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Exchange Rate Flexibility in China: Why it Really Matters and How to Make Progress

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I. Introduction

Chairman Baucus and honorable members of the Senate Finance Committee, thank you for the opportunity to share with you my views on this important bilateral economic relationship between China and the United States.

This relationship is relevant not just to the two economies themselves; it may also have implications for the smooth functioning of the global trade and financial systems. The rising linkages between the U.S. and China of course now stretch far beyond just trade and finance, to a variety of geopolitical and global security issues. Nurturing this relationship is therefore of considerable importance.

The currency issue has in recent years become a major thorn in this relationship. With the U.S. trade deficit reaching record levels and the bilateral trade deficit with China swelling, China's tightly managed exchange rate regime has come under increasing scrutiny. China's rising trade surplus, not just with the U.S. but the world at large, and its rapid accumulation of foreign exchange reserves have led to accusations of currency manipulation, with some observers calling for a drastic revaluation of the currency. There have also been calls for imposing large tariffs on U.S. imports from China if there isn't rapid progress on exchange rate reform.

I strongly believe that a confrontational approach calling for immediate and drastic policy actions is not the way to make progress in this matter. This would simply poison the U.S-China relationship in a manner that could have deleterious long-term consequences on many fronts. Furthermore, this approach is unlikely to have a large or lasting impact on problems such as the U.S. trade deficit or imbalances in the Chinese economy, and could make matters worse for everyone by creating instability in the global economy.

There is a great deal of commonality of economic interests between the two countries and it is these shared interests that should be the basis for a mutually beneficial economic relationship. What this requires is that the issue of exchange rate flexibility in China be placed in the broader context of reforms to the Chinese economic structure.

Chinese currency reform need not be a zero sum game. There is a better way to help China, in a few years, to float its currency, free up capital flows with fewer risks, and put in place an independent interest rate policy regime. This would, in turn, boost consumption growth in China, increase demand for imports, and facilitate inflows of capital and financial expertise. This would be win-win international financial diplomacy--it would improve Chinese macroeconomic performance and defuse tensions abroad.

The first step is to recognize that exchange rate flexibility, while an important policy priority, is hardly an end in itself. It is, however, an important building block for other reforms—especially reform of the financial sector—which the Chinese recognize as being vital for economic stability and which they have focused a great deal of energy and resources on.

Now that Chinese policymakers have started allowing greater—if still very modest—exchange rate flexibility, a key issue is what monetary policy framework will take the place of the fixed exchange rate as an anchor for inflation expectations. Marvin Goodfriend (Carnegie-Mellon University) and I have developed a specific package of proposals for a new monetary framework that would foster macroeconomic stability and help make progress towards the multiple goals laid out above.[1]

China should adopt an inflation objective—a long-run target range for low inflation—in place of the exchange rate objective as a new anchor for monetary policy. An inflation objective, coupled with exchange rate flexibility, would work best to stabilize the Chinese economy and enable policymakers to deal nimbly with various domestic and external shocks that the economy will inevitably face as it grows more complex and market-oriented, and more connected to the global economy. Focusing on inflation stability is also the best way for monetary policy to achieve broader objectives such as financial stability and high employment growth. Thus, this framework will provide the macroeconomic stability that will enable financial sector development and other more fundamental reforms to take root. It will also place the issue of exchange rate flexibility in a broader domestic context rather just on its role as a solution for trade imbalances.

Framing the issue in this manner is relevant for economic as well as political reasons, and will serve as a basis for a more constructive engagement between the two economies. The U.S. does have a crucial catalytic role to play in the Chinese reform process. But this can be done in a way that generates results rather than just kicking up a lot of dust. This is not to say that the U.S. should display infinite patience for reforms to take root. The efficacy of both technical advice and practical guidance should be regularly evaluated against benchmarks of actual progress. The importance of simultaneous and complementary reforms in several dimensions needs, however, to be recognized by Chinese policymakers and to be emphasized by U.S. policymakers as part of the bilateral policy dialogue.[2]

Ultimately, it is stable and sustained growth in China—rather than ad hoc policy actions at the behest of internal or external forces—that will best serve the interests of the Chinese and U.S. economies, as well as those of the global economy at large.

