
IMF Reform: A Chinese View

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For most Chinese economists, including myself, the IMF is designed to serve three purposes. First, it operates as a forum for multilateral economic cooperation. Second, it helps countries to formulate the right macroeconomic policies to achieve higher employment and growth. Third, it provides temporary financial support with conditions to help members address balance of payments difficulties without resorting to measures that could endanger national or international prosperity.

China is a strong supporter of the IMF. Even during the Asian financial crisis, China's criticism of the IMF was quite muted. When Japan proposed an Asian monetary fund, China rejected the proposal for fear of weakening the IMF's authority. The Chinese see no reason why the IMF's mandate should be fundamentally changed despite its recent failures in Asia and Latin America.

One should be cautious about changing the IMF's mandate for numerous reasons. The IMF should not be presumptuous and assume that it knows local situations better than the local economists and local governments. The governments of the member countries are accountable to their people. But the IMF is not accountable for the fortunes of its member countries. This asymmetry between power and accountability may lead to disasters. The experience of Indonesia during the Asian financial crisis is a case in point.

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IMF Managing Director Rodrigo de Rato pointed out (in chapter 3 of this volume) that the IMF's mandate to foster international economic cooperation, promote rising prosperity and high employment, and safeguard global financial stability remains as vital as ever. I think the Chinese government fully endorses this gradualist and evolutionary approach.

The world needs a strong and effective IMF. Unfortunately, the IMF has instead become weak and ineffective. This is a fair observation. The Asian financial crisis damaged the reputation of the IMF greatly in East Asia. The IMF failed to forewarn the Asian countries of the crisis; it provided the wrong diagnosis; and it made the crisis worse in some countries.

With the benefit of hindsight, a proposal to create an Asian monetary fund obviously threatened the IMF's authority, no matter how innocent Japan's intention was. The Chiang Mai Initiative may pose the same problem for the IMF. For Asian countries, however, not only is a regional financial architecture that can provide timely financial assistance to countries in need a necessity but also they can create such an architecture because of the huge accrual of foreign exchange reserves in the region.

Progress in constructing an Asian regional financial architecture can either weaken or strengthen the IMF's role depending on the IMF's responses to such developments. If the IMF fails to respond to the new reality in its policy and its management, the centrifugal force on the IMF will become increasingly strong. The emergence of a tripartite world economic structure is inevitable. The IMF should accept such a prospect and facilitate the emergence of such a world economic structure.

In chapter 13, C. Fred Bergsten attributes the ineffectiveness of the IMF to the incompetence of the Group of Seven (G-7). As an outsider, I am not in a position to comment on this. What I can say is that there is a lot of room for the IMF to improve its governance. As pointed out by Ted Truman in chapter 9, the IMF's most salient governance challenge is the lack of balance in the representation of the countries on the Executive Board and in shares of voting power.

China supports increasing quotas and the size of the Fund. It supports the reallocation of voting shares in the context of overall increases in the size of the Fund. It welcomes the gesture of some EU countries to reduce their quota shares. Of course, it supports the increase in developing countries' representation and is not happy with US veto power. China knows that it is underrepresented in the IMF; however, it will be very patient.

Personally, I think China should increase its contribution to the Fund by turning a larger chunk of its foreign exchange reserves into international reserves in the Fund. Bergsten suggests that China should be involved, somehow, in the G-7 or in a similar group. As for the G-7, my understanding is that China's government fully understands the importance of the G-7. It wants to develop its dialogue with the G-7. China's leaders would like to use the opportunity to meet with the heads of state of the G-7 and establish friendly personal relationships with them.

However, even if it were invited, China sees no urgency to join the G-7 at the moment. China does not want to intrude on an exclusive club consisting of so-called like-minded people. China ultimately might join the G-7 and play a role proportional to its economic strength. However, that time has yet to come.

On the matter of global imbalances, as the world's sixth-largest economy and the third-largest trading nation, China indeed has the responsibility to help correct those imbalances. I have been a longtime supporter of depegging the renminbi from the US dollar and of revaluing the renminbi. In my view, however, the possible role of renminbi revaluation in the correction of global imbalances has been greatly exaggerated.

Global imbalances are explained along two lines: the investment-saving gap and the misalignment of exchange rates. I believe that the two explanations are not exclusive of each other but that the fundamental cause of global imbalances is the investment-saving gap of the United States; the role of the strong US dollar is secondary. The investment-saving gap leads directly or indirectly to high interest rates, which in turn lead to large capital inflows. Capital inflows push up the US dollar exchange rate and sustain the US current account deficit. In this process, the strong dollar is just a facilitator of the current account deficit necessitated by the investment-saving gap. If the United States somehow eliminates the investment-saving gap, the US current account deficit will disappear automatically, regardless of what happens to the nominal US dollar exchange rate.

On the other hand, the realignment of the dollar exchange rate vis-à-vis other major currencies is conditional on the elimination of the investment-saving gap. If the investment-saving gap persists, devaluation of the US exchange rate will lead eventually only to the rise of inflation. The real exchange rate of the US dollar will remain unchanged.

