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# CHINA'S EXCHANGE RATE POLICY: THE CASE AGAINST ABANDONING THE DOLLAR PEG

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

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**Abstract**

This paper critically evaluates the policy literature surrounding China's exchange rate regime. It first discusses several popularly raised contentions in relation to the dollar peg employed by China, which in fact are poorly grounded in evidence. These include notions 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 China should abandon the peg in favour of a flexible exchange rate regime. We see numerous weaknesses in this position but a few stand out. Moving to a flexible regime is far from the most proximate policy response to the problems that the consensus literature itself identifies 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 managed float may be in China's best interests - but for now the focus needs to be firmly in the area of domestic financial reform.

**Keywords: exchange rate, dollar peg, managed float, China.**
**JEL classifications – E58, F31**

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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 one of the hottest topics in international finance. Since late 2000, much of the interest has been prompted by speculation that China will revalue its currency. The 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 meanwhile have referred to a flexible exchange rate regime as being a long-term goal. As outside pressure has increased, 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 now become a factor in China's exchange rate policy decisions and the official media has been saturated with commentary seeking to justify the dollar peg.

This paper critically evaluates 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 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 summarises the discussion.

## 2. Common myths surrounding China's exchange rate regime

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

a. *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 labour 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 also changed, so to have these countries relocated much of the 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. Now their share stands at more than 50 percent (Eichengreen,

2004). 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 in leading OECD trading nations (Germany's trade surplus in 2003 was 6.3 percent of GDP). McKinnon (2004, p.330) makes the obvious 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 implemented at the behest of developed countries, 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, 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 neighbours.

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*. Unfortunately, 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 (based on a variety of methodologies, not all of which are equally meritorious) of the extent of RMB "undervaluation" seen by the authors have ranged from between 0 to 50 percent. Indeed the very notion of an equilibrium exchange rate is awkward given that even freely floating exchange rates are often said to be over or undervalued as they reflect speculative factors as well as economic fundamentals.

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 form this flexibility should take varies by source, ranging from recommendations 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" (i.e., reducing the U.S trade and current account deficits). Most however prefer to argue from the standpoint of the benefits that would accrue to China itself. While each author presents a variety of minor justifications, the heart of this position is that maintaining a dollar peg forces China to adopt a monetary policy unsuited to its current circumstances and one that threatens macroeconomic stability. Particularly since 2001, the PBC has had to buy large volumes of $US assets, principally U.S Treasury bonds, in order to maintain the pegged exchange

rate. As a result, China's total 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). Theoretically, 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 significantly limit the extent to which such bonds can be absorbed in practice. 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 is 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 in done in most OECD countries.

**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**

| Unit - $US billion | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|---|---|---|---|
| Current account surplus (CAS) | 7 | 37 | 31 | 21 | 21 | 17 | 35 | 46 | 70 |
| Net FDI ($US billion) | 38 | 42 | 41 | 37 | 37 | 37 | 47 | 47 | 61 [1] |
| Other capital inflows [2] | -13 | -43 | -66 | -49 | -47 | -4 | -5 | 69 | 77 |
| Total reserve accumulation, inc. gold (RES AC) | 32 | 36 | 6 | 9 | 11 | 50 | 77 | 162 | 207 |
| Total reserves, inc. gold | 108 | 143 | 150 | 158 | 169 | 219 | 295 | 457 [3] | 619 |
| GDP | 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. 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.
2. "Other capital flows" are calculated as the residual of the change in total reserve accumulation minus net FDI inflows minus the current account surplus
3. In 2003 the Chinese government used $US45 billion from its foreign reserves to recapitalise 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).

While we concur with the consensus position that macroeconomic stability in China needs to be accorded the utmost importance, we have numerous reservations regarding whether a flexible exchange rate regime would better achieve this outcome. Firstly, there is the general point to be made that based on existing data it simply cannot be inferred

that flexible exchange rate regimes outperform pegged regimes. While few countries these days hard peg to the dollar, soft pegging remains common. Soft pegging is to say that although officially classified by the IMF as having some form of flexible exchange rate regime, the central banks in these countries tightly control exchange rate fluctuations such that in essence they remain pegged. Not so long ago in an IMF Economic Issues paper that analyzed country experiences with fixed and flexible exchange rate regimes, 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 exchange rate regime a country chooses, long term success depends upon a commitment to sound economic fundamentals – and a strong banking sector”. Over the past decade China has been one of the most successful countries in "getting the fundamentals right". It has had stunningly low inflation for an economy that has been growing between 7 – 10 percent annually. Each year the World Economic Forum compiles a macroeconomic environment index, which combines several measures of macroeconomic performance, most notably stability considerations. In the 2003-2004 report, China finished 24$^{th}$ out of the 104 countries ranked and ahead of OECD countries such as France (25), Germany (26) and Japan (29). It is also now in the midst of radical banking sector reforms, which would have been inconceivable even five years ago. At the end of 2003, China used $US45 billion from its foreign exchange reserves to recapitalize two of the big four state banks in preparation for their public listing. A similar strategy has been mooted for the other two big state banks. Foreign investment in smaller domestic banks has been encouraged and as part of its World Trade Organization (WTO)

accession agreement China agreed to extend full national treatment to foreign banks by 2006.

