

China's exchange rate policy: the case against abandoning the dollar peg **

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Abstract

This paper critically comments on the policy literature surrounding China's exchange rate regime. It first seeks to expose as myths several popularly raised contentions regarding the dollar peg employed by China, including the belief that the RMB is clearly undervalued and that its value is a prominent cause of the U.S trade deficit. The paper then describes a consensus position that has emerged which argues that in the interests of better promoting its own macroeconomic stability, China should abandon the peg in favor of a more flexible exchange rate regime. We see numerous weaknesses in this position but a few stand out. Available data do not suggest that flexible regimes outperform fixed regimes in terms of inflationary outcomes. Moving to a flexible regime is also far from proximate policy response to the problems that are in evidence in China's economy. Institutional realities that make moving to a flexible regime difficult also appear to have been seriously overlooked. The paper concludes by noting that in the longer term moving to a more flexible regime may be in China's best interests. But for now, the focus needs to be firmly in the area of domestic financial reform.

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1. INTRODUCTION

One might imagine that an exchange rate left unchanged for 11 years would not generate much interest. Yet toward the end of 2004 *The Economist* magazine (01/10/2004) observed that issues surrounding China's pegged exchange rate regime had become amongst the hottest topics in international finance. Since late 2000, much of the interest has been prompted by speculation that China would revalue its currency. The chief impetus for this speculation has been an accusation emanating from U.S government circles that the dollar peg is a prominent cause of the U.S trade deficit with China. The contention is that China's currency, the Renminbi (RMB), is pegged at an undervalued rate and is a source of unfair advantage for Chinese exporters. Amongst members of U.S Congress such complaints have reached fever-pitched proportions. There is currently a bill set for debate before July 2005 that proposes a 27.5 percent tariff be imposed on all Chinese imports unless the dollar peg is adjusted within six months. In a report to Congress in May 2005, Secretary of the U.S Treasury John Snow described China's exchange rate policies as being "highly distortionary" and if left unaltered, would lead to China being labeled an exchange manipulator under the Omnibus Trade and Competitiveness Act of 1988. Secretary Snow stated in the report that the U.S government was calling on China to switch to a more flexible exchange rate regime. European Union (EU) officials and the G-7 group have echoed this call as the Euro in particular is seen as having been forced to bear the brunt of the dollar's depreciation in recent years appreciating from €1.132:\$US1 in January 2002 to €0.748:\$US1 at the end of 2004. Between 2002 and 2004 the EU's trade deficit with China more than doubled (compared with the U.S trade deficit with China which increased by a little over one half) (*WSJ*, 17/05/2005). In the first half of 2005 trade disputes in textiles became particularly prominent, with both the U.S and E.U erecting punitive measures in May to slow a surge in Chinese imports that resulted from the phasing out of global textiles quotas at the end of 2004. Calls for greater exchange rate flexibility have also come from outside of government circles by senior economists in the IMF (Rajan and Subramanian, 2004; Prasad, et al., 2005) and the Asian Development Bank (ADB) (*IHT*, 28/05/2005) and other prominent international economists based in central banks, research institutes and

academia such as Roberts and Tyers (2003), Bergsten (2003), Eichengreen (2004), Goldstein and Lardy (2004), Bernanke (2005), Roubini and Setser (2005) and Frankel (2005).

Policy-makers in China have referred to a more flexible exchange rate regime as being a longer-term goal and not one that is on the immediate policy agenda. The only concession to date has been a 2 percent revaluation in July 2005 and linking the value of the RMB to a basket of currencies rather than solely the U.S dollar. As outside pressure has increased for greater flexibility, so to has the rhetoric coming from China. Wu Xiaoling, Vice-Governor of the People's Bank of China (PBC), has stated that, "If the United States had not created this environment, the reforms would probably have happened more quickly than people predicted" and that U.S pressure to appreciate the RMB is, "...detrimental to the launch of the reform on the RMB exchange rate" (*People's Daily*, 11/05/2005; 12/05/2005). Chinese Premier, Wen Jiabao followed these comments by stating that, "If conditions are not available, the Chinese government will never hastily take any action, regardless of how great the pressure from outside is" (*People's Daily*, 13/05/2005). "Face" has clearly now become a factor in China's exchange rate policy decisions and the official media has been saturated with commentary seeking to justify a stable peg.