Whether devaluation can eventually lead to the elimination of the investment-saving gap so that the current account deficit can eventually be eliminated is a more intriguing question. In the literature, most discussions about the effect of currency devaluation on the current account are conducted in terms of the so-called switching effect of devaluation, which is based on a partial equilibrium model and does not refer to the investment-saving gap. In contrast, the question of the effect of devaluation on the investment-saving gap can be answered only within a framework of general equilibrium. An increase in the current account surplus (trade account surplus, more precisely) caused by devaluation will lead to an increase in national income, which, other things being equal, in turn will lead to an increase in savings. Theoretically speaking, as long as a devaluation is big enough, an increase in savings vis-à-vis investment will be big enough to eliminate the investment-saving gap.

For various reasons, such as the low pass-through of changes in the exchange rate to demand and the exogeneity of government expenditures, the needed growth rate of GDP to eliminate the investment-saving gap

might be higher than the potential growth rate of GDP. As a result, inflation will lead to a revaluation of the real exchange rate, which in turn will result in the worsening of the current account. Alternatively, the high growth rate of GDP and the accompanying high interest rate might attract large capital inflows, which in turn will force the nominal exchange rate to revalue. In short, my point is that even if the depreciation of the dollar is helpful for the reduction of the US current account deficit, it must work through the reduction of the investment-saving gap.

One is even more mistaken to give the renminbi-dollar exchange rate a central place in the correction of global imbalances. According to Bergsten in chapter 13 of this volume, in 2004, China's current account surplus accounted for 20 percent of the US current account deficit with Asia, far less than Japan's corresponding share of 48 percent.

Why should China, as a country in deficit with the rest of East Asia, be blamed for its reluctance to appreciate its currency against the US dollar? Why should China have to lead the way in Asian appreciation? This would mean that China would have to run even larger current account deficits with the rest of Asia so that Asia as a whole can reduce its current account deficit against the United States. Is this demand fair?

Except for 2005, China's current account surplus of the past 10 years has been quite small. (2005 is rather special because of excessive supply in many sectors, for example, the iron and steel sector, resulting from excessive investment during the past two years, the overall weakening of domestic demand, the release of pent-up pressure after the elimination of textile quotas, and other factors.) In 2004, the contribution of the trade surplus to China's economic growth was less than 1 percent. Unlike Japan, which runs current account surpluses and capital account deficits continuously, China's dominant contributor to the increase in its foreign exchange reserves has been its capital account surplus, not the economy's current account surplus.

China has failed to translate its capital account surplus into a current account deficit as developing countries usually do. By running the twin surpluses, China is making bad deals with the rest of the world, especially with the United States. The late Professor Rudi Dornbusch pointed out that it is certainly not reasonable for residents of poor countries to buy US Treasury bills in preference to investing resources in their own countries so as to raise their productivity and standard of living.

The irrationality of China's flows of funds across its borders was pointed out by Paul Krugman and many others, myself included, many years ago. China's saving rate has been as high as 40 to 50 percent, higher than its investment rate. As a result, China has been running a trade account surplus (and a current account surplus as well) consistently during the past 20 years.

It is assumed in development economics that developing countries should run current account deficits and capital account surpluses so as to

utilize foreign savings to obtain an investment rate higher than what their domestic savings can support. If a country is running current account surpluses, it is assumed that there must be excess saving in the country and that the country concerned is exporting capital. However, while China is running a very large capital account surplus, it is also running a moderate current account surplus. China's international balance of payments structure has been characterized by the so-called twin surpluses (current account and capital account surpluses) during the past decade.

China's persistent twin surpluses, especially the capital account surplus, result in the continuous increase in foreign exchange reserves. China imports capital in the form of foreign direct investment (FDI) and exports capital in the form of accumulating US Treasury bills. On the whole, China is a capital-exporting country because it runs current account surpluses. It can be said that, although a significant amount of China's investment is financed by FDI, a larger amount of foreign consumption and investment is financed by China's savings. In this sense, US direct investment in China is the recycled Chinese savings.

China's inability to finance its domestic investment directly by its own savings and its reliance on FDI is attributable to a large extent to distortions in domestic financial markets. On one hand, even though a huge amount of household savings is packed into banks as saving deposits, small and medium enterprises cannot get enough, if any, credit from the banks. On the other hand, owing to the country's preferential policy toward FDI, the small and medium enterprises can establish joint ventures with foreign investors easily so as to get the financing needed. In fact, these enterprises may not need to buy foreign goods at all (which is implied by excess savings over investment). They simply sell the foreign exchange injected by their foreign partners to the People's Bank of China and then use the renminbi thus obtained to buy goods and services available domestically. If the enterprises had access to domestic bank credit or if there were no preferential policy toward FDI, either capital inflows would not happen or a current account deficit would occur (in which case foreign goods and services are really needed). In either case, there should be no increase in foreign exchange reserves.

Market distortion is also related to undervaluation of the exchange rate. If a country really needs FDI to improve its welfare, the exchange rate should be set at an appropriate level to allow the capital inflow to be translated into a current account deficit.