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[1] Marvin Goodfriend and Eswar Prasad, 2007, "A Framework for Independent Monetary Policy in China," *CESifo Economic Studies*, Vol. 53, No. 1.

[2] Eswar Prasad and Raghuram Rajan, 2006, "Modernizing China's Growth Paradigm," *American Economic Review*, Vol. 96, No. 2, pp. 331-36.

II. The Costs of an Inflexible Exchange Rate

Based on their own public remarks, it is fair to say that the Chinese authorities recognize the complications that arise from having a tightly managed exchange rate relative to the U.S. dollar. This exchange rate objective makes it difficult for the People's Bank of China (the central bank) to use interest rate policy to guide credit growth and pursue other domestic objectives. In recent years, offsetting the strong pressures for currency appreciation generated by the strong productivity growth in China has been an increasingly difficult task. Moreover, forcing the nominal exchange rate to remain stable has contributed to a rising trade surplus and large capital inflows over the last few years, leading to a gusher of liquidity pouring into the domestic banking system and making the monetary authorities' job of controlling credit expansion much harder.

The availability of abundant and cheap money has played a big part in the remarkably high rate of investment growth, which has been a key contributor to growth in recent years. The fact that this investment growth is in large part driven by state-owned enterprises and financed by state-run banks, neither of which are run as commercial market-oriented entities, creates serious concerns about the efficiency and sustainability of such investment. This could result in a resurgence of nonperforming loans in the banking sector in the future, setting back the progress that has been made in recent years.

Furthermore, the lack of financial market development and the general increase in macroeconomic uncertainty has made households nervous, increasing their savings to very high levels and restraining consumption growth. These problems and concerns are not news to anyone—indeed, the Chinese leadership has itself highlighted the seriousness of the domestic imbalances and sought to address them forcefully.

In present circumstances, however, a sizeable increase in policy interest rates to make financing of investment more expensive and to boost consumption growth—both stated objectives of the government—could trigger more inflows of capital from abroad. The expectation of a currency appreciation and an increase in interest rates would be too powerful a temptation for money from abroad, even if it had to find its way into China through unofficial channels. Thus, the exchange rate regime has made monetary policy subservient to the objective of maintaining a stable exchange rate relative to the U.S. dollar, hampering its use to promote domestic objectives.

A more flexible exchange rate, which would almost certainly result in a currency appreciation in the short term, would provide much more room for monetary policy maneuver. Giving the PBC room to raise interest rates by freeing it from having to target the exchange rate would help rein in credit to enterprises and deter reckless investment, reducing the risk of a boom-bust cycle. Indeed, higher inflation is not the only risk on the horizon—there are also risks of asset price bubbles and of future deflation resulting from a buildup of excess capacity if investment growth is not restrained.

So why are the Chinese authorities so reluctant to allow for a more flexible exchange rate when it is clearly in their interest? Among the concerns they have articulated are that allowing the currency to appreciate could, in the short run, hurt export competitiveness, harm the agricultural sector by making food imports cheaper, and expose domestic banks to risks of currency volatility. None of these in itself seems like a compelling reason to avoid currency appreciation. In any case, the broader benefits of a flexible exchange rate are obvious and would far outweigh these factors. But the costs of a currency appreciation would of course be borne by small groups that therefore complain the loudest, and they have been quite effective at blocking major changes.