This paper critically comments the policy literature surrounding China's exchange rate regime. Section two argues that the usual justifications given for claims that the RMB is undervalued and a significant cause of the U.S trade deficit are more myths than reasoned positions. In section three we offer our critique of the consensus position that has emerged which argues that China's macroeconomic stability would now be best served by abandoning the peg and adopting a more flexible exchange rate regime. Abandoning the peg would be a major policy switch and is one that is deserving of more thorough debate than presently exists in the literature. Section four summarizes the discussion.

2. COMMON MYTHS SURROUNDING CHINA'S EXCHANGE RATE REGIME

There are four common contentions, which are poorly grounded in rigorous evidence, that often surface in relation to China's exchange rate regime. These include –

1. *China's large and growing trade surplus with the U.S proves that the RMB is undervalued and that China is unfairly benefiting from trade.*

Economic theory does not suggest that any country will or should have balanced trade with each of its trading partners. This will be dynamically determined by many factors, principally comparative advantage considerations. Aside from U.S companies taking advantage of China's cheap labor through foreign direct investment (FDI), as the comparative advantage of other U.S trading partners such as Japan, South Korea, Hong Kong and Taiwan has changed, so to have these countries relocated much of their labor-intensive manufacturing base to China. This is reflected in the rising share of foreign invested enterprises (FIEs) in China's total exports. In 1990, FIEs accounted for less than 15 percent of China's exports. By 2004, their share had risen to 57 percent. Overall, China's trade surplus with the U.S is largely offset by deficits with other countries, most notably its neighbours in the region such as Japan and South Korea. In 2004, China's overall trade surplus was only \$US32 billion, a modest 2 percent of GDP. This value is less than that routinely recorded by leading OECD trading nations (Germany's trade surplus in 2003 was 6.3 percent of GDP). McKinnon (2004, p.330) makes the self-evident but important point that as long as the U.S household savings rate remains unusually low and the U.S government runs a large budget deficit (3.5 percent of GDP in 2004), "...the relatively high-savings East Asian countries are virtually forced to run export surpluses in order to lend their "surplus" savings to the United States - whatever the exchange rate regime". It also goes without saying that were it not for previous trade in textiles being so distorted by quota arrangements, the U.S and the E.U would not be experiencing the present surge in imports of these goods.

A revaluation of the RMB would do little to reduce the U.S trade deficit, which in 2004 was in the order of \$US 600 billion, or 5.5 percent of GDP. China currently accounts for only around 10 percent of U.S total trade (and only 3 percent of E.U total trade). As a result, a revaluation of more drastic proportions than even the most ardent China critics are calling for - say to the tune of 50 percent - would only reduce the dollar's effective (i.e., trade weighted) value by 5 percent. Yet between March 2002 and March 2005, the dollar's real effective value fell by 27.6 percent, a time period during which the U.S trade deficit only widened.

It is sometimes said that China adopting a more flexible exchange rate would have a broader impact because it would solve a coordination problem faced by other East Asian countries. This line of thinking argues that other East Asian countries are resistant to allowing their currencies to become more flexible (and presumably appreciate) without China doing likewise for fear that their exporters would be undercut. There are numerous problems with this argument however. For one, the numbers remain small. U.S trade with China plus Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand still only amounts to 21 percent of U.S total trade. Thus, a general appreciation of East Asian currencies to the tune of 25 percent would only reduce the dollars effective value by around 5 percent. Secondly, China's export structure means that it does not heavily compete in third-country markets with many of the East Asian countries that peg to the dollar anyway. It should not be forgotten that it has been the Asian tigers (Hong Kong, Taiwan, Korea and Singapore) that have been so heavily investing in China and using it as a base for exporting back home and abroad. Thus, this argument only holds any real weight in the context of ASEAN countries such as Malaysia and Thailand (Weiss and Gao, 2003). Thirdly, this logic assumes that a coordination failure has been behind the reluctance of East Asian countries to adopt more flexible exchange rate regimes in the past. But the penchant of East Asian countries for maintaining stable exchange rates is more readily explained by the fact that their mutual development has been well-served by them (this point will be returned to later). Japan is the exception in having a more flexible exchange rate and the performance of its economy since abandoning its former peg has hardly been confidence inspiring for its neighbors.

