the USA's current account deficit absorbed more than three-fifths of the overall international account surpluses of 67 creditor countries (Greenspan, 2008). By now, as the analysis of *Bracke, Bussiére, Fidora, Straub* (2007) shows, this value has reached 75 per cent.

Balance can be achieved in the long run by reducing excess saving in the creditor economies, while stimulating net saving in the United States. Such a scenario would make it unnecessary to change nominal exchange rates, which is considered necessary by the majority of researchers representing the traditional view of global imbalances (Gábor, 2008). According to McKinnon and Schnabl (2008), who reject global correction by means of the nominal appreciation of the renminbi's exchange rate, global net saving balance is subject to the stability of the currencies of economic powers. In the following pages, I focus on the unbalanced international financial intermediation and loss of monetary control in China. Because of the one-way bet on renminbi appreciation as aggravated by the extraordinary cuts in U.S. interest rates since the summer of 2007, the People's Bank of China (the PBC) has had to intervene massively in the domestic market *to buy dollars* .[4] In order to understand China's current mone-

Chart 1

THE BALANCE OF SAVINGS AND INVESTMENTS AND CURRENT ACCOUNT IN CHINA AND THE USA



Source: IMF

tary impasse, I shall give a brief overview of China's foreign exchange policies since its start of the open door policy which had triggered the 1979 economic liberalisation.

THE DIFFERENT PHASES OF THE RENMINBI-DOLLAR EXCHANGE RATE AFTER THE ECONOMIC LIBERALISATION

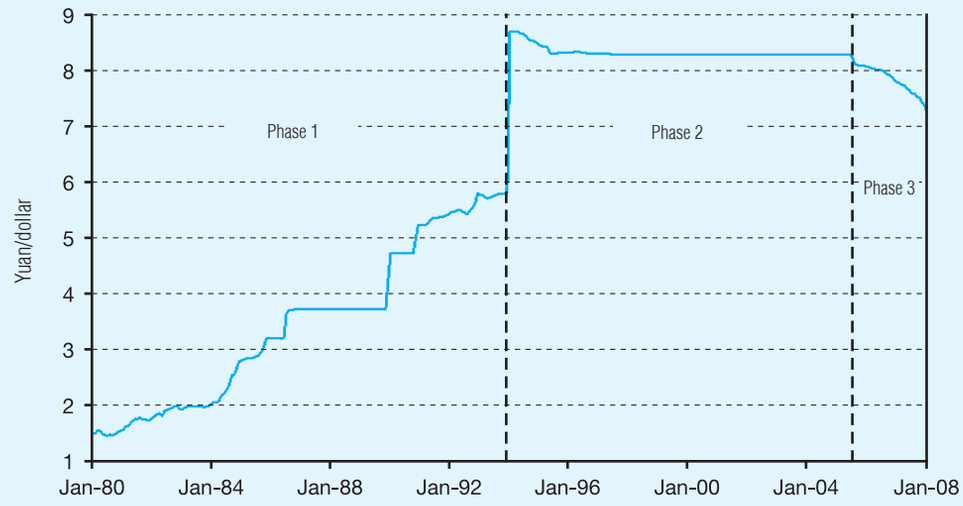
The movement of the yuan's exchange rate against the dollar after the economic opening can be divided into three phases *(see Chart 2)*. *Phase 1* was the period of currency inconvertibility and exchange depreciation, Phase 2 – was characterised by a fixed dollar exchange rate from 1995 to 21 July 2005 – while the *last phase* represented the beginning of appreciation by a predictable upward crawl. In the forthcoming, I provide a detailed description of the above three periods, and then I discuss the misconceptions about the unilateral renminbi appreciation.

Phase 1: between 1979 and 1994

Before 1994, the yuan was an inconvertible currency in the strong sense of the word. Before moving towards an open world economy in the 1980s, the Chinese currency was fixed to the US dollar at the rate of 2.5 yuan per dollar. This exchange rate did not reflect the purchasing power parity of the currency, but back then the role of foreign trade was still negligible in the economy. After the launch of the open door policy and economic reforms, there was a downward pressure on the Chinese currency – it was down to 1.5 yuan per dollar – which resulted in a slight current account deficit. In order to restrict the black market – where the exchange rate of the yuan was much lower – it became indispensable from 1984 to gradually devalue the yuan. In parallel with this, so-called "foreign exchange certificates" (FECs) were issued to foreign trade partners for the purpose of settlement. These certificates were much more stable, but their use was limited. Only organisations engaged in for-

Chart 2

RENMINBI/DOLLAR EXCHANGE RATE BETWEEN 1980 AND 2008



Source: State Administration of Foreign Exchange of the People's Republic of China

eign trading and foreign multinational companies were allowed to trade with these certificates in "swap centres" specifically set up for that purpose. The conversion ratio was much lower in these swap centres than the official rate.

There were *exchange controls* on both current and capital account transactions, and on both exports and imports as a result of which any economic transactions with foreign partners had to be conduced by state trading companies. As a consequence of the *double exchange rate*, domestic relative prices were still determined by the central financial management, while in the special economic zones[5] on the East Coast, relative prices were influenced by world markets. Chart 2 shows only the official exchange rate's path from 1.5 yuan per dollar back in 1979 and gradually increased to 5.8 yuan per dollar by the end of 1993. Due to a strict currency control, "hot" money inflows were prevented, but it implied that the official exchange rate was not efficient economically.