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 same economies that experienced a relatively short period of crisis had earlier experienced long periods of macroeconomic stability and rapid economic growth *and* 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 neighbours, 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 contention is also often heard that while fixed exchange rate regimes may have once been feasible, the sheer volume of highly mobile capital in today's global economy means this is no longer the case. 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. During the Asian financial crisis, the speculative bet for a time 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. There is good reason to think that speculators may again be disappointed. Despite inflationary fears surfacing in 2004 the latest economic data points to a soft landing. 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 problem with the consensus position is that it appears not to fully appreciate (and very often entirely ignores) the role the dollar peg has played in pinning down the domestic price level. 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, we find it odd that few have asked the obvious question why current inflation is not higher than it is? For the few economists who have dissented from the consensus view such as 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.

A third problem we see with the consensus literature is that it appears to eschew proximate policies. In focusing on inflows of foreign capital and increases in foreign exchange reserves, it misdiagnoses the causes of recent inflationary pressure and speculative investment in China. HSBC (2005) points out that total foreign capital inflows (FDI and short-term capital) last year were only equal to around 20 percent of the total value of fixed asset investment. National Bureau of Statistics data show that of the fixed asset investment that was completed in 2004 funding from domestic credit was more than 2.5 times larger than funding from foreign sources. 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 proximate policies would centre on reducing the incentives for hot money to enter the country and bolstering the prudential regulation of the banking sector.

A fourth problem in our view is that the consensus literature does not exhibit a consistent take on current Chinese institutional realities. On the one hand, it does note that China's domestic financial markets currently do not permit effective sterilization activities 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 because their budget constraint is soft (Laurenceson and Chai, 2003). While traveling to Shanghai may give the visitor the impression that China has attained a level of development parity with richer countries, 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 adjustments in 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 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. As a result of the measures put in place last year the growth rate in domestic credit fell 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 had slowed to 14 percent (down from 19.6 percent in 2003) and was below the year-end target of 15 percent. 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. In response, McKinnon and Schnabl (2004, p.341) point out, "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". The key issue again is the effectiveness of banking sector regulation - not exchange rate policy.

Finally, the consensus position displays too little regard to the potential costs of a more flexible RMB 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 the 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 ¥/$US 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 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 to

a more flexible exchange rate regime. We argue that this position does not have nearly the basis in evidence ascribed to it by proponents. 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 demonstrate how the problems it sees in China's economy today (i.e., inflationary pressure, excessive fixed asset investment) will be best addressed by abandoning the peg and adopting a more flexible regime. More proximate policies would center around restraining the growth in domestic credit, reducing the incentives for hot money to enter the country and bolstering the prudential regulation of banks. All of these can be done, and indeed are being done, 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" of free capital mobility, a fixed exchange rate and an independent monetary policy. It is to this trilemma that the consensus literature appeals, either explicitly or implicitly. While its capital controls are certainly porous to a degree, when combined with partial sterilization and administrative controls over the money supply they have nonetheless been sufficient to allow China to maintain both macroeconomic stability and a pegged exchange rate. Moreover, there is no reason to think that China will want or need to further significantly relax capital controls in the foreseeable future. As long as the domestic financial sector remains fragile, even the consensus literature is quick to acknowledge that capital controls serve a useful role and that moving to a flexible exchange rate regime should not be confused

with capital account liberalization. China is also fortunate in the sense that its high savings rate, cheap labour 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). The usual argument underlying the position that even developing countries are best served by flexible exchange rates is that it will allow them to maintain macroeconomic stability (i.e., an independent monetary policy) while removing capital controls, with the assumption being that the benefits of access to foreign capital (funding for investment, technology and expertise, 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 not quite true 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. So the opportunity cost to China of maintaining exchange rate stability is foregoing access to more (potentially volatile) short-term capital (that it does not really need anyway) and, more importantly, 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 wildcard in this scenario that may push the balance in favour of China adopting a more flexible exchange rate regime, even in the short to medium term. As Mundell and McKinnon have noted, 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 neighbours. 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 financial markets.

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