U.S politicians would further do well to grasp that the dollar value of overall trade flows are a poor guide to the size and distribution of benefits. U.S consumers clearly benefit from cheap Chinese imports and Andy Xie from Morgan Stanley has also estimated that for each dollar of China trade the United States value-added is six to eight times China's. Thus, while in 2004 the dollar value of U.S exports to China may only have been 17.7 percent the dollar value of imports from China, the profits accruing to U.S firms are likely to have been in excess of those accruing to their Chinese counterparts. It is for this reason that U.S industry bodies are presently much quieter than in the Japan-bashing episodes of the early 1980s. Similarly, because many of "China's exporters" are in fact foreign-invested companies, an appreciation of the RMB is not something they are keen on seeing.

It is also worthwhile elaborating upon the unusual way in which the statistics collated by the U.S Department of Commerce deal with Hong Kong's entrepôt trade. The U.S-China Business Council notes that these statistics count the full value of Chinese re-exports from Hong Kong as being Chinese exports, despite the fact that services (simple processing, packaging, marketing, etc) provided in Hong Kong add roughly 25 percent to the value of the goods originally exported from China. Meanwhile, all U.S goods exported to Hong Kong are counted as exports to Hong Kong, even those that are re-exported to China. According to Nicholas Lardy from the Institute of International Economics, after accounting for Hong Kong's entrepôt trade, the actual U.S trade deficit with China in 2003 was 11.5 percent less than that recorded by the Department of Commerce.

2. The decline in China's real effective exchange rate since late 2001 means the RMB must now be undervalued.

China's real effective exchange rate fell by 14 percent between July 2001 and January 2005. A longer-term perspective however shows that this alone does not necessarily

imply the RMB is undervalued. The value of the RMB in January 2005 was the same as in early 1996. Moreover, this level was only about 8 percent less than at the height of the Asian financial crisis in the second half of 1997. It seems to have been quickly forgotten that at this time speculators were betting on an RMB devaluation as the prevailing wisdom was that the Chinese currency had been rendered decidedly *overvalued*. It would seem that economists simply do not have the means of computing equilibrium exchange rates with a level of confidence that makes their estimates of much use to policy makers. Estimates of the extent of RMB "undervaluation" seen by the authors have ranged from between 0 to 50 percent.

3. Productivity improvements associated with China's economic transformation mean that the RMB must now be undervalued.

Ceteris paribus, if over the past decade productivity had grown more rapidly in China than in the U.S, then there would be a case for RMB appreciation. The problem though is that it is not at all clear that this is what has happened. It is true that in the late 1970s and 1980s China was able to elicit rapid productivity improvements by liberalizing its agricultural and non-state sectors. A study by IMF economists (Hu and Khan, 1998) estimated that the average annual rate of productivity growth in China over the period 1979-1994 was 3.9 percent. This compared with around 2 percent in other Asian tigers (during 1966-1991) and 0.4 percent in the U.S (during 1960-1989). However, Sachs and Woo (1997) warned some time ago that such simple sources of productivity growth associated with China's transitional economy were likely to soon be exhausted and continued gains would be dependent upon reforming the more challenging state-owned sector. Reforming the state sector has been the policy focus since the mid-1990s and while progress has been made, the pace has been more gradual. Anecdotally, the fact that higher economic growth rates over the past decade have required ever-larger shares of GDP be devoted to investment is hardly evocative of an economy experiencing rapid productivity improvements. Table 1 shows that the incremental capital output ratio in China has remained roughly constant since 1996. U.S productivity meanwhile picked up during the 1990s. China's experience during the 1980s also shows how the impact of

relative productivity movements on the exchange rate can easily be swamped by other factors. By the time a unified exchange rate was adopted in 1994 and the official rate was allowed to converge to the rate in currency swap markets at the time (i.e., the market rate), the RMB had *depreciated* from RMB1.5:\$US1 at the start of the reform period to the current RMB8.28:\$US1, in spite of any relative productivity *improvements*.

4. The surge in China's foreign exchange reserves proves the RMB is being held at below equilibrium levels to boost exports.

This argument fails to distinguish between the contribution of economic fundamentals to foreign exchange accumulation, such as the trade surplus, and speculative capital inflows betting on an RMB revaluation. Over the period 2001-2004, the current account surplus accounted for just 34 percent of total reserve accumulation while the dominant source was capital inflows other than FDI (Table 2). A recent study published by economists from the IMF (Prasad and Wei, 2005) reported that nearly 75 percent of the change in capital flows has come from categories of flows sensitive to market expectations on the future trend of the RMB/\$US exchange rate, rather than the underlying fundamentals. Needless to say, speculative sentiments can quickly change.