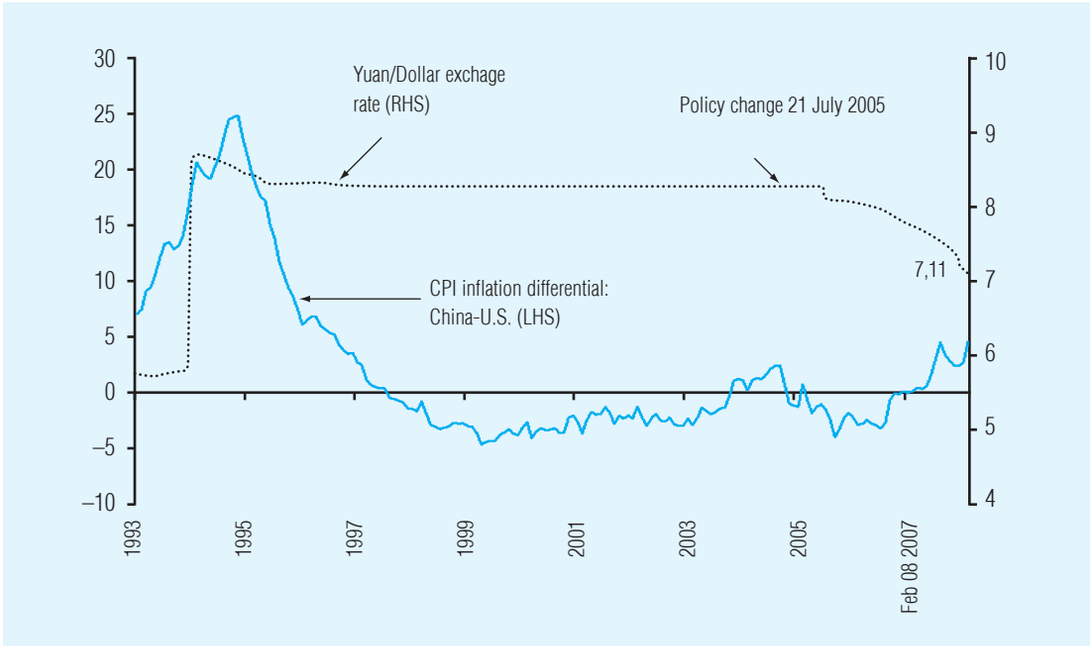
Phase 2 – between 1994 and 2005

In 1994, the *yuan was in effect devaluated* by unifying the official and swap exchange rates. This new, weaker exchange rate allowed for even better performance of the export sector, which became the number one source of the country's growth. From 1994, *financial reforms accelerated* in China. The tax reform, foreign trade liberalisation, the abolishment of exchange controls on current-account transactions contributed to the unification of the double exchange rate. By 1996, China had formally satisfied the International Monetary Fund's Article VIII on current account convertibility.

The new consolidated official rate was set at 8.7 yuan per dollar, which was closer to the former swap rates. This represented a substantial devaluation of the official rate compared to the dollar, which was however justified by *high inflation* in the period between 1993 and 1995. *Chart 3* shows that with the nominal deprecia-

Chart 3

YUAN/USD EXCHANGE RATE AND CHINA-U.S. INFLATION DIFFERENTIAL



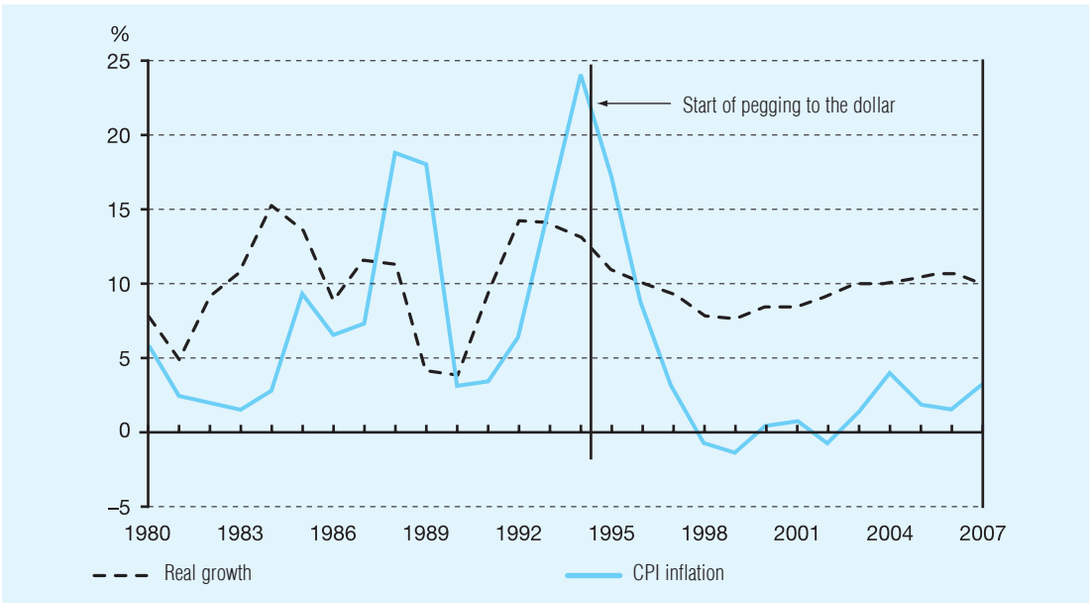
Source: McKinnon és Schnabl (2008)

tion of the official rate, the price differential between China and the United States decreased in the same extent. At the same time, with the currency unification – and the accompanying devaluation – real depreciation was negligible. As Chart 2 demonstrates the renminbi exchange rate had settled down to about 8.28 yuan per dollar and was held there by the monetary policy-makers for 10 years. The main motivations for so fixing the exchange rate were twofold. China had suffered from a "roller coaster" ride in the rate of real output growth and in inflation rates-peaking out with the high inflation of 1993–95 *(see Chart 4)*.

