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COMMENT

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Discussions about the Chinese exchange rate regime inevitably focus on China's large and growing current account surplus. The bilateral trade balance between China and the United States receives even more attention, raising the hackles of politicians in the United States who view China as gaining an unfair advantage through its currency policies. Indeed, many politicians in Washington, as well as some analysts, view China as a prime contributor to the growing global current account imbalances. This has led to calls for a sharp revaluation of the Chinese currency against the U.S. dollar.

Strong economic pressures have been exerted for an appreciation of the Chinese RMB, based in large part on relatively stronger productivity growth in China's tradable goods sector compared to those of its trading partners. And there are indications that the RMB is undervalued, with different analysts and academics producing a wide range of estimates of undervaluation.

In the face of all these pressures, can China continue to maintain a de facto pegged exchange rate that moves in a very tight range around the U.S. dollar? And what is the right remedy if the present regime is not sustainable?

The United States should first consider this issue from a domestic perspective, setting aside the matter of international pressures for the moment. Notwithstanding the sentiments of many observers, my view is that the issue of sustainability of the current regime, at least from a narrow domestic perspective, is a red herring. The current regime is likely to be sustainable for a long period. Indeed, if anything, the current constellation of Chinese domestic interest rates and industrial country interest rates makes sustainability even less of an issue than it was a couple of years ago. Here's why. One of the principal reasons that appreciation pressures on a currency become difficult to resist beyond a point is that the costs of sterilization become too large. The explicit costs of sterilization are related to the fact that the interest paid on sterilization instruments such as central bank bills or government securities is, in most developing countries, generally higher than the interest earned on reserves, which are typically held in industrial country government securities. As a result, the more capital that flows in and needs to be sterilized (in order to prevent this liquidity from flooding domestic markets and creating inflationary and other risks), the greater the costs to the central bank.

In China, however, the explicit costs of such sterilization have been held down simply by getting the state banks to purchase government (or central bank) bonds at low interest rates that are close to, or below, the rate of return earned by the central bank on its reserve holdings.[2] Indeed, as of April 2006, the rate of return on short-term U.S. Treasury instruments is almost two percentage points *above* the rate on Chinese central bank bills of corresponding maturity, meaning that the (PBOC) at the margin actually makes money on its sterilization operations!

Of course, even China cannot escape the basic laws of economics. In truth, the broader costs of sterilization may just not be obvious. Controls on capital outflows and domestic financial repression are required to help maintain at low levels the rate of interest paid on central bank bills. To maintain bank profits, the government must then mandate low-interest rates on deposits. The cost of these distortions is ultimately borne by depositors in the banking system—which includes most households, given the lack of alternative investment opportunities—in the form of very low real rates of return on their deposits (Prasad and Rajan 2005).

Thus, the perpetuation of the current regime is dependent on two sets of distortionary policies—financial repression and a relatively closed capital account. I see both of those as having very significant welfare costs for China. The lack of effective monetary control has meant that bank credit has continued to grow rapidly and by all accounts goes largely to state enterprises, with this lending not driven by commercial considerations. As a consequence, investment growth has remained unsustainably high, especially since much of this investment is being undertaken in a limited set of sectors where there are indications of a significant buildup of excess capacity (see Goldstein and Lardy 2004).

A greater concern related to a fixed exchange rate regime is that, over time, the capital controls could prove increasingly ineffectual as the incentives to evade them became stronger. Maintaining a fixed exchange rate system in the face of the inevitable erosion of capital controls could pose risks to the financial system, which remains weak in many respects (Eichengreen 2004; Prasad, Rumbaugh, and Wang 2005).

FLEXIBILITY

What alternative exchange rate policy would suit China best? Before answering that question, let me refer back to the calls for a revaluation of the RMB as the appropriate way to reduce China's current account surplus. My view is that a large revaluation by itself is unlikely to be a good idea. Ultimately, focusing on the current account surplus is probably not as useful as thinking through the deeper structural problems that may be contributing to this surplus. In fact, a revaluation as a quick fix to a large and growing current account surplus could, if done in isolation, be counterproductive by perpetuating some root problems.

The key point is that maintenance of a de facto fixed exchange rate regime can complicate domestic monetary management, as evidenced by the recent rapid accumulation of international reserves and its fallout in terms of faster domestic monetary expansion. Having more flexibility in the exchange rate would give China an autonomous monetary policy, a powerful tool to counter domestic and external shocks. Thus, it seems far more productive to frame the issue in terms of more exchange rate flexibility for

China rather than try to orchestrate a particular level of the exchange rate that would make all concerned parties satisfied.

