

China's exchange rate debate **

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Abstract

This paper reviews and critically comments on the policy debate surrounding China's exchange rate regime. There are presently two key issues – firstly, whether the RMB has become significantly undervalued, and secondly, whether China would benefit from adopting a flexible exchange rate regime. We find little rigorous evidence in support of the first proposition. With respect to the second, the consensus view is that a flexible exchange rate is desirable as it would support macroeconomic stability by providing greater monetary independence. Most absent in this position is convincing evidence that exchange rate stability is associated with macroeconomic instability, either in the context of China or broader international experience. The consensus position also appears to understate many of the benefits that accrue to China as a result of having a stable exchange rate, as well as many of the costs associated with moving to greater flexibility. We conclude that while adopting a flexible exchange rate regime may pass the cost/benefit test sometime in the future, for now the focus ought to firmly be on domestic financial reform.

Key words – exchange rate, China

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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 fixed exchange rate, in which the Renminbi (RMB) had been pegged to the U.S dollar at a rate of RMB8.28:\$US1 since 1994, 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 the RMB is pegged at an undervalued rate and is a source of unfair advantage for Chinese exporters. 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 adopt 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 since 2002. Between 2002 and 2004, the EU 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.

Outside of government circles, calls for greater exchange rate flexibility also became the norm from economists in the international organizations such as the IMF (Rajan and Subramanian, 2004; Prasad, et al., 2005) and the Asian Development Bank (ADB) (*IHT*, 28/05/2005), as well as from those 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). While most of these authors concur with the U.S government position that the

RMB is, if anything, undervalued, this is not their primary focus. Rather, the commonality they share is the viewpoint that greater exchange rate flexibility would be in China's own best interests as it would support macroeconomic stability by providing greater monetary independence. This became a topical issue during 2003 and 2004 when inflows of hot money betting on an RMB appreciation correlated with rapid growth in the domestic money supply and in real estate prices in cities such as Shanghai.

In response to accusations of undervaluation, high-level officials in China initially retorted that greater pressure from abroad for more rapid reform would only slow the process down (e.g., *People's Daily*, 13/05/2005). July 2005 saw a concession of sorts with the RMB revalued by 2.1 percent to RMB8.11:\$US1 and the announcement that the currency's value would be linked to an undisclosed basket of currencies. Following this move, officials speaking in the government-run media began referring to the country's new "flexible" or "floating" exchange rate regime (e.g., *People's Daily*, 22/09/2005). In reality however, any newfound flexibility is limited. At the time of writing in September 2005, the most the RMB had been allowed to appreciate was RMB8.08:\$US1, or less than an additional 0.5% over the initial revaluation. Such changes amount to tinkering around the edges and nothing like the degree of flexibility being called for by the consensus position.

This paper reviews and critically comments on the policy debate surrounding China's exchange rate regime. There are two key issues – firstly, whether the RMB has become significantly undervalued, and secondly, whether China would benefit from adopting a flexible exchange rate regime. Section two finds that the usual justifications given for claims that the RMB is undervalued have a poor basis in evidence. In section three we offer a critique of the consensus position that China would now be best served by adopting a more flexible exchange rate regime. Our primary purpose here is to present the other side of the flexibility debate, which hitherto has been marginalized in the existing literature. Moving away from a stable exchange rate would be an abandonment of a policy that seemingly has served the country well for more than a decade and in our

estimation the case for doing so is far less convincing than the consensus position portrays. Section four summarizes the discussion.

2. THE VALUATION DEBATE

There are four common arguments presented in support of the view that the RMB is significantly undervalued. 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.*

The problem with this argument is that 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. Part of the increase in the U.S trade deficit with China simply reflects comparative advantage considerations being allowed to run their course after having been suppressed in the past by, for example, barriers to trade such as the Multifibre Agreement. China is also a relatively new member of the global economy and its exports are growing from a very small base. Another part of the rising U.S trade deficit with China is the result of foreign direct investment emerging as a means of recycling a country's comparative advantage. U.S firms, as well as those of U.S trading partners such as Japan and the Asian tigers (Hong Kong, Korea, Singapore, Taiwan), have all been active in relocating labour-intensive manufacturing production to China in a bid to remain competitive. Japan and the tigers have, in effect, transferred part of their trade surplus with respect to the U.S to China. Quite staggeringly, in 2004 foreign-invested enterprises in China accounted for 57 percent of the country's total exports, up from just 15 percent in 1990. As a result, it should come as no surprise that China's rapidly rising share of world merchandise exports is matched almost entirely by a decline in the share of Japan, and to a lesser extent, the tigers. According to WTO statistics, between 1993 and 2003 China's share rose from 2.8 percent to 5.8 percent while Japan's share and that

of the tigers fell from 9.6 percent to 6.3 percent and 10 percent to 9.5 percent respectively.