With only an embryonic domestic capital market and with the progressive relaxation of central planning and direct price controls, the PBC had great trouble anchoring the overall price level by domestic means alone. *Pegging the yuan* presented an opportunity to adopt a more stable external nominal anchor. Chart 4 shows that as the exchange rate was unified and remained fixed, cycles of *inflation and the fluctuation of real output growth* were smoothed- while inflation came down to 10 per cent. In addition to fixing the currency, the monetary policy had numerous other instruments to prevent the economy from overheating, for example, through regulating bank loans – and by establishing reserve obligations, credit quotas and credit limits granted to various sectors. However, the most effective way to curb inflation has in any case proved to be pegging the currency to the dollar. China's underdeveloped bond market and the rigid interest rates fixed for credits and deposits played an important part in curbing inflation, as well ass China's refusal reluctance to use various open market transactions that would have allowed to better control the macroeconomy. Without it, it is clear that currency pegging was the only certain means of keeping

Chart 4

REAL GDP GROWTH AND CPI INFLATION IN CHINA, 1980–2007



Source: IMF

price levels stable. In Japan between 1949 and 1971, when the economy underwent the same economic reform and real output demonstrated the same levels, the yen was fixed at the 360-dollar level, thereby stabilising the growth of the economy.

To summarise Phase 2, the 10-year fix at 8.28 yuan per dollar was seen as the main instrument of implementing monetary policy, made possible by the currency unification in 1994 and the move to current account convertibility in 1994–96. Currency pegging seemed highly successful in anchoring domestic levels up through 2004 (Chart 3) and smoothing fluctuations in real economic growth (Chart 4). Contrary to what is often held by economic researches who investigate the reasons for global imbalance,[6] I believe that the fixed exchange rate was not a device to "cunningly" undervalue the renminbi so as to create artificially incentives for trade, rather, it was an instrument of stabilising the economy and keeping the price level low.

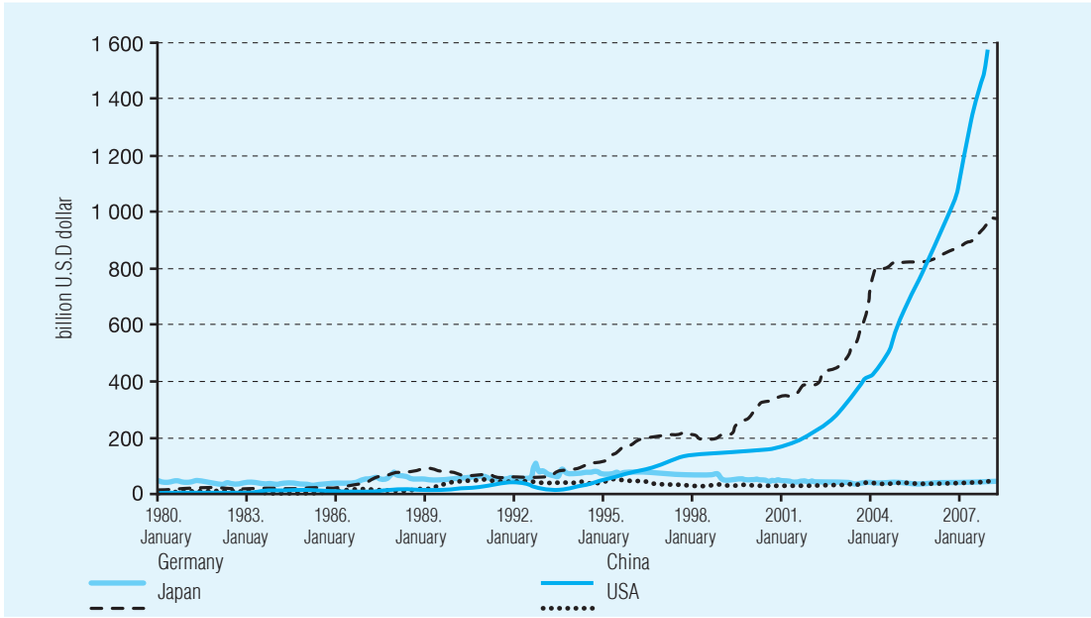
Phase 3

We can see that Phase 2 was a period of uninterrupted growth and macro-economic stability. It is justified to raise the question what then pushed made China's monetary policymakers off the break with the fixed-rate anchor.

First, after 2003, *current account surpluses began to rise exponentially,* which – coupled with inflows of foreign direct investment – led to balance of payments surpluses. Chart 1 illustrates that China's current account surplus went up from 2 per cent to 11.4 per cent of its GDP by 2007. *The United States became the largest buyer of China's manufactured exports* on which China's growth rested. During that process, by 2006, China's bilateral trade surplus reached 1.1 per cent of U.S. GDP – twice as large as Japan's. The resulting loss of jobs in U.S. manufacturing makes American politicians more and more worried (McKinnon, Schnabl, 2008). *Second*, China's *increasing trade surpluses* were misinterpreted and disapproved by international economists and

Chart 5

OFFICIAL EXCHANGE RESERVES OF GERMANY, JAPAN, CHINA AND THE USA, 1980–2007



Source: *IMF*

politicians as they thought the renminbi was artificially "undervalued" as a means to support exports. China's significant build-up of official exchange reserves between 2003 and 2005 was taken as per se *evidence of unfair currency manipulation* by international – but, in particular, American – economic experts.