3. THE CASE AGAINST ABANDONING THE DOLLAR PEG

Thankfully much (although certainly not all) of the commentary on China's exchange rate regime that comes from sources outside the U.S Treasury does not take a strong stand on whether the RMB is undervalued or not. Nor does it consider the value of the RMB a factor that influences the U.S current account deficit in any significant way. Nonetheless, there is a broader point upon which a consensus is reached – that China ought to abandon its peg and adopt a more flexible exchange rate regime. The recommended form this flexibility should take varies by source, ranging from proposals for a simple revaluation through to a full float. The U.S Treasury predicates this policy standpoint upon the need to reduce "global financial imbalances". Most, however, prefer

to argue from the standpoint of the benefits that would accrue to China itself. While a variety of minor justifications are presented, the commonality that all contributors share is the belief that maintaining a dollar peg forces China to adopt a monetary policy unsuited to its current circumstances and one that threatens macroeconomic stability. It is said that domestic growth drivers (e.g., private consumption spending) have now developed to the extent that China requires greater monetary independence. But instead, owing largely to inflows of non-FDI capital since 2001, the PBC has had to buy large volumes of \$US assets, principally U.S Treasury bonds, in order to maintain the peg. Consequently China's reserve assets have swollen from \$US169 billion at year-end 2000 to \$US619 billion at year-end 2004 (Table 2) and the RMB money supply has experienced rapid rates of increase (Table 1). To ameliorate the impact on the money supply, the PBC could have sterilized the purchases of \$US assets by issuing an equivalent value of local currency denominated bonds. China's underdeveloped domestic bond markets and regulated interest rates however limit the extent to which such bonds can be absorbed in practice¹. The evidence suggests that roughly half of the increase in foreign reserves has filtered through to the domestic money supply. By continuing to support the dollar peg, the main fear is that the resultant monetary expansion has been fueling inflationary pressures and excessive fixed asset investment, particularly in speculative areas such as real estate. Inflationary concerns were particularly high during 2004 when the consumer price index (CPI) rose from -0.8 percent at the end of 2002 to 5.3 percent by July 2004. The producer price index climbed even further topping 8 percent. Fears of a property bubble are also widely expressed in the official media and National Bureau of Statistics data shows average house prices increased by 14.4 percent in 2004 (considerably more in places like Shanghai), up from 3.8 percent in 2003. In light of these risks, the consensus position argues that China would be better served by a flexible exchange rate regime that frees monetary authorities up to tackle inflationary pressures by effecting interest rate adjustments in financial markets, as is done in most OECD countries.

¹ Against the under-developed nature of China's capital markets however is the fact that sterilization bonds issued by the PBC remain attractive to the large state banks. As Stephen Green from Standard Chartered Bank has observed, China's regulators have given the state banks until January 2007 to meet the 8 percent capital adequacy ratio. Purchases of PBC sterilization bonds carry no capital requirement in contrast to loans to companies, which require a capital equivalent of 100 percent of the value of the loan.

Table 1. Selected economic data

	1996	1997	1998	1999	2000	2001	2002	2003	2004
1. Real GDP growth (%)	9.6	8.8	7.8	7.1	8.0	7.5	8.3	9.3	9.5
Gross capital formation 2. (% GDP)	39.3	38.0	37.4	37.1	36.4	38.0	39.2	42.3	
3. Incremental capital- output ratio (ie. 1 / 2)	0.24	0.23	0.21	0.19	0.22	0.20	0.21	0.22	
4. Money supply growth (%)	25.3	20.7	14.9	14.7	12.3	15.0	19.4	19.7	14.8
5. Domestic credit growth (%)	24.6	19.8	20.0	12.1	11.0	13.6	29.3	19.6	9.2
6. Fixed investment growth (%)	14.8	8.8	13.9	5.1	10.3	13.0	16.9	27.7	25.8

Source – National Bureau of Statistics and the People's Bank of China.