China's export performance over the past couple of decades is far less dramatic than that of Japan's in the post-WW2 period. Between 1983-2003, China's share of world exports grew by 3.5 percent. Yet between 1953 and 1973, Japan's share grew by 4.9 percent, in spite of having a weaker comparative advantage in labour-intensive manufactured goods and foreign investment contributing virtually nothing to its exports. China's overall trade surplus is also not particularly large at around 2 percent of GDP in 2004. This reflects the fact that while China may have a large trade surplus vis-à-vis the U.S, it has a deficit with respect to other countries. China's trade surplus is routinely less than that recorded by leading OECD trading nations such as Germany and Japan. In 2003, Germany, for example, had a trade surplus equal to 6.3 percent of GDP. Viewed in this broader perspective, the view that China is pursuing a merchantilist development strategy (e.g., Kelly, 2005) looks decidedly shaky.

Irrespective of the source of the U.S trade deficit with China, it is patently clear that a revaluation of the RMB would do little to reduce the U.S trade deficit overall, which in 2004 was in the order of \$US600 billion, or 5.5 percent of GDP. China 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. The answer to the problem of the trade deficit lies elsewhere, notably in raising private and public savings rates in the U.S. 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 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. World Trade Organization (WTO) statistics show that trade with China plus the six East Asian Traders (Hong Kong, Korea, Malaysia, Singapore, Taiwan and Thailand) still only amounts to a little over 20 percent of U.S total trade. Thus, a general appreciation of these country's currencies to the tune of 25 percent would only reduce the dollar's 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 more or less fix their currencies to the dollar anyway. 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. Since the 1980s Japan has been the exception in East Asia in terms of having a genuinely flexible exchange rate and the performance of its economy since this time has hardly been confidence inspiring for its neighbors.

Another relevant issue here is that the dollar value of overall trade flows is 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 U.S 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 should also not be forgotten that more than half of China's exports originate from foreign-invested companies, including those established with U.S capital. It is for these reasons that industry bodies in the U.S have not been particularly vocal in supporting the government's call for an RMB appreciation

and they have certainly been much quieter than in the Japan-bashing episodes of the early 1980s.

Finally, it is 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. At this time speculators were betting on an RMB devaluation as the prevailing wisdom was that the Chinese currency had been rendered decidedly overvalued. Debates over China's equilibrium exchange rate over the past decade have amply illustrated the limitations of estimates provided by economists. Estimates of undervaluation currently range between 0-50 percent. Estimates of overvaluation during the Asian financial crisis were similarly vague.

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 improvements in total factor productivity 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 improvements in total factor productivity. 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 RMB8.28:\$US1, in spite of any relative productivity improvements.

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.

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 the trade surplus to foreign exchange accumulation and the contribution of 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 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.

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.

3. THE FLEXIBILITY DEBATE

A consensus position has emerged which argues that China would benefit from greater exchange rate flexibility because the increase in monetary independence it entails would be more conducive to maintaining macroeconomic stability. Macroeconomic stability does need to be accorded the utmost importance given that it has underpinned all of China's other successes during the reform period. However, the first point to note in response is simply that international data 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. In a study of this issue, IMF economists, Ghosh, et al. (1996, p.12), 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”

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 adjustments at the behest of fluctuations in sentiment regarding the equilibrium value of the RMB.

Much of the recent shift in orthodoxy towards flexible exchange rate regimes appears to have been motivated by the events of the Asian financial crisis. 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 under a fixed exchange rate regime and returned to a stable exchange rate 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. A more flexible yen brought on largely by pressure from the U.S in the early 1980s 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 more than a decade ago. 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 a flexible regime also appears to have been given a popularity boost by increasingly mobile international capital flows. It is often said that given the sheer volume of international capital flows these days if speculators feel a currency is incorrectly valued it would be futile for a central bank to try and defend it. 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 healthy stockpile of foreign exchange reserves and is running current account surpluses. In the current environment, China's credibility will only be lost if it becomes clear that exchange rate stability is costing the economy excessively in terms of macroeconomic stability.