Then, under American political pressure, *China's monetary leaders began appreciating the renminbi* from 21 July 2005. These decisions were directly preceded by "threatening" of the U.S. government, led by *Senators Charles Schumer and Leslie Graham,* to sanction China by imposing import tariffs. In response, on 21 July 2005, the yuan was appreciated discretely by 2.5 per cent, and since then the Chinese currency has been appreciating against the dollar by about 6 per cent a year. By the end of October 2008, the exchange rate of the currency declined to 6.8 yuan per dollar, but seemed to be stagnant in recent months as a sign of adjusting to the world economic recession.[7] As further renminbi appreciation was expected, the Federal Funds rate fell from 5.25 per cent August 2007 to just 0.25 per cent by December 2008, and it became the crucial determinants of the huge accumulation of official exchange reserves in China (Chart 5).[8] Despite massive sterilization efforts by the PBC, the monetary base continued to grow to an extent exceeding GDP which carried the *risk that inflation could not be fully contained.*[9]

Chart 6 demonstrates that from 2001 when America's central bank made gradual interest cuts in order to stimulate the economy – by lowering the prevailing federal exchange rate to 1 per cent on 25 June 2003 – the Chinese consumer price index (hereinafter called CPI) began to rise. After that, from June 2004 up until June 2006, as the FED started to raise interest rates foreign capital inflow into China dropped, leading to a fall in Chinese CPI. At the same time, from September 2007, when the FED implemented interest cuts again in response to the emerging American sub-prime mortgage crisis, inflation expectations signifi-

cantly grew in China and in the whole world. As a result, China's official reserve accumulation further accelerated. The further growing monetary base due to the *increased dollar purchase* could no longer be fully contained by the PBC's sterilisation measures by the first half of 2008. On top of monetary oversupply, *soaring raw material and food prices* represented further pressure (cost inflation) by the summer of 2008. By May 2008, the Chinese consumer price index had climbed above 8 per cent.[10]

Chinese consumer prices have apparently been on a gradual decline since the summer of 2008 due to the world economic recession and slumping global demand (Chart 6). This fall, however, cannot be justified by the previous arguments – the opposite movements of the U.S. interest rate and Chinese CPI – because the American prevailing interest rate has remained practically unchanged, i.e. 0.25 per cent, since December. China's inflation in the month of November 2008 was down to 2.4 per cent at an annual level.[11] The explanation behind the fall of over 6 per cent is the *slumping demand* caused by the deceleration of the economy. In 2008, due to the present economic world crisis, Chinese GDP-growth shrunk to a one-digit chart, i.e. 9 per cent, unseen for a long time. According to the forecast of the World Bank, it is going to be down to 7.5 per cent in 2009. The deflationary impact resulting from the yuan appreciation could not be felt in this period, because the yuan appreciation has temporarily been suspended by the Chinese monetary policy since autumn 2008.[12] While in the first half of 2008, the Chinese monetary authorities attempted to contain inflation, today they are confronted with a downward *deflationary spiral* produced by falling prices. This is shown by the fact that the high Chinese central bank base rate of 7.47 per cent at the beginning of the year was cut several times by the monetary authority, fighting inflation, in the second half of 2008, and was reduced to 5.31 per cent by December.

Let us now disregard the cyclical changes – namely falling raw material prices, narrowing demand and the resulting decreased inflationary expectations – produced by the world economic recession. China's consumer price index reached 8.4 per cent in April 2008. It is very likely that the Chinese price level would have continued to rise if it were not for the global recession that erupted in the summer. But in that case, now with inflationary pressure on the world, China – which until 2007 had a deflationary force on the world – would have made the fight against global inflation even more difficult.

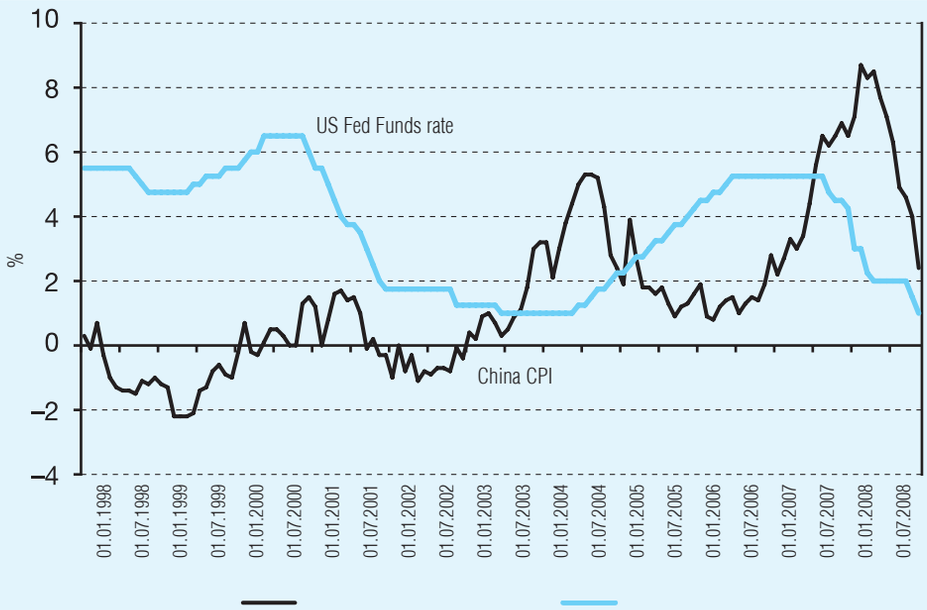
With domestic consumer prices rising, Chinese wage increases are putting additional upward pressure on the international dollar prices for Chinese manufactures. From July 2007, China had been transformed from being a *deflationary* force on the world economy into an inflationary one. *The combination of internal inflation* and *an appreciating renminbi* is now raising the world price level. *Chart 7* shows that while before 2007 the prices of goods imported from China had a downward pull on the world price level, from mid-2007, however, the prices of exported Chinese goods were putting a gradual inflationary force pressure on the world.