Table 2. China's foreign exchange reserves - sources of accumulation

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total reserves, inc. gold (\$US billion)	108	143	150	158	169	219	295	457 ¹	619
Total reserve accumulation, inc. gold (RES AC) (\$US billion)	32	36	6	9	11	50	77	162	207
Current account balance (CAS) (\$US billion)	7	37	31	21	21	17	35	46	70
Net FDI (\$US billion)	38	42	41	37	37	37	47	47	61 ²
Net non-FDI ³ (\$US billion)	-13	-43	-66	-49	-47	-4	-5	69	77
GDP (\$US billion)	821	903	954	999	1079	1176	1271	1412	1593
CAS (% GDP)	0.8	4.1	3.2	2.1	1.9	1.4	2.8	3.2	3.0
RES AC (% GDP)	3.9	4.0	0.6	0.9	1.0	4.3	6.1	11.5	3.9

Source – International Monetary Fund

Notes –

1. In 2003 the Chinese government used \$US45 billion from its foreign reserves to recapitalize two state banks. As a result, the 2003 figure for total reserves is the official value plus \$US 45 billion. The 2004 figure is simply the official estimate. This has been done in keeping with Roubini and Setser (2005).

2. The FDI figure for 2004 it is *not* a net figure. It is simply inward FDI. The source is the National Bureau of Statistics. In previous years, outward FDI recorded in the national accounts has been very small.

3. Net non-FDI is calculated as the residual of the change in total reserve accumulation minus net FDI minus the current account balance.

While we concur with the consensus position that macroeconomic stability needs to be accorded the utmost importance given that it has underpinned China's economic success during the reform period, we have numerous reservations regarding whether a flexible exchange rate regime would better achieve this outcome. We also point out that what we are discussing here is relatively large-scale regime change not simply tinkering around the edges. It is hard to see how China would be better off simply by effecting a small revaluation or introducing a slightly wider band within which the RMB could fluctuate. Indeed, these sorts of policies carry the distinct risk of serving to heighten speculative capital flows and reducing policy credibility. Thus, in our estimation, the choice China is currently facing is between maintaining the peg or adopting *substantial* exchange rate flexibility.

Our first concern with abandoning the peg is that data simply do not suggest that flexible exchange rate regimes outperform fixed regimes in terms of macroeconomic stability. In fact, the data speak convincingly to the opposite effect. Deciding what type of exchange rate regime best promoted macroeconomic stability was a particularly topic issue during the 1990s. In an extensive study undertaken by IMF economists, Ghosh, et al. (1996), it was concluded -

“Does the exchange rate regime matter for macroeconomic performance? The experience of IMF member countries since the 1960s suggests that it does. The strongest results concern inflation. Pegged exchange rates are associated with significantly better inflation performance (lower inflation and less variability), and there is at least some evidence of a causal relationship. There is, however, an important caveat. Countries that have frequent parity changes – while notionally maintaining a peg – are unlikely to reap the full anti-inflationary benefits of a fixed exchange rate regime” (p.12)

Thus, not only does the data point to a better inflationary outcome under a fixed regime it also appears to lend support to China's reluctance to undertake frequent revaluations/devaluations at the behest of fluctuations in sentiment regarding the equilibrium value of the RMB.

Xu (2000) showed that a striking long run correlation exists between movements in the domestic price level and the real exchange rate dating back to the start of the reform period. Xu interprets this relationship to be a bi-causal one. Before the adoption of a unified exchange rate in 1994, changes in the official exchange rate followed domestic price level fluctuations (i.e., inflationary episodes forced devaluations). Since 1994 when the official rate was allowed to depreciate to the prevailing market rate and by which time China's global trade linkages had strengthened, stability in the exchange rate has helped to secure the domestic price level. Indeed, for all the talk of inflationary pressure in the consensus literature, it is odd that few have sought to seriously explain why actual inflation remains low. For Mundell and McKinnon, the answer is plain enough – the peg is doing its job in serving as a price anchor and is doing it very well. The price anchor role of the dollar peg is sometimes dismissed on the basis that bilateral trade with the U.S represents only a fraction of China's total trade. But this misses the point made repeatedly by the likes of McKinnon that the overwhelming majority of trade within East Asia is invoiced in \$US and that other countries in the region (with the notable exception of Japan) also either hard or soft peg to the dollar.