Exchange rate flexibility could also be important for another major priority of Chinese policymakers—financial sector reform. The link is a subtle one. Since most Chinese saving is intermediated through the banking system, a more commercially oriented banking system would ensure a more efficient allocation of resources in the economy. And this, in turn, would require that banks respond to market-based measures to control economic activity. The instruments that are typically employed in such circumstances in market economies include the short-term interest rate. In the absence of exchange rate flexibility, however, the independence of monetary policy has been greatly constrained, even if capital controls have insulated the monetary system to some extent. This has resulted in the monetary authority having to use nonmarket measures such as moral suasion to control credit and investment growth, an outcome that may have worked in the short run but that has vitiated the process of banking reforms. The need to sterilize large waves of capital inflows has also put a heavy burden on the central bank.

Although exchange rate flexibility by itself is hardly going to be a panacea, attaining monetary policy independence through greater flexibility will eventually remove an important shackle that has hindered financial sector reforms and restrained other key aspects of the move towards a more market-oriented economy.

AN ALTERNATIVE NOMINAL ANCHOR

Having said that, the big question on the floor is: if not the fixed exchange rate regime, what could possibly serve as a reasonable nominal anchor for China? For a developing economy, indeed for any economy, having a firm and stable nominal anchor is essential not just in terms of price stability but in terms of overall macro stability.

Marvin Goodfriend and I have argued that in China a low-inflation objective would be a reasonable anchor for monetary policy (Goodfriend and Prasad 2006). We are particular not to use the term *inflation* targeting because that carries connotations of a very formalistic framework with very stringent requirements in terms of data, in terms of the monetary control mechanism, and so on. For an economy such as China that is undergoing marked transitions in a variety of dimensions, there would be numerous impediments to effectively operating a full-fledged inflation targeting regime.

Nevertheless, we think that a relatively more broad definition of inflation targeting, which could take the form of a long-run low-inflation objective, would be quite workable for China.[3]

Our approach is more practical for the foreseeable future, and it should deliver most of the benefits of formal inflation targeting. In light of the changing structure of the economy and weaknesses in the monetary transmission mechanism, our framework could accommodate a continued role for the monitoring and management of monetary (and credit) aggregates by the PBOC. But money would not constitute a good standalone nominal anchor since the changes in China's economic structure and financial markets imply that the rate of money growth consistent with a stable rate of inflation is likely to be difficult to measure and highly variable.

We view a low-inflation objective as being consistent with promoting sustained high employment growth, which is a key consideration for Chinese policymakers. Indeed, it is precisely by providing a firm and credible nominal anchor through a low-inflation objective that the PBOC can best contribute to overall macroeconomic stability and best provide for sustained employment growth and financial stability.

What is needed for such a nominal anchor to be put in place? We think that operational independence for the Central Bank is crucial. Not complete independence, but operational independence, and in fact, strategic guidance and support from the government for a low-inflation objective could be critical for the PBOC to be able to achieve its low-inflation objectives.

In terms of the mechanics, a prerequisite for the PBOC to run this sort of a regime well would include effective control of aggregate bank reserves. That makes exchange rate flexibility a primary requirement for this alternative nominal anchor because, if you are trying to use monetary policy to support an exchange rate objective, it makes it very difficult to have effective control of bank reserves.

Some of the infrastructure for effective control of reserves is already in place. The interbank market is functioning well, but other structural problems have to be dealt with, including the very large level of excess reserves in the banking system which the Chinese authorities are trying to deal with.

In addition, there is one critical aspect, which is the monetary transmission mechanism. In China, this will largely run through the banking sector since the rest of the financial sector remains rather underdeveloped.

Ultimately, then, these reform objectives are tied together. You need exchange rate flexibility in order to push forward financial sector reform. But the stability, the macroeconomic stability that could come from having a firm nominal anchor that does not require distortionary domestic policies to support it, would in fact be very important for financial sector reform.

Banking sector reform, however, is going to take a while. No one has any illusions that full modernization of the banking sector is going to be completed in the next couple of years. In order to put in place a low-inflation objective, however, Goodfriend and I argue that a relatively minimal set of financial sector reforms is all that is required. In particular, what is essential is the strengthening of bank balance sheets by removing legacy nonperforming loans (NPLs) from the banking system. This is necessary to make the banking system robust to interest rate fluctuations and would be very important in terms of giving the PBOC operational independence to be able to use the interest rate instrument very effectively.