The current economic recession may continue – according to preliminary calculations – until 2010–2011. As a result of the subsequent stabilisation and new *business cycle,* the above-described *inflationary force* may gain prominence again. Investments aimed at boosting supply postponed due to low oil prices, the increasing Chinese population, the ever growing domestic demand by the population and rising real wages will definitely represent a great challenge to China and the world economy in the decades to come.

To sum up Phase 3 of the yuan exchange rate, we may conclude that the short-term

Chart 6

CHANGES IN CHINA'S INFLATION AND THE US FED FUNDS RATE IN PERCENTAGE, 1998–2008



Source: National Bureau of Statistics of China, Fed, Bloomberg

inflationary forces developing due to the unilateral appreciation pressure essentially narrowed the scope of the PBC's set of monetary instruments. As a result, there is hot money inflow into the economy, the PBC appears continually as a dollar buyer on the foreign exchange market, price level increases cannot be prevented by the monetary policy, and finally, a further growth in the surplus of the balance of trade can be observed, still uncovered by private capital outflows.

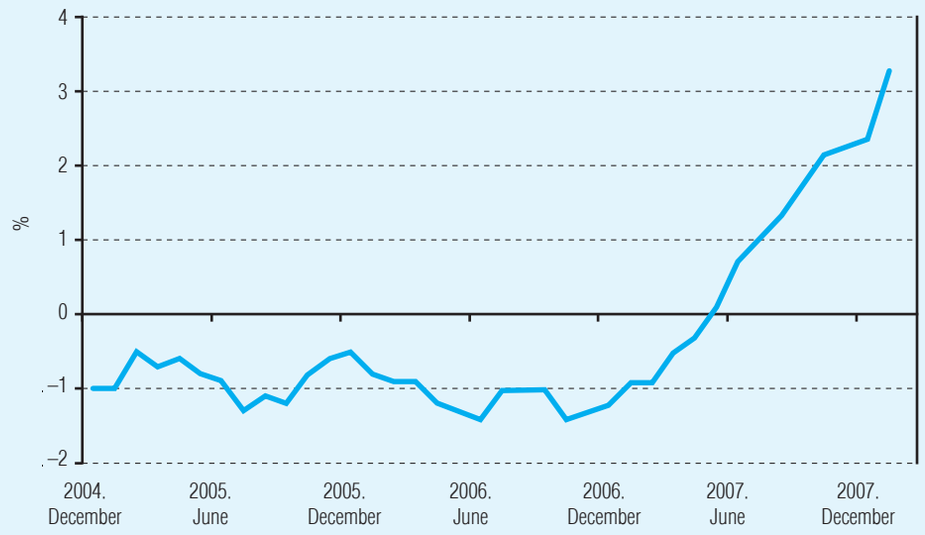
MISCONCEPTIONS ABOUT THE ARTIFICIALLY UNDERVALUED YUAN

Until the summer of 2008, China was characterised by a *monetary and exchange rate impasse* with a unilateral *appreciation pressure* on the currency. Its economy was threatened by overheating induced primarily by a rate of inflation in excess of 8 per cent. Thus, China's monetary policymakers were inhibited from taking appropriate actions to reduce its ballooning net trade (saving) surplus. Obvious steps for reducing net saving – such as cutting taxes and increasing government social expenditures – would have a near-term inflationary impact. Meanwhile, China's growing current account surplus, uncovered by outflows of private capital, continually worsens the monetary impasse. The build up of official exchange reserves, which *rose by USD 40 billion a month* on the average in 2008, was much *higher than the monthly trade surplus (see Chart 8)*. By September 2008, the build-up of exchange reserves exceeded USD 1900 billion![13]

Because foreign experts misinterpret the trade surplus and rapidly accumulating official exchange reserves, they call for further appreciation of the yuan. This foreign pressure strengthens the expectation that – according to McKinnon és Schnabl (2008) – a stronger currency may cause more inflows of hot money.

Chart 7

THE IMPACT OF IMPORTS FROM CHINA ON THE AMERICAN PRICE LEVEL, 2005–2005



Source: McKinnon és Schnabl (2005)

What is the best way to escape from this empasse? It seems obvious that China cannot end its exchange rate impasse, and the world-wide monetary turmoil that goes with it, on its own. Currency stabilization, which could be successfully carried out with *proper foreign cooperation,* should in any case be preceded by measures to correct the *saving-investment imbalance* which may take months or years. Nevertheless, to be successful, China must also commit itself. Definite *fiscal measures* are needed that are aimed at eliminating its future saving surpluses and result in boosting domestic consumption.