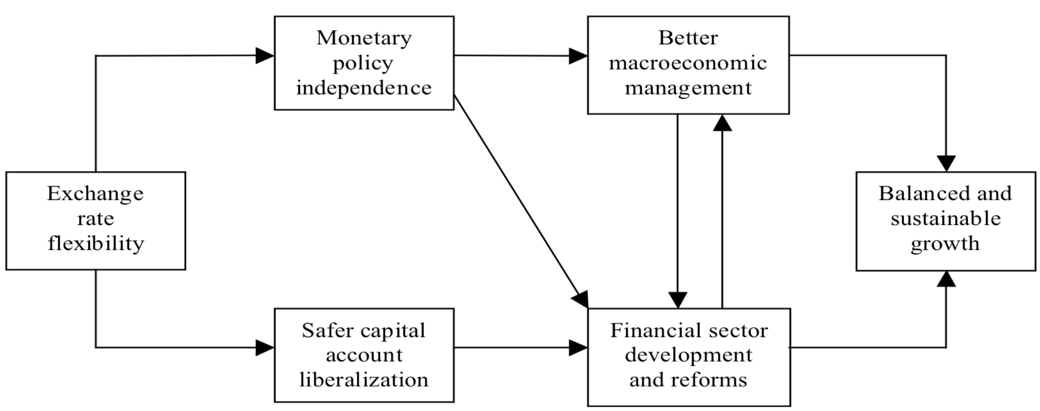
A more salient point is that the Chinese authorities are putting a great deal of emphasis on banking reforms and broader financial market development, which they view as far more important priorities than currency reform. These are indeed crucial reform priorities for long-term growth. But there seems to be an underlying notion, which can be gleaned from public statements of Chinese officials, that any disruptions arising from a shift in the exchange rate regime might make such core reforms harder to implement.

Therein lies a big window of opportunity for the international community to catalyze substantive change in the Chinese exchange rate regime. It turns out that there is an excellent basis for translating the authorities' own priorities into a strong case for making the exchange rate more flexible.

III. Why is Exchange Rate Flexibility Important? It's Not All About Trade

The case for a more flexible exchange rate should be made on the basis of a deeper set of policy priorities, with the ultimate objective being stable and sustainable growth in the longer term. The connections among the different objectives are subtle but highlight the need to take a more holistic approach to the reform process, including currency reforms.

Making the Right Connections



An independent monetary policy is a key tool for improving domestic macroeconomic management and promoting stable growth and low inflation. As the Chinese economy becomes more complex and market-oriented, it will become harder to manage through command and control methods as in the past. And, as it becomes more exposed to global influences through its rising trade and financial linkages to the world economy, it will also become more exposed to external shocks. Monetary policy is typically the first line of defense against macroeconomic shocks, both internal and external. Hence, having an independent monetary policy is important for overall macroeconomic stability.

Monetary policy independence is, however, a mirage if the central bank is mandated to attain an exchange rate objective. Capital controls, which prevent money from moving in an out of an economy easily, do insulate monetary policy to some extent. But capital controls are notoriously leaky (the unofficial flows into and out of China itself are ample testimony to this) and tend to become increasingly less effective over time. Thus, a flexible exchange rate is a prerequisite for an independent monetary policy.

Independent monetary policy, in turn, is a key input into financial sector reforms. Until the late-1980s, lending operations of state-run banks (which still dominate the financial landscape in China) were determined by the government. The legacy of directed lending lives on in some ways, especially since Chinese banks have still not developed risk-assessment expertise or been given the right incentives to lend on commercial principles. Thus, using interest rate policy, rather than government directives, to guide credit expansion is essential to encourage banks to become more robust financial institutions. Trying to foster the commercial orientation of the banking sector in the absence of monetary policy tools to guide credit and money growth vitiates banking reforms.

The argument that the financial system needs to be fully modernized before allowing currency flexibility has it backwards. Indeed, durable banking reforms are likely to be stymied if the People's Bank of China's (PBC) ability to manage interest rates is constrained by the exchange rate objective. The PBC then has to revert to its old practice of telling state banks how much to lend and to whom, which hardly gives banks the right incentives to assess and price risk carefully in their loan portfolios. This makes financial reforms even more complicated than they already are.