Much of the recent shift in orthodoxy towards more flexible exchange rate regimes appears to have been motivated by the events of the Asian financial crisis as many of the affected economies operated either hard or soft dollar pegs. Yet this misses the bigger picture. The economies that experienced a relatively short period of crisis had earlier experienced long periods of macroeconomic stability and rapid economic growth *and* they returned to soft dollar pegging and strong growth once the crisis had passed (McKinnon and Schnabl, 2004). If China was looking for policy inspiration from its neighbors, the Japanese experience would be the one that stands out. After experiencing miraculous growth under a pegged exchange rate regime for three decades, political pressure from the U.S forced it to adopt a more flexible exchange rate in the early 1980s. A more flexible Yen however did nothing to promote macroeconomic stability or steel the Japanese economy against speculative activities and it continues to languish from the bursting of the bubble economy in the late 1980s. It would be a serious misreading of the

evidence to claim that the experience of East Asia shows that economic development is best served by flexible exchange rate regimes.

The case for flexible exchange rate regimes also appears to have been given a boost by the contention that the sheer volume of highly mobile capital in today's global economy means that fixed regimes are no longer viable. Sometimes this view is couched in the following terms - if speculators feel a currency is undervalued or overvalued, rightly or wrongly, it would be futile for a central bank to try and defend the currency. For Mundell (2003), this misses the point. Credibility is the key issue. Mundell points out that we do not see any speculative capital movements within countries as the exchange rate domestically is entirely credible. If a peg is credible, speculation will in fact be discouraged. Juxtaposed against countries such as Thailand during the Asian financial crisis, China's has a huge stockpile of foreign exchange reserves and is running modest current account surpluses. China has also demonstrated a willingness to resist currency speculation in the past. During the Asian crisis the speculative bet was on an RMB devaluation. The peg however remained credible, capital flight slowed, monetary stability in East Asia was promoted and China's economy continued to grow strongly, albeit a little off the boil. In the current environment of growing foreign exchange stockpiles and current account surpluses, credibility will only be lost if it becomes clear that maintaining the peg is costing the economy excessively in terms of macroeconomic stability. Despite inflationary fears surfacing in 2004 the annual rate of growth in the consumer price index has fallen from 3.9 percent at the end of 2004 to 1.8 percent in April 2005. Average real estate price growth is also heading in the right direction, falling from 14.4 percent at the end of 2004 to 12.5 percent in the first quarter of 2005. A policy package aimed at reducing property market speculation implemented in May 2005 is expected to further slow price growth in the future (*China Daily*, 13/05/2005). Secondly, while not committing to a flexible exchange rate regime, the Chinese government has taken steps to reduce the pressure on the growing foreign exchange reserve stockpile. For example, Chinese companies have been encouraged to invest abroad through the relaxing of rules that had previously restricted their ability to acquire foreign exchange. In 2005 Chinese companies will be permitted to invest a combined \$US5 billion abroad, up from \$US3.3

billion the year before (*IHT*, 24/05/2005). Rules allowing individuals to buy foreign exchange have also been loosened. While these numbers are quite small relative to the size of the increase in China's foreign currency reserves, such policy actions nonetheless play an important signaling role to speculators. Thirdly, the threat of blanket U.S trade sanctions against China is not credible as it is not an approach with broad support amongst U.S industry bodies, and in any case would be in violation of WTO rules.

A second weakness we see in the consensus literature is that it appears to eschew identifying proximate problems and policy responses. In focusing on inflows of foreign capital and increases in foreign exchange reserves, it misdiagnoses the causes of inflationary pressure and speculative investment in recent years. HSBC (2005) points out that total foreign capital inflows (FDI and short-term capital) in 2004 were only equal to around 20 percent of the total value of fixed asset investment. If dampening inflationary pressure and slowing the rate of fixed asset investment is the goal, domestic credit is the most obvious place to start. And even if one does conclude that foreign capital inflows are a significant part of the problem, then an appropriate response would center on reducing the volume of hot money entering the country and bolstering the prudential regulation of the banking sector. The key lesson to emerge from the Japanese experience is the importance of having a strong banking sector, not having a particular type of exchange rate regime. When looking into cross-country performance under fixed and flexible exchange rate regimes, IMF economists Caramazza and Aziz (1998) concluded that –

“The analysis suggests that exchange rate regimes cannot be unambiguously rated in terms of economic performance. But it seems clear that, whatever the exchange rate regime a country chooses, long term success depends upon a commitment to sound economic fundamentals – and a strong banking sector.”