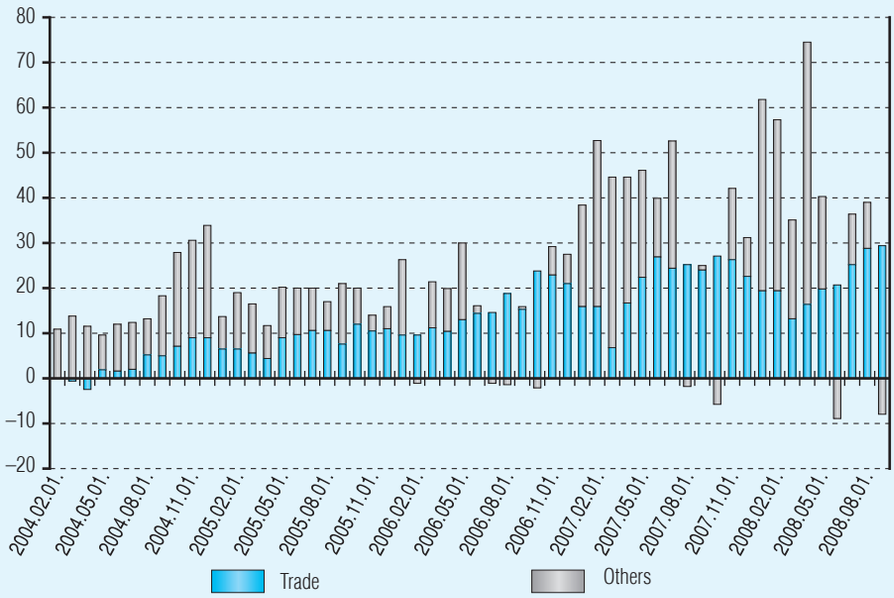
Despite all the above, there are t*hree misconceptions* about the Chinese exchange rate policy in international literature, which have to date inhibited the efficient treatment of the problem. In the following pages, I describe the misconception of the international literature about the Chinese exchange rate outlined by McKinnon and Schnabl (2008) .

MISCONCEPTION 1: The exchange rate can affect the trade balance.

The majority of economists dealing with the international exchange rate mechanism believe that a country's net trade balance can be controlled by manipulating the level of its exchange rate. However, *a current account surplus just only reflects a surplus of saving over investment at home and the converse opposite abroad.* Thus, how a discrete appreciation of a creditor country's currency will affect its current account surplus is neither obvious nor unambiguous. It is however true that its export goods would become more expensive to foreigners-*the relative price effect.* But, in an economy open to international capital flows, domestic investment would fall because appreciation makes production in the country much more expensive. Also, because China owns huge stocks of dollar claims, a negative wealth effect from having the dollar fall against the renminbi would further reduce domestic

Chart 8

MONTHLY CHANGE OF CHINA'S FOREIGN RESERVE BUILD-UP, 2004–2008



The black and white areas indicate the change in reserve accumulation, while the white areas indicate the change in the trade balance.

Source: People's Bank of China, Customs General Administration of China

expenditures-including imports. This decline in imports offsets the dampening effect of higher foreign currency prices for exports so as to leave any change in the net trade balance small and ambiguous (Qiao 2007). To illustrate this exchange rate-trade balance misconception, it is instructive to examine the example of Japan after 1971. Similarly to the Chinese currency, there was a foreign appreciation pressure on the yen at the time. As a result, in 1971, the yen was no longer fixed to the dollar and the yen rose from 360 to the dollar to reach 80 yen to the dollar in April 1995! Despite this enormous cumulative appreciation, Japan's net trade surplus rose from about 2 percent of GDP in the 1970s to 5 percent in the 1980s, and today it remains 4–5 per cent of GDP with the yen at 90–110 to the dollar. Consequently, the *massive currency fluctuations had no systematic impact on Japan's net trade (saving) balance.* However, the great nominal appreciations of the yen against the dollar, which Japan more or less welcomed during the worldwide inflation of the 1970s, eventually unhinged Japan's macro-economy. In the late 1980s, the syndrome of the ever-higher yen provoked bubbles in Japan's stock and land markets. When the bubbles broke in 1990–91, followed by a further sharp rise in the yen up until 1995, Japan was thrown into deflationary slump: its infamous *"lost decade"* of 1992 to 2002. Foreign exchange risk created a near zero interest liquidity trap that renders monetary policymakers virtually impotent for stimulating domestic spending. (Krugman, 1998). Although Japan has had modest export-led GDP annual growth of 2 to 3 per cent since 2002, the economy continues to suffer from the deflationary consequences: wages and per capita consumption are stagnant.

MISCONCEPTION 2 Ongoing exchange rate appreciation reduces inflation.

The *second misconception* is that ongoing exchange appreciation can reduce domestic price inflation or, at the very least, insulate the economy from international inflation. It is almost taken as a fact that *appreciation is an effective device in fighting inflation.* This is certainly true in the long run, as Japan's unfortunate experience with eventual deflation from yen appreciation attests makes it clear to us. However, for a country emerging from a fixed nominal exchange rate where domestic and foreign rates of price inflation had been more or less aligned, *the near-term effect of appreciating currency can be highly inflationary* – as seen in the cases of China and Japan. In the near-term, the inflationary impact from the loss of monetary control can overwhelm the deflationary impact of a higher level of the exchange rate (McKinnon, Schnabl, 2008).

Again, let us refer to Japan's earlier experience with this problem. Under the Bretton Woods system of fixed exchange rate parities, the yen had been successfully fixed at 360 to the dollar from 1949 to August 1971, so that price inflation in tradable goods (WPI) between the U.S. and Japan was similar. In the spring of 1970, however, market participants began to project that the dollar might be rapidly depreciated. Hot money began to flow which would have resulted in hot money flowing out of the United States into European countries as well as Japan. As it had actually happened, as a response, the Japanese monetary management intervened heavily in the foreign exchange markets with a rapid build-up of foreign exchange reserves and surge in domestic money growth. By 1974, annualized WPI inflation in Japan became higher than in the United States: 31.3 per cent versus 18.9 per cent in the U.S. Only in the late 1970s did Japanese inflation fall below American CPI when the deflationary effect of a higher yen made its effect felt. But the length and strength of the near-term inflationary transition was beyond any expectation.