Another requirement for broader financial market development is a stable macroeconomic environment, for which again good macroeconomic policies, including effective monetary policy, are necessary. On the flip side, the lack of effective macroeconomic management could generate risks via the financial sector. In the absence of room for maneuver on interest rates, liquidity flows into the economy could result in asset price bubbles, including in the real estate and stock markets. These markets could become vulnerable to sudden and unpredictable shifts in investor sentiment, which could send them tumbling at the slightest provocation, with broader ripple effects throughout the economy.

For developing the domestic financial sector, opening up of the capital account—to inflows as well as to outflows—could also serve as an important catalyst. Inflows can bring in technical expertise on developing new financial instruments, creating and managing risk assessment systems, and improving corporate governance. Indeed, the approach of using foreign strategic investors, including U.S. banks, to improve the efficiency of domestic banks is a strategy the Chinese authorities see as playing a useful role in their overall reform effort. Allowing outflows would help increase efficiency by creating competition for the domestic banking system and limiting the captive source of funds (bank deposits) that now keep domestic banks flush with liquidity.

However, opening the capital account ahead of introducing greater flexibility in the exchange rate could pose serious problems in the future.[3] History is replete with examples of countries that opened up the capital account while things looked good, even while keeping their exchange rates fixed, and were then subject to large exchange rate depreciations when they were subject to sudden stops and/or reversals of capital flows.

Ultimately, stable macroeconomic policy and a well-developed and efficient financial sector are crucial ingredients for stable, balanced and sustainable growth. Exchange rate policy is clearly not an end in itself but, as shown by the connections depicted above, has an important role to play in achieving these deeper policy reforms and also the ultimate objectives in terms of growth and welfare.

The Broader Case for A Flexible Exchange Rate

- Changes in the exchange rate regime or level will not by themselves solve trade imbalances or other structural imbalances in the Chinese economy.
- But exchange rate flexibility (rather than just revaluation of the currency to a different level) is a prerequisite for monetary policy independence, which in turn is essential for effective domestic macroeconomic management.
- An independent monetary policy will foster macroeconomic stability, improve the composition of growth (away from a heavy reliance on exports and inefficient investment), and set the stage for more fundamental reforms, including reform and development of the financial sector.
- Thus, exchange rate flexibility is not an end in itself but a key component of the overall reform process that is needed to foster balanced and sustainable growth.

IV. Reorienting the Debate: An Alternative Monetary Policy Framework

For an emerging market economy, keeping domestic inflation low and stable, and controlling inflation expectations, is always a difficult challenge. For all its flaws, the exchange rate link to the U.S. has served as a useful anchor for inflation expectations in

[3] Eswar Prasad, Thomas Rumbaugh and Qing Wang, 2005, "Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China," in *China and the World Economy*, Vol. 13, No. 4, pp. 3-20. For a good summary of this article, see the Economics Focus column of the *Economist* magazine, March 18, 2005

China. So what could serve as a suitable alternative anchor for inflation expectations in place of a tightly managed exchange rate?

China should adopt an explicit inflation objective—a long-run range for the inflation rate and an explicit acknowledgement that low inflation is the priority for monetary policy—as a new anchor for monetary policy. An inflation objective, coupled with exchange rate flexibility, works best to stabilize domestic demand in response to internal and external macroeconomic shocks. Indeed, focusing on inflation stability is the best way for monetary policy to achieve broader objectives such as financial stability and high employment growth.

Over time, the inflation objective would provide a basis for currency flexibility. Thus, exchange rate reform will be seen as a key component of an overall reform strategy that is in China's short- and long-term interests, rather than as a policy that is aimed at appeasing foreign interests.

The time is right for making the switch—economic growth is strong and headline inflation is low. At an operational level, the PBC could continue its current approach to monetary policy, which includes setting targets for money and credit growth. The crucial difference would be to switch the strategic focus from the exchange rate to the inflation objective, which means that the currency could appreciate or depreciate in response to more fundamental economic forces such as productivity growth.