Our third major critique of the consensus view is that it appears not to exhibit a consistent take on current Chinese institutional realities. On the one hand, it does note that China's domestic financial markets limit the extent to which effective sterilization activities can be performed by the PBC. Yet on the other hand, it calls upon the PBC to use these same

financial markets to target inflation through open market operations. Monetary authorities in OECD countries target inflation by effecting interest rate adjustments in diverse and liquid financial markets with market determined interest rates. Such institutional conditions are a far cry from the segmented, heavily regulated and shallow bonds markets in China that authors such as Bottelier (2003) describe. Furthermore, the most prominent group of borrowers in China's banking system, the state-owned enterprises, are not particularly sensitive to interest rate changes as long as their budget constraint remains soft (Laurenceson and Chai, 2003). The success of inflation-targeting in OECD economies over the past couple of decades is of limited relevance for China. The reality is that the monetary transmission channel used by OECD countries is much weaker and less predictable in China. It is for this very reason that historically when the PBC has sought to rein in inflation, it has done so primarily through administrative measures such as formal and informal limits on domestic credit growth (often by economic sector) and by adjusting the required reserve ratio for financial institutions. This continued to be the case through 2004 when rising inflation was met with such a policy package. Later in 2004 when the PBC also marginally raised interest rates (by 0.27 percent) the volume of subsequent commentary in financial publications was out of all proportion to the size of the increase simply because it was the first time the PBC had done so in nearly a decade. One should not discount the effectiveness of administrative controls in the Chinese context where the state-owned banks remain dominant. When combined with partial sterilization, the administrative measures put in place last year caused the growth rate in domestic credit to fall from 19.6 percent in 2003 to 9.2 percent in 2004 (Table 1). World Bank (2005) observes that at end-March 2005, the growth rate in the money supply (M2) had slowed to 14.6 percent (down from 19.6 percent in 2003) and was once again within the target range of the monetary authorities. The rate of growth in fixed asset investment remains high (25.7 percent through April 2005) but HSBC (2005) points out that there is usually a lag of more than 12 months before tighter domestic credit filters through to construction investment.

Another institutional reality that makes moving to a more flexible exchange rate regime difficult is an absence of financial markets that perform hedging operations. While

bankers and traders in OECD economies have ready access to instruments such as exchange rate futures, in developing countries these agents rely on a stable exchange rate. A potential problem with using a pegged exchange rate as a hedge, and one that received much airplay in the aftermath of the Asian financial crisis, is the fear that it might worsen moral hazard amongst domestic banks and encourage them to over-borrow in foreign currency. However, again, the key issue is banking sector regulation, not exchange rate policy. McKinnon and Schnabl (2004, p.341) also point out that -

"Against this however is the view that the risk premium in domestic interest rates is a direct function of how stable the domestic currency is relative to the center currency (i.e., the dollar). Thus, if the domestic exchange rate against the dollar varies erratically in a free float, domestic interest rates will be higher and so will the margin of temptation to overborrow in foreign exchange. In summary, one cannot say *a priori* whether or not soft pegging aggravates the moral hazard in badly regulated banks to overborrow".

A final concern we have regarding a more flexible RMB has to do with the implications increased volatility would have on the relationship between the mainland and Hong Kong - the showcase of the one country, two systems approach and an autonomous region that also operates a hard peg to the dollar. Hong Kong is the classic textbook example of a small, open country that benefits from a stable exchange rate vis-à-vis its trading partners Hong Kong's trade is more than two and a half times the size of its GDP. According to Hong Kong trade statistics, in 2004 total trade (direct and entrepôt) with the mainland accounted for 43.7 percent of its total, followed by trade with the U.S at 11 percent. It is often asserted that because China's exports have a high imported component, an RMB appreciation would only marginally impact on export growth. Yet given the dependence of Hong Kong on trade with the mainland even a modest appreciation could have a significant impact on the much smaller, more trade dependent economy. Hong Kong has also been by far the largest "foreign" investor in the mainland with the Hong Kong Trade Development Council claiming that at the end of 2004, 47 percent of overseas registered projects on the mainland had Hong Kong connections. While the consensus literature tends to cite econometric studies which suggest that on average FDI and exchange rate fluctuations are only weakly related, authors such as Mundell (2003) and McKinnon and Schnabl (2003) prefer to point out case studies closer to home that may well be

considered more pertinent by China's policy makers. Japanese FDI into many other East Asian countries, for example, has tended to closely follow trend movements in the Yen/Dollar exchange rate.