China is still currently in the same situation where Japan was in the 1970s. *As a result of the external appreciation impact, the near-term inflationary impact is more and more overheating China's economy*.[14] Are there circumstances where China should acquiesce to the external political pressure and to continual renminbi appreciation? Clearly, if the United States under the world dollar standard continues to inflate too much, the People's Bank of China would have little choice but to acquiesce to appreciation of the renminbi against the dollar.

MISCONCEPTION 3: Floating the rate would equilibrate the foreign exchange market.

China's fragile banking system, its underdeveloped foreign exchange market and the lack of instruments to treat exchange risk make us come to the conclusion that a more flexible exchange rate system can only be introduced step by step starting with widening the exchange band which would pre-fix the yuan's daily value.

China's monetary policymakers are very unwilling to adopt a more flexible exchange rate system, because *floating would cause serious disturbances in the Chinese economy* (Makin, 2008). In the event that the central bank allowed floating the currency from one day to the other with the abolition of its controls of private capital outflows, it would trigger capital flight which would undermine the ever so fragile banking system.[15] Therefore, full-scale reform of China's exchange rate system will have to await completion of the reform of its banking system, which will take at least several more years. According to *C. Fred Bergsten* (2007) – who as opposed to the present author's view believes that the present global imbalances can be corrected by appreciation of the yuan and depreciation of the dollar – the reform is yet several years away. He thinks that the adoption of a flexible exchange rate regime in China can be only a second stage which should be preceded by the reform of its bank-

ing system and the continued appreciation of the yuan.

Opinions hugely *differ* on this issue in the international economic literature. The research staff of the Peterson Institute as well as representatives of the traditional school dealing with the sustainability of global imbalance propose an immediate yuan appreciation in more than one step to ease tensions (Gábor, 2009).

In this professional debate *Tatom* (2007) belongs to one of the few who is optimistic and states that the undervalued yuan exchange rate should not give cause for concern, because the real exchange rate is going to return to the long-term average through purchase power parity mechanism. McKinnon and Schnabl (2006) go even further and fundamentally question that yuan appreciation would lead to global correction.

China is unable to abandon foreign market intervention, and thus it cannot allow floating its currency – as did European countries after the collapse of the Bretton Woods system. For this step would require the existence of a determinate foreign exchange rate that could only evolve if the PBC were to exit the foreign exchange market. Unlike the European situation, however, China faces an ongoing *currency mismatch* leading to the syndrome of "conflicted virtue" – a term introduced by McKinnon and Schnabl[16] – that prevents private market players from clearing the excess supply of dollars.

What causes the mismatch that undermines floating? The renminbi, like the currencies of other developing economies, is not used significantly widely for international borrowing or lending; but China couples this "gap" in its capital markets with an enormous saving (trade) surplus. The surplus thus accumulated is less and less acceptable for the country's commercial partners who believe that the artificially undervalued yuan creates an *inequitable market situation.* Natural private market players such as Chinese banks – or even insurance companies and pension funds – all have their liabilities denominated in renminbi. Thus, even if the yuan per dollar rate fluctuated only randomly, Chinese financial institutions would be exposed to too much *exchange risk,* which explains why they are reluctant to pile up dollar assets. At some point, local market participants would try to get rid of their dollar asset, while their official exchange reserves continue to accumulate. Consequently, a *free float would result in an indefinite upward spiral of the renminbi against the dollar* – with no well – defined balance point where Chinese financial institutions become buyers of dollar assets to stop their further depreciation. "Conflicted" manifests itself for the PBC when the ongoing appreciation, which generates serious deflationary forces, drives the economy into a *zero interest rate liquidity trap* as local market participants want to "get rid of" their dollar assets on a large scale. On the other hand, if appreciation is not carried out – either because it is not successful or not desired – it will lead to trade sanctions against the country. So it is evident that, falling victims to the conflicted virtues, Chinese monetary leaders were forced to abandon the peg to the dollar as of 21 July 2005.

The *third misconception* is closely linked to the first. *A floating and gradually appreciating renminbi would not predictably reduce China's trade surplus,* and dollars would continue to pour into the economy. On the other hand, if China was not a creditor country because foreign trade (net saving) was close to being balanced, then no internal currency mismatch would exist. This would give a green signal to the monetary authorities to float the currency. However, even in this case, floating would raise serious problems and it would be inhibited by the underdeveloped Chinese stock market and capital controls on private individuals. Then forward markets for private hedging against currency risk becomes difficult to organize and

expensive. So if the monetary policymakers decides to float the rate, it would soon be drawn back to a narrow band in order to reduce the risks of exporters and importers. (McKinnon and Schnabl, 2008).

TOWARD A CREDIBLY FIXED EXCHANGE RATE

Overcoming these three misconceptions about the exchange rate is crucial for stabilizing China's monetary system. For a developing country like China, *the exchange rate is best considered just an extension of domestic monetary policy* – and not an incentive instrument of trade policy. In McKinnon's and Schnabl's view (2008), the key to China's monetary policy and solution of the global economic tensions could be if China had a yuan per dollar exchange rate at which its currency could be kept stable. Although a fixed rate is not considered desirable, since in today's liberalised world economy fixing exchange rates is not acceptable – especially for the world's forth largest economic power – it is nevertheless proposed that a *narrow currency band* should be used. In this case, China's economy would be stabilised similar to what has been described about Phase 2 of the yuan. The precise level of the new rate is much less important than having it *credibly* stable in the long run. However, for any new fix to be sufficiently credible to achieve this it is first of all necessary to end international pressure on China and to *eliminate the one-way bet on future requirement of renminbi appreciation.*

According to the proposal, the first step should be to cease external political pressure, then the PBC could reset the yuan per dollar rate and stick to it in the future. As a result, the yuan appreciation would come to a halt. If such an action were to take place today, this exchange rate would very likely be 6.8 yuan per dollar. A *massive outflow of private capital,* largely intermediated by Chinese banks, insurance companies, pension funds, would surely follow, which would be welcome by all financial intermediaries because of the advantages offered by diversification. With the narrow currency band system, the PBC could stop purchasing dollar assets on the foreign exchange market. Indeed, if the new capital outflow exceeded the current account surplus, the PBC should intervene by selling dollar reserves to keep the renminbi fixed against the dollar near the middle rate. In any event, the PBC could regain control over the domestic money supply, and inflation would come down and the efficiency of domestic financial intermediation would improve.