But how could such a regime—which is in many ways similar to that advocated for the U.S. by Ben Bernanke—work effectively in an economy with a weak financial system? The basic condition is that banks' balance sheets must be robust to interest rate fluctuations. The PBC has already made good progress on this front by clearing bad loans from the books of the key large banks and recapitalizing them. Full modernization of the banking system is a long way off, of course. But it would be inadvisable to wait for that outcome before moving to a new monetary framework. Indeed, as noted earlier, effective monetary policy is necessary for pushing forward with financial sector reforms.

I am not advocating a full-fledged inflation targeting regime, although this could serve as a useful long-term goal. The approach I have outlined above is more practical for the foreseeable future, and it should deliver most of the benefits of formal inflation targeting.

Two related points are worth noting. Independent interest rate policy requires a flexible exchange rate, not a one-off revaluation or a sequence of revaluations. A flexible exchange rate buffers some of the effects of interest rate changes, especially in terms of offsetting the temptation for capital to flow in or out in response to such changes. A one-off revaluation can solve this problem temporarily, but could create even more problems subsequently if interest rate actions in a different direction become necessary, or if investor sentiment and the pressures for capital inflows or outflows shift. This is why the focus on a large one-time revaluation to atone for past sins doesn't get us anywhere, either in terms of the policy debate or in terms of effecting reforms that really matter.

Exchange rate flexibility should also not be confused with full opening of the capital account. An open capital account would allow the currency to float freely and be market-determined. But the exchange rate can be made flexible and the objective of monetary policy independence achieved even if the capital account is not fully open. Indeed, as noted above, there are good reasons why it is preferable to move more gradually on capital account opening than on exchange rate flexibility. A free float with an open capital account is a useful long-term objective, but is not a high priority in the short run.

Elements and Implications of an Alternative Monetary Policy Framework

- A low inflation objective—a long-run target range for low inflation, with an explicit recognition that price stability is the main priority of monetary policy—would enable monetary policy to make its best contribution to macroeconomic stability and to longer-term goals of high and sustained growth.
- This framework would be relatively easy to put in place given China's present economic circumstances. It would provide for operational continuity but would require a change in the strategic focus of monetary policy.
- It would provide a broader context for undertaking reforms to the exchange rate regime, which are essential for effective independent monetary policy.
- Independent interest rate policy requires a flexible exchange rate, not a one-off revaluation or a series of revaluations.

V. How to Make Progress

The debate about the Chinese exchange rate regime has been distorted in some ways, and made political rather than substantive, by placing it in the narrow context of the U.S.-China trade balance. There is an important strategic (and educational) element related to putting the exchange rate issue in a broader context. This is where external pressure from the international community can be helpful, not in the form of threats but by reorienting the discussion in a fashion that makes the linkages between currency reform and other reforms—on which there is broad consensus within China—much clearer.

Furthermore, working with the Chinese to develop deadlines for achieving specific policy goals would be useful if done in a collaborative rather than confrontational manner.[4] These intermediate steps could serve as concrete guideposts for the reform process and help break down internal resistance to the reforms. Commitments that the Chinese made in the context of accession to the World Trade Organization, for instance, have helped to galvanize internal reforms. In China—as in any other country—there are some groups

[4] The Goodfriend-Prasad paper (see footnote 1), for instance, lays out some intermediate steps and goals along the path to organizing the monetary framework around an inflation objective.

that stand to lose disproportionately from certain reforms, even if those reforms may be hugely beneficial overall. This is precisely where external pressure, if applied judiciously, can be helpful in generating enough momentum to help the forces that are predisposed towards undertaking reforms. A confrontational approach, on the other hand, could well prove counterproductive by bolstering the forces opposed to reform and allowing them to paint certain reforms as being detrimental to China and in the interests only of other countries.

In particular, rather than push for a massive one-off currency revaluation or threaten to impose trade sanctions, it would be far more productive to actively encourage and assist China to undertake deep and enduring reforms that would promote sustained and stable growth. This is ultimately the best contribution that China could make to an orderly resolution of global current account imbalances. And for this, currency flexibility is an essential but hardly sufficient policy priority.