4. CONCLUSION

This paper first sought to expose some of the common myths surrounding China's exchange rate policy. It is far from obvious that the RMB is undervalued and given the variation in equilibrium estimates offered by economists, the reluctance of Chinese policy makers to significantly revalue the RMB is understandable. And even if the RMB were undervalued, there is no convincing reason to think that an appreciation would have any meaningful impact on the U.S trade and current account position. The paper then sought to provide a critique of the increasingly popular view that China should abandon the peg and move toward a more flexible exchange rate regime. Our basic view is that many of the benefits currently accruing to China as a result of the peg are not sufficiently recognized (e.g., the price anchor role of the peg) and similarly the costs involved in moving to a more flexible regime (e.g., current institutional constraints). Perhaps the most prominent shortcoming of the consensus literature is that it fails to convincingly demonstrate how the problems in China's economy today (e.g., inflationary pressure, excessive fixed asset investment) will be best addressed by abandoning the peg and adopting a more flexible regime. Proximate policy responses would center on restraining the growth in domestic credit, reducing the volume of hot money entering the country and bolstering the prudential regulation of banks. All of these can be done, and indeed are being done to a greater or lesser extent, within the context of the pegged exchange rate regime that has served China well.

China's economic performance over the past decade suggests that it has not been hopelessly trying to reconcile the "irreconcilable trilemma" from macroeconomic theory, which states that a country cannot simultaneously pursue free capital mobility, a fixed exchange rate and an independent monetary policy. While its capital controls are certainly porous to a degree, when combined with partial sterilization and administrative controls over banks they have nonetheless been sufficient to allow China to maintain both

macroeconomic stability and a pegged exchange rate. China is also fortunate in the sense that its high savings rate, cheap labor force and attractive domestic market means that it does not face the same opportunity cost other developing countries might when retaining capital controls (Laurenceson, 2005). It is worthwhile briefly elaborating on this point. The usual argument underlying the position that even developing countries are best served by flexible exchange rates is that it will allow them to use an independent monetary policy to maintain macroeconomic stability while removing capital controls, with the assumption being that the benefits of access to foreign capital (e.g., funding for investment, technology and expertise, consumption smoothing, etc.) more than outweigh the costs of abandoning the fixed exchange rate. But with a savings to GDP ratio consistently around 40 percent, China already has ample savings to fund investment. The problem for the domestic financial sector has always been one of using existing savings more efficiently rather than the need to mobilize more. Also, it is incorrect to say that China has not liberalized capital controls. In fact, restrictions over FDI have been gradually liberalized to the extent that China now receives more FDI than any other country in the world. Consequently, the opportunity cost to China of maintaining exchange rate stability is foregoing access to more non-FDI capital (that in aggregate it does not really need anyway) and the chance for domestic savers to earn higher returns abroad. Given that macroeconomic stability, foreign trade and FDI have underpinned the rapid growth in living standards during the reform period, forgoing the opportunities of higher returns abroad is likely to be considered an acceptable sacrifice by the average Chinese saver.

There is one factor that may push the balance in favor of China adopting a more flexible exchange rate regime, even in the short to medium term. Some of the benefit China currently derives from the dollar peg flows from the fact that other countries in the region also peg to the dollar. Japan is the sole exception with any economic weight. For Mundell and McKinnon, the first best scenario would be for Japan to return to dollar pegging. Political considerations however make this virtually unthinkable. Thus, if the Yen does for whatever reason fluctuate markedly against the dollar and / or if political pressure on other East Asian countries forces their currencies to fluctuate, a new cost-benefit analysis

will need to be undertaken by China's policy makers regarding their optimal response. In the longer term, moving to a managed float may pass the cost-benefit test, irrespective of the exchange rate policies of its neighbors. Once China's own institutional environment has been bolstered, a managed float becomes more appealing. Still, based on what we know about the economy at this point in time and the lessons learned from other countries, the area most urgently in need of policy attention is domestic financial reform - strengthening prudential regulation, shoring up the capital base of the banks, resolving ownership ambiguities, instituting effective corporate governance structures and building more complete, unfettered, liquid and transparent direct financial markets.

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