The word renminbi was essentially unknown to most Americans before 2003. A search of an electronic database (NewsPlus/Factiva) of all news articles in the four largest newspapers (*New York Times*, *Wall Street Journal*, *Washington Post*, and *USA Today*) revealed an explosive growth in the news interest in Chinese exchange rate in recent years. Between January 1, 1980, and December 31, 1982, only four articles in these four newspapers combined made any mentioning of “renminbi,” or “RMB,” or “Chinese yuan.” The growth was slow initially. During the three-year period of 1990–92, only 19 articles made any mention; and 10 years later, during 2000–2002, the count increased to 33 articles, still a relatively low number. Then an explosion started in 2003. Between January 1, 2005, and October 18, 2007, there were no less than 231 articles (!) that mentioned these words. If the count of the news articles were an asset price, such a rapid rise may spark suspicion of bubbles. Today, I would like to comment on some possible bubbles in the discussion of China’s exchange rate policy.

In Eswar Prasad’s paper, he stressed the benefits of a move to a more flexible exchange rate for China in improving its macroeconomic management. Others have advocated the benefits of a more flexible Chinese yuan in alleviating global imbalances. I would like to suggest that both benefits may have been oversold a bit in policy circles. I say so on two grounds. First, the role of a flexible exchange rate regime in facilitating current account adjustment may be vastly exaggerated. Second, the virtue of a flexible RMB exchange rate regime in enhancing the effectiveness of China’s macroeconomic stability may also be overrated.

**Would a flexible exchange rate really speed up current account adjustment?**

I ask this question not just due to the fact a country’s current account imbalance is the difference between its national savings and national investment, that the large US current account deficit is a reflection of its large saving deficit, and that the US bilateral deficit with China is only part of its overall deficit with the rest of the world. All these are true.

Beyond these, many economists and policy wonks take it as self-evident that a flexible exchange rate regime must deliver a faster current account adjustment. Many IMF statements also reflect this supposition. There is in fact no systematic evidence supporting it. I call this a faith-based initiative, something widely assumed to be true and actively peddled to countries as policy advice but with little solid supportive evidence.
In a systematic analysis of this issue, Menzie Chinn and I find absolutely no support in the data for the notion that countries on a *de facto* flexible exchange rate regime exhibit faster convergence of their current account to the long run equilibrium (Chinn and Wei 2007). This is true when we control for trade and financial openness; and this is true when we separate large and small countries.

To be sure, the current account does have a tendency to revert to its long run steady state. This is clearly reflected in our empirical work. However, the speed of adjustment is not systematically related to the degree of flexibility of a country’s nominal exchange rate regime.

Should we be surprised by this finding? Perhaps not. The current account responds to the real exchange rate, not the nominal exchange rate. If the real exchange rate adjustment does not depend very much on the nominal exchange rate regime, then the current account adjustment would not depend very much on nominal exchange rate regime either. Menzie Chinn and I therefore go on to check whether the nature of a country’s nominal exchange rate regime significantly affects the adjustment process of its real exchange rate. After looking at enough regressions, we conclude that the answer is no: The real exchange rate adjustment is not systematically related to how flexible a country’s nominal exchange rate regime is. If anything, there is slight, but not very robust evidence that less flexible nominal exchange rate regimes sometimes exhibit faster real exchange rate adjustment.

Just to be clear, if one could engineer a real appreciation of the RMB, it could have some effect on China’s trade or current account balance. Indeed, in a separate research project that I am doing with Caroline Freund and Chang Hong, using China’s bilateral trade data and separating processing from nonprocessing trade, we find evidence that bilateral trade volume clearly responds to changes in bilateral real exchange rate, especially for nonprocessing trade (Freund, Hong, and Wei 2007). But a more flexible exchange rate does not promise a faster current account adjustment or resolution of global current account imbalances.

If China does opt for a more flexible exchange rate regime today, its real exchange rate will most likely appreciate on impact. However, given China’s still shaky financial sector and the credit crunch in advanced economies, it is certainly possible for the real exchange rate to go the other direction the day after tomorrow. After all, today’s expectation of an RMB undervaluation is a relatively recent phenomenon, emerging in late 2003. As clearly shown in figure 1, taken from a paper with Jeffrey Frankel, until October 2003, the market actually expected RMB depreciation, as measured by the nondeliverable forward rate (Frankel and Wei 2007). But the expectation shifted in late 2003 when US officialdom and scholars at prominent think tanks started to up the volume in the call for an RMB revaluation.

The very high speed of China’s foreign reserve accumulation really took off within the last four years, as seen in figure 2. It may very well be