Once its domestic monetary and exchange rate system was stabilized, China could then proceed deliberately to reduce excess domestic saving relative to its huge domestic investment without worrying about exacerbating near-term inflation.

INSTEAD OF A SUMMARY

In this paper, I wished to present China's exchange rate policy differently from the mainstream international economics. As opposed to most researchers of global imbalances, I have attempted to highlight that the *wave of appreciation created by external political pressure will not necessarily move the Chinese economy towards the desired goal, and will in no case lead to global corrections in the short run.* My intention was to demonstrate the views represented by the "other" side. By giving a detailed description of the three phases of the Chinese exchange rates following the country's open currency policy, I have shown that it was in Phase 2, i.e. the period of fixing the exchange rate to the dollar, that China's macro-economy became the most stable. In view of the above, the designation of a narrow band exchange rate

would be desirable both for the Chinese economy and global corrections instead of the ongoing crawling appreciation of the yuan.

I believe that western economic powers regard their own economic and social interests when applying pressure on the Chinese economy to carry out yuan appreciation rather than respecting the interests of the global economy as a whole. The United States is concerned about its current account deficit which has surged to record highs in recent years and about the substantial American manufacturing job losses, a source of social tensions, due to Chinese exports – i.e. global-scale competition. In order to reduce global turbulences, Chinese monetary policymakers should stop buying up dollar assets. It can however only be accomplished if Chinese market participants do not convert the huge amounts of dollars flowing into the country through exports in fear of appreciation. On the other hand, if they hold a part of their revenues in dollars, there would be an outflow of capital to American and European markets for better capital recovery. There would be! For neither the American nor the European governments welcome the inflow of Chinese private capital. It is thus obvious that it is a *vicious circle.* Leading economic powers are threatening China with restrictions, but they are unwilling to make concessions. However, without concessions yuan appreciation cannot be expected to yield the desired result.

Although the current financial world crisis has suppressed the problems of the overheated Chinese economy for a while through *changes in cyclical factors* – falling raw material prices, narrowing global demand – I still believe that having overcome the crisis, the problems addressed in the paper will resurface. It may be critical for the global economy as a whole to handle the problem at the earliest stage, and as a first step the pressure to appreciate the yuan could be ended.

NOTES

[1] International Monetary Fund, World Economic Outlook Database, October 2008

[2] CIA The World Factbook, 2007 data

[3] The term renminbi is used in the American professional language for denoting the Chinese yuan.

[4] Up until 2005, PBC had no choice but purchasing dollar , since Chinese enterprises had to convert their export dollar revenues into the local currency. After 2005, the more and more revaluated yuan made it unreasonable to keep dollars, which led to further dollar sales by the private sector.

[5] As a result of the favourable environment in the so-called Special Economic Zones, more than 83 per cent of FDI inflows were received by these provinces in 1999. The most attractve provinces were: Guangdong (28 per cent), Jiangsu (12 per cent), Fujian (12 per cent), Shanghai (5 per cent), Beijing (4 per cent) és Tianjin (4 per cent) (Fu, 2004).

[6] See, for example, Dooley, Folkerts-Landau and Garber 200 4, according to which the Asian countries deliberately keep their currencies undervalued relative to the dollar as an attempt to attract local and foreign capital investments into the export-oriented sectors. It leads to long-term current account surplus and the accumulation of further piles of dollars in Asian central bank reserves.

[7] Source: State Administration of Foreign Exchange of the People's Republic of China

[8] The liquidity surplus due to the low American federal base rate led to record high private sector consumption – with record low saving – as a result of which Chinese exports to the United States substantially grew. As a result, there was an even larger dollar inflow into the China which explains its further rising official exchange reserves.

[9] While the value of GDP at current price grew by 205 percent between 2002 and 2007, the M2 monetary aggregate showed a 256 per cent increase in

the same period. Source: National Bureau of Statistics, China

[10] As a consequence of a slump in raw material and food prices from the summer of 2008 and the decreased world economic demand, the Chinese CPI inflation was 6.3 per cent in 2008, a cause for further concern. Source: National Bureau of Statistics of China

[11] Source: Bloomberg

[12] The suspension was of such an extent that the Chinese currency depreciated to 6.87 yuan per dollar from 6.81 between July and September 2008. The sudden strengthening of the dollar since the beginning of summer has also contributed to this process.

[13] Source: State Administration of Foreign Exchange, People's Republic of China

[14] Upward inflationary forces from near-term impacts have been reduced with the escalation of the global economic crisis. Nevertheless, when escaping from the current recession the former trend is likely to continue where it was suspended unless international agreement is reached in connection with an appropriate exchange rate policy.

[15] For the fragility of China's banking system see Lin X., Zhang (2006).

[16] The term "conflicted virtue" is not translated by this author word-by-word into Hungarian.

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