China's current account surplus, capital account surplus, and accumulation of foreign exchange reserves are an inseparable trinity. One cannot really be explained without understanding the others.

The final portion of my remarks is on Morris Goldstein's manipulation accusation. He has done a lot valuable work, which has been very helpful to Chinese economists and government officials in understanding the necessity for allowing the renminbi to appreciate. I appreciate his frankness.

I will respond in the same way—no hard feelings. I have four comments to offer.

First, Goldstein accuses China of failing to play by the rules. What is the rule? Goldstein's most important argument is that protracted, large-scale intervention in one direction in the foreign exchange market constitutes exchange rate manipulation. This argument is not in line with either the spirit or the letter of the IMF rules. I will not deny that China has been conducting large-scale, one-way intervention in the exchange market for more than two years. But would this amount to manipulation? Unfortunately, I cannot find any IMF rule that says so.

Even if there are such rules, it's still difficult to produce a guilty verdict because the phrase that Goldstein quotes is too vague to serve as a basis for a court ruling. For example, we do not know how long "protracted" is and how large "large scale" is. Before Goldstein pursues China on this matter, he should pursue the IMF to make its rules on manipulation clear. I guess this is what Goldstein and Bergsten have been doing recently. However, after hearing IMF Managing Director de Rato at this conference, I believe, to my relief, they are not going to succeed.

Second, protracted, one-way intervention is compatible with a legitimate fixed exchange rate regime. It is entirely possible, under certain circumstances, that to maintain a fixed exchange rate, a country has to engage in protracted, large-scale, one-way intervention. One can say that a government is stupid to stick to a fixed exchange rate for too long, but one cannot accuse that government of being guilty of manipulation.

Third, a legitimate fixed exchange rate regime is not conditional on whether the exchange rate is basically in line with the equilibrium exchange rate. According to Goldstein, it cannot be legitimately maintained that China alone gets to decide as a sovereign matter what the exchange rate between the renminbi and the dollar should be for long periods, regardless of economic signals about whether that rate is or is not an equilibrium rate. My point is that, if the purpose and the result of intervention is to maintain a fixed exchange rate, it does not matter whether the nominal rate is in line with the equilibrium real exchange rate or not, unless from the start the rate is significantly overvalued or undervalued. If the fixed exchange rate is legitimate, so should be the so-called protracted, one-way intervention.

A fixed exchange rate regime, by definition, should exclude the consideration of the equilibrium rate. The Hong Kong dollar has been pegged to the US dollar for more than 20 years at the level of HK\$7.8 to US\$1. Has the Hong Kong Monetary Authority ever been required to consider what the equilibrium exchange rate of the Hong Kong dollar is?

The equilibrium exchange rate is changeable and certainly will change over time. If the exchange rate should be set in accordance with the equilibrium rate, there will be no more fixed exchange rate regimes in the world. Furthermore, the concept of equilibrium exchange rate is elusive.

Who on the earth can be sure what the right renminbi equilibrium exchange rate is? In chapter 6 of this volume, John Williamson pointed out that there are many definitions of equilibrium exchange rates. Among them are DRER (desired long-run equilibrium real exchange rate), LRER (long-run equilibrium exchange rate), DEER (desirable equilibrium exchange rate), BEER (behavioral equilibrium exchange rate), GSDEER (Goldman Sachs dynamic equilibrium exchange rate), and NATREX (natural real exchange rate).

Even after picking a certain kind of equilibrium exchange rate one has tremendous difficulty saying what the right value of the equilibrium exchange rate should be. China has been given numerous suggestions on the renminbi equilibrium level. Correspondingly, the suggested magnitudes of appreciation ranged from 2 to 40 percent. Which advice should China follow? In chapter 6, Williamson admits

... one could not realistically hope to pin down the equilibrium exchange rate more precisely than to within plus or minus 10 percent; some subsequent writers have suggested that even this is overambitious and that a range of plus or minus 15 percent (as used by the European Monetary System in its final years) is more realistic. One implication is that it is unreasonable to expect that countries will accept obligations to hold exchange rates at levels that can only be calculated subject to such a wide margin of error.

This is absolutely right. If one cannot be sure, one has to be content with a gradual appreciation. The Chinese economy is at a delicate turning point in its growth, and the government cannot afford to make a misstep in economic policy. The government will make its next move after making sure that a further appreciation will not have an unbearable negative impact on the economy.

Finally, even if Goldstein were 100 percent right, his approach is counterproductive. What do you want to achieve? Do you have any leverage to force a revaluation on China? Are you prepared to call for sanctions against China? Of course you are not. Goldstein's suggestions in the last pages of his chapter are quite modest. Confrontation inevitably will lead to a lose-lose situation.

Patience is needed. Managing Director de Rato understands that. US Treasury Secretary John Snow understands that, too, and his patience has paid off. The United States has waited for more than two years. Why can't it wait for another few months? A two-percentage-point revaluation is a small step for the United States, but it is a giant step for China. Psychological barriers have been eliminated, and more changes are in the pipeline for China.

