China Should Not Hasten Its Transition to Flexible Exchange Rates

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Abstract:
The dispute over whether or not China should move much faster towards greater currency flexibility is very contentious. Many arguments which support faster movement seem sound on the surface but hold together less well on closer inspection. The goals of this paper are to present a case for a more gradual transition of China’s exchange rate and capital account policies and to discuss the weakness of the theories and evidence used to support the opposite argument.
The reality of the present current account imbalance between the United States and China worries many economists. The exchange rate between the renminbi and the US dollar is not determined by markets. Instead, China chooses an official rate undervaluing its currency and interfering in the markets to keep it trading at its official value. Dooley, Landau, and Garber (2003) characterize the effect of undervaluation as a subsidy to Chinese exports (i.e. manufactured goods, tradables, etc)

The discrepancy between what the cost of the RMB in dollars would be if it were determined by markets and what the Chinese government forces it to cost throws off equilibrium in the global economy. There are serious worldwide economic ramifications to currency account imbalances. According to Feldstein (2011), trade deficit countries feel internal pressures for protection, tariffs, and similar policies which are damaging to the world economy. He also suggests that policies which lead to surpluses can lead to bad effects like artificially low interest rates and cross-border misallocation of capital. This can be seen in the persistence of the large spread between domestic RMB yield and foreign RMB yield.

Proponents of a floating USD–RMB exchange rate argue that if China’s exchange rate were allowed to become more flexible then there would be an appreciation in the value of the RMB versus the dollar and the United States’ current account deficit would shrink. This belief is more likely to be held by politicians and by those who are less familiar with the complexities of the world current account imbalance problems. Shrinking the imbalances, however, is not as simple as praying China’s peg out of existence, for when economists speak of the renminbi being undervalued, they are talking about the real exchange rate not the nominal exchange rate (which the Chinese monetary authorities target using the peg). Wei (2007) notes that there is no quantitative evidence supporting the argument that a flexible currency encourages current
account adjustment. He characterizes this belief as being “faith-based” because in the middle and long-term, a complete liberalization of the RMB-USD exchange rate is unlikely to cause the real exchange rate to appreciate and thereby close the current account imbalance.

At the broadest level, Feldstein (2007) describes what needs to happen for the current accounts to adjust. He says countries running surpluses need to reduce saving and/or increase national investment while deficit countries increase savings and/or decrease investment. “The saving-investment imbalance alone determines the country’s current account deficit or surplus.” In this explanation, there is no mention of nominal exchange rates. Between countries with completely liberal economies, there should be no significant capital account imbalance because if one country starts to develop a current account surplus, i.e. imports do not keep up with exports, the real exchange rate appreciates such that it becomes more expensive for the deficit country to continue importing more than it exports to the surplus country and the imbalance adjusts. Other interventions beside the nominal peg are responsible for keeping Chinese saving high and U.S. investment low.¹

A look back at attitudes towards the Chinese currency can shows that the renminbi has not always been thought of as undervalued or manipulated.² Wei also approximately identifies the time when China started gaining a reputation as a currency manipulator as 2003. Around that same time, China started accumulating foreign assets (in the form of assets and liabilities) which, in conjunction with governmental policies of financial repression, has done the most to distort the real value of the renminbi-dollar exchange rate. Papers, written by Aizenman & Lee (2007) and Korinek & Serven (2010), show that China accumulates foreign reserves for both precautionary and mercantilist purposes. Their empirical analysis shows that desire to guard

² Wei, Shang-Jin, “Don’t Over-sell the Benefits of a Change in China’s Exchange Rate Policy”
against a bad economic shock is more significant in making up China’s demand for foreign reserves than the desire to stimulate their exports. The effect of these desires, however is simultaneously to “raise the value of tradable versus non-tradable goods (i.e. undervalues the real exchange rate)”\(^3\). The underlying economic logic is that the renminbi will weaken as China invests in the U.S. (i.e accumulates foreign reserves) and will strengthen as investment comes in from abroad.

If people could freely move their money into or out of China, reserve accumulation would be less effective at undervaluing the exchange rate. China’s methods of financial repression include an artificially low domestic interest rate and laws which prevent Chinese investors from either investing in foreign currency or taking RMB out of mainland China, keeping the real value of the exchange rate undervalued.

Jeanne (2012) describes the same effect differently. He says that the controls act as frictions which induce a deviation from Ricardian equivalence. By accumulating foreign reserves, restricting foreign ownership of domestic equity, and forbidding domestic savers from investing in foreign markets where they could get a higher interest rate than the one in China, the government is able to control the level of net foreign assets.

The real interest rate is undervalued by the existence of capital controls and the policy of accumulation. Changing the exchange rate regime would not do much to the real exchange rate or current account balance unless the government decreased capital controls and accumulation and increased the openness of its markets.

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\(^3\) Korinek & Serven. 2010. “Undervaluation through Foreign Reserve Accumulation”
Having this kind of 180 degree reversal of policy happen too fast makes the senior Chinese policy makers rightfully nervous. In fact, the rest of the world should also be nervous if this change were to happen too fast.