This leads to our second objection to the consensus position. Despite suggestions to the contrary, it is not at all clear that exchange rate stability has contributed to macroeconomic instability in China in a significant way. According to the consensus view, as hot money has flowed into China the People's Bank of China (PBC) has been forced to buy dollar assets to maintain the exchange rate stability and this has resulted in a rapidly expanding domestic money supply, excessive fixed asset investment and increases in inflationary pressure, particularly with respect to asset prices. But as HSBC (2005) has pointed out, total foreign capital inflows 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. This was precisely the approach taken by the Chinese authorities in 2004 with the growth rate in domestic credit falling from 19.6 percent in 2003 to 9.2 percent in 2004 (Table 1). Inflation which began rising in 2003 and 2004 began to fall in 2005. World Bank (2005) observes that at the end of the first quarter of 2005, the growth rate in the domestic money supply had slowed to within the target range set by the monetary authorities. Also acting to limit the inflationary pressures wrought by foreign capital inflows has been sterilization activities undertaken by the central bank. Stephen Green from Standard Chartered Bank has estimated that the PBC sterilized 47.5 percent of foreign exchange inflows during 2004 and around 70 percent in the first half of 2005. The costs of this sterilization have also been extremely low (see Green, 2005).

The fact that exchange rate stability can help to anchor the domestic price level appears to have been forgotten. 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 explain why actual inflation remains low. For Mundell and McKinnon, the answer is plain enough – the stable exchange rate is doing its job in serving as a price anchor and is doing it very well. The price anchor role of the exchange rate 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 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 more or less peg to the dollar.

Our third criticism of the consensus view is that it understates the importance of institutions in managing a flexible exchange rate regime. On the one hand, in highlighting the dangers posed by hot money inflows, the consensus literature frequently refers to the difficulties faced by the PBC in undertaking effective sterilization when domestic financial markets are underdeveloped. Yet at the same time it calls upon the PBC to use these financial markets to target inflation through open market operations as is done in most OECD economies. Central banks in OECD economies have at their disposal a powerful monetary transmission channel that results from having a complete set of financial markets where interest rates are market determined and where borrowers are sensitive to changes in the cost of borrowing. In contrast, China's financial markets are shallow, incomplete, highly regulated (see Bottlier, 2003) and the major borrowers, the state-owned enterprises, in many cases still do not face a hard budget constraint. Thus, the success of inflation targeting in OECD economies over the past couple of decades is of limited relevance to China today. To be sure, as Green (2005) has pointed out, progress in China's domestic financial markets is being made, but for good reason monetary policy in China continues to rely heavily on direct administrative controls such as formal (and informal) limits to credit growth rather than indirect measures such as interest rate adjustments.

In China there is also a distinct absence of financial markets that perform risk management roles such as hedging against exchange rate fluctuations. While bankers and traders in OECD economies have ready access to instruments such as exchange rate futures contracts that can protect them against undesirable exchange rate fluctuations, in developing countries such as China these agents rely on the de-facto hedge of a stable exchange rate. In the aftermath of the Asian financial crisis, using a stable exchange rate to provide a hedge was criticised on the basis that it might worsen the moral hazard in domestic banks and encourage them to over-borrow in foreign currency. McKinnon and Schnabl (2004) have pointed out however that the risk premium in domestic interest rates is dependent upon how stable the domestic currency is relative to the currency of borrowing, i.e., the \$US. As a result, if the cross rate varies erratically, domestic interest rates will be higher and so will the margin of temptation to over-borrow in foreign exchange. For this reason they conclude it is not possible to say *a priori* whether a stable exchange rate worsens the moral hazard in poorly regulated banks to over-borrow. In any case, the key issue is the effectiveness of banking sector prudential regulation not the exchange rate regime.

A final concern we have with a flexible exchange rate has to do with the implications increased volatility would have on Hong Kong - the showcase of the one country, two systems approach and an autonomous region that 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 would be of concern for 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

The exchange rate debate in China has emerged as one of the most talked about topics in international economics. In our reading of the existing literature, there are numerous myths purporting to be facts and the debate regarding the appropriate degree of exchange rate flexibility is more one-sided than is desirable. There is little solid evidence that China's currency is undervalued and even if it were, given the variation in equilibrium exchange rate estimates offered by economists, reluctance on the part of China's policy-makers to significantly revalue the RMB is unsurprising. Many of the benefits currently accruing to China as a result of a stable exchange rate also appear insufficiently recognized (e.g., an anchor for the domestic price level) and similarly many of the costs involved in moving to a flexible regime (e.g., institutional constraints). Perhaps the most prominent shortcoming of the consensus position is that it fails to convincingly demonstrate how exchange rate stability is at the root of problems in China's economy today (e.g., inflationary pressure). 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 monetary policy in which administrative tools remain effective, China has been able to maintain both macroeconomic stability and a stable 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). 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 integrating into global financial markets (e.g., investment funding, consumption smoothing, etc.) more than outweigh the costs of abandoning a stable 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. Restrictions over FDI have been gradually liberalized to the extent that in 2002 China received more FDI than any other country in the world. Consequently, the opportunity cost to China of maintaining the capital controls that support 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.

In the longer term, moving to a flexible exchange rate regime may pass the cost-benefit test. Once China's institutional environment has been bolstered, for example, a managed float will become more appealing. Yet 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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