A deeper issue is that of separating the financing of state-owned enterprises (SOEs) from the banking system because even if you clean all the existing NPLs off the books, the possibility that new lending could show up as fresh NPLs could be a problem. In our essay, we have a proposal for how we think new financing of SOEs (not financing of new SOEs!) could in fact be separated from the banking system.

TIMING

In principle, an orderly exit from a fixed exchange rate regime can best be accomplished during a period of relative tranquility in exchange markets. A next-best set of circumstances is when there are pressures for an appreciation amidst capital inflows since it is in general easier to deal with appreciation rather than sharp depreciation pressures. This is the situation that China is in today, with the added comfort of having a robust domestic economy, at least in terms of headline numbers showing high growth and low inflation.

Waiting longer to modify the exchange rate regime could present some risks, including the continued buildup of imbalances in the economy if monetary policy effectiveness remains restricted because of the fixed exchange rate regime (Goldstein and Lardy 2004). A more serious risk is related to the capital account. With a relatively closed capital account, the lack of exchange rate flexibility is less of a problem. On the other hand, an open capital account and a fixed exchange rate together make an economy highly vulnerable to external shocks, especially the vagaries of international capital flows. The problem for China is that, with expanding trade and the increasing sophistication of domestic and international investors, the capital account is becoming more porous over time.

It would therefore be prudent to consider an early move toward flexibility, while existing capital controls are still reasonably effective and the underlying structural problems are manageable. The current strength and stability of the economy, together with existing capital controls, have contributed to a reasonably high level of confidence in the domestic banking system despite its weak financial position. But domestic banks are likely to come under increasing competitive pressure, especially once foreign banks are allowed to enter the Chinese market in early 2007 under China's World Trade Organization accession commitments.

Another concern expressed by the authorities is that exchange rate flexibility cannot be instituted until the technical infrastructure is put in place. Although this is a legitimate concern, it definitely should not be a show-stopper. The China Foreign Exchange Trading System has been enhanced in various ways in the last few months. Allowing more market participants to have access to this trading system, and taking other measures to improve the depth and liquidity of the market, can be done relatively easily. Besides, it is difficult to have instruments for hedging foreign exchange rate being developed and offered unless there is sufficient volatility in the exchange rate to justify them. The experiences of other emerging market economies suggest that markets can generate such instruments fairly quickly once there is a demand for them.

As for the shift to a new nominal anchor, we think there are significant advantages to consider making this move relatively soon. Our proposal for anchoring monetary policy with a low-inflation objective would allow for continuity in the operational approach to monetary policy. The PBOC could continue its current operations and gradually adapt its procedures to the pursuit of independent monetary policy as supporting reforms are put in place. Our proposal would mainly entail a shift in strategic focus to a well-defined inflation anchor. Many other emerging market economies that have made the transition to inflation targeting regimes have had to deal with the initial pain of bringing down high rates of inflation. China is fortunate that, under present circumstances, the shift to an inflation anchor would be seamless since it would involve merely locking in the current low rate of inflation.

We also believe that the adoption of an effective independent monetary policy would facilitate various reforms that have intrinsic benefits of their own. For instance, the resulting macroeconomic stability would facilitate the modernization of the financial system. In addition, the new policy regime would necessitate improvements in the statistical base that would enhance public sector transparency and encourage better communication about policy intentions.

In sum, present circumstances are favorable for moving more rapidly to a more flexible exchange rate regime and for putting in place a new nominal anchor. Such windows of opportunity for instituting major macroeconomic reforms without the risk of extensive disruptions tend to be rare and fleeting, and should not be missed. Furthermore, these steps would be in China's own interest for promoting stable and sustainable growth in the long run. As argued by Prasad and Rajan (2006), this may be the time to move beyond a piecemeal and incremental approach to reforms to a bolder and more comprehensive approach.

NOTES

1. At the time of this writing, Eswar Prasad was the Chief of the Financial Studies Division in IMF's Research Department. Previously he was the head of the IMF's China Division from 2002 to 2004. The views expressed in this comment are those of the author and do not necessarily represent the views of the IMF or IMF policy.

2. Of course, in an environment where large savings continue to flow into the banking system and the banks are under pressure from the central bank to restrain their credit growth, they are quite eager to hold central bank bills rather than simply increase their reserves deposited at the central bank, since excess reserves carry a lower rate of return than that on central bank bills.

3. This is similar to the view that Ben Bernanke has espoused for the United States. Of course, given their different stages of financial sector and broader macroeconomic development, we have very different reasons for recommending a similar monetary framework for China.

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