In the first place, the Chinese government has used these repression and accumulation policies as the centerpiece of an export-based growth strategy which has served China remarkably well over the past decade. If China were to stop supporting its industrial base with these policies, the manufacturing sector might well see a contraction which would lead to significant unemployment to social instability.

Even though it would solve the US-Chinese current account imbalance, a look at the recent outcomes for promising fast-growing emerging market economies (EMEs) after doing capital account liberalizations is decidedly off putting! After IMF programs liberalized many Southeast Asian countries, a brief period of robust growth fell out of bed in the Asian financial crisis of 1996-1997. Misbehaving governments, modern financing methods used by the rich countries, and sudden stops of speculative foreign investment contributed to the collapse under stress of the underdeveloped domestic financial systems and institutions.

When richer countries like Brazil and Japan had financial crises after trying to make sweeping changes to insufficient financial institutions and systems, they fell into this “Middle-Income Trap” even after experiencing extended periods of economic gain and increased GDP per capita. The prevailing economic and political authorities pressured both countries to liberalize using many of the same arguments being used on today’s Chinese policy makers. What followed for both countries was serious and long-lasting negative economic impact.

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4 Rogoff, Kenneth, Lecture 11-04-2013
5 Rogoff, Kenneth lecture 11.04.2013
Even though China’s economy is the world’s second largest, its financial system is no better prepared to support an advanced economy than the financial systems of the Southeast Asian countries worst hit in 1996. Chinese finance still retains too many vestigial elements of a communist command and control system. Economic policy makers in China understand this and are concerned that if they liberalize their capital account, their relatively primitive financial system will come under more pressure than it can handle especially if their economy becomes overloaded with foreign investor’s renminbi denominated investments.

Prasad and Ye (2013) argue that China has not yet reached the development required to satisfy the worldwide demand for onshore investment. They measure China’s financial markets as being underdeveloped in breadth, depth, and liquidity especially in debt sectors. The United States has the most sophisticated financial system in the world which allows it to handle the so many innovative financial instruments; this is not true of China, on the other hand, and if it speeds down the path to liberalization, it puts itself at risk of encountering two serious problems caused by the scarcity and ill-suited nature of investment vehicles in the form of corporate bonds or public debt.

If China opens up its capital account before their systems and institutions can handle the increased burdens of high-complexity transactions and demands, there is likely to be unhealthy real USD-RMB exchange rate volatility because of price stickiness. If China liberalizes and an adequate currency derivatives market still does not exist, Chinese exports will be hurt by higher exchange rate uncertainty; Investors, exporters and importers need to be able to hedge currency risk or Chinese trade will fall harming its economy and reducing stability at the same time. Similarly, the market for Chinese government bonds will need to grow dramatically before

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7 Prasad & Ye. 2013. “Renminbi’s Prospects as a Global Reserve Currency”
foreign capital and investment is allowed. The current public debt market in China is so underdeveloped that even a small negative economic shock would place the Chinese government at the mercy of the international bond markets.\(^8\)

The Chinese have done a masterful job avoiding the pitfalls fast-growing countries often fall into but if China surrenders to the middle-income trap, decades of growth can be easily undone. This is why it is important not to be overconfident and make potentially destabilizing changes. China is following its own course which is very gradually making changes to become more open. China has taken steps in recent years to give offshore markets access to renminbi denominated bonds while at the same time using administrative means to maintain soft control over inflows and outflows.\(^9\)

Fixing its financial system piece meal is not a good option either. The risk is that developing one aspect of domestic financial markets without similar improvements to many other aspects would suit the interests of some parties and do a disservice to others. For instance, developing the markets for RMB denominated assets would be good for foreign investors and central banks but without corresponding development of currency markets, importers and exporters would be hurt by the increased exchange rate volatility.\(^10\)

The model of development proposed by Bhagwati (1982) seems to minimize the risk the country will fall into the middle-income trap. He makes the case that a country like China with under-developed capital markets and restrictions on capital mobility can improve on their first best option for development by choosing a sub-optimal strategy which opens capital markets and improves domestic institutions and financial systems by making many small reforms which

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\(^8\) Rogoff, Kenneth Lecture 11.04.13.

\(^9\) Prasad & Ye. 2013. “Renminbi’s Prospects as a Global Reserve Currency”

\(^10\) Prasad & Ye. 2013 “Renminbi’s Prospects as a Global Reserve Currency”
taken together gradually prepares the country to manage the stresses of openness.\textsuperscript{11} The steps China has taken to internationalize the renminbi makes China’s strategy seem like ones which Jagdish Bhagwati would have recommended.\textsuperscript{12} It does not seem possible that China can continue to grow convincingly, liberalize slowly, and avoid all the traps EMEs usually face but perhaps China can move along fast enough with the second best option so as to avoid getting sucked into the middle-income trap. Unfortunately, no good evidence exists supporting one option or the other. Simply saying that China’s currency should abandon its peg to help ameliorate current account imbalances ignores the complexities and risks of the policy.

Aside from the current account problems, advocates of an open current account and floating exchange rate regime will argue that it is in both China’s and the world’s best interest that China become integrated into the world financial markets. They cite renminbi’s prospects as a global reserve currency which would deepen and diversify world currency markets while allowing China greater ease of borrowing in international capital markets and an element of exorbitant privilege. Economists such as Fischer and Summers would argue that openness to international capital will lead to higher rates of institutional development and economic growth from importing new technologies and from equity market development. Work by Prasad and Rajan (2008) examines the collateral benefits which China might experience after opening their capital account. These secondary benefits would mostly likely affect China’s governance and institutional structures as they are forced to become more transparent and effective as a condition for international capital flows. The improvement which would come to the Chinese financial system with new innovative techniques brought by foreign banks and financial firms is a good

\textsuperscript{11} Rogoff, Kenneth Lecture 11.04.2013
\textsuperscript{12} Ibid.
example of this kind of benefit. More sophisticated methods of finance are greatly needed in the Chinese economy.

These are good arguments but they have their flaws. It makes economic sense to think that as a country opens up to international financial markets the transfer of new technology and capital to the developing country increases growth and access to capital markets increases the country’s stability. The problem for this theory is that the empirical proof is missing. Financial economists for decades have tried to use econometric analysis such as cross-country regressions to show that countries with open and integrated financial systems have higher long-term growth and lower overall economic volatility. The empirical analysis has consistently failed to show any benefit to liberalization. Prasad, Rajan and Subramanian (2007) find that non-industrial countries which rely very little on foreign capital have not grown slower than countries take a lot of foreign financing. Many economists now think that capital inflows by themselves have only temporary effects on output growth. Indeed, immediately following capital inflows, a period of high catchup growth is not uncommon but does not last long. Productivity growth and not capital inflows are much easier to tie to growth rates, indeed analyses such as that of Gourinchas and Jeanne (2006) show exactly this. The medium and long-term effects on growth of opening up to foreign capital on are small. Therefore it is foolish to think that China will somehow have direct growth gains from liberalization.

The issue of collateral benefits is more complicated, Prasad & Rajan (2008) describe gaining these benefits from financial integration as a “Catch-22”. They describe two theories of how collateral benefits might be gained: a country can gain collateral benefits if its economy has gained above a certain level of economic development, or collateral gains can be made if the country has achieved a certain level of institutional development. It can be difficult to pin down
which side of the threshold a country is on. This is the case with China; eventually, its markets will one be developed enough for the benefits to outweigh the risks of taking international capital without restriction, but currently no one really knows. As I already discussed, there are substantial reasons not to rush China’s integration into world markets and China’s questionable collateral benefits do not convince me that the second best strategy China currently pursues is not really its better option.

The higher growth from openness theory is very closely related to the one which claims that more openness will lead to increased economic stability. The conventional wisdom expounded by economists is that having a more flexible exchange rate regime would allow the Chinese central bank to conduct independent monetary policy like employing counter-cyclical actions (i.e. adjustment of the domestic interest rate) to serve as an instrument for addressing future bad shocks to the economy thus increasing stability. While its nominal exchange rate is pegged to the US dollar, China is effectively employing the monetary policies of the Federal Reserve Bank targeted at US problems and not Chinese problems.¹³

Shang-Jin Wei makes two counter arguments one questions how much additional macroeconomic stability China would actually achieve from a more flexible exchange rate. He explains that China’s current monetary policy still has room to maneuver as evidenced by its ability to keep its nominal peg during the South East Asian crisis of the 1990’s and by the strength of its fiscal stimulus during the financial crisis of 2007. Most informed economists would agree that the US dollar, renminbi peg constrains the extent to which China can employ monetary policy but this peg also has significant tangible benefits.

¹³ Rogoff, Kenneth Lecture 11.04.2013
McKinnon & Schnoble (2003) discuss why countries which have achieved stability with a pegged currency have a ‘fear of floating’. As seen with the monetary union of the south Asian countries before the 1996 crisis. These countries were afraid to give up their peg to the dollar because they were worried that an independent monetary policy would not be able to maintain price stability. In China’s case, “a less stable domestic price is a risk which cannot be ruled out” if there is move to greater currency flexibility.\textsuperscript{14} During most of the period between 1986 and 1996, inflation in China was well above 7%.\textsuperscript{15} It is not clear whether China’s central bank would be able to resist the political pressures to deviate from policies which maintain price stabilities if it has a more flexible currency and independent monetary policies.\textsuperscript{16}

\textsuperscript{14} Wei, Shang-Jin. “Don’t Over-sell the Benefits of a Change in China’s Exchange Rate Policy” VoxEU.org, Oct. 29, 2007
\textsuperscript{15} Fig. 3, Ibid.
\textsuperscript{16} Rogoff, Kenneth Lecture 11.04.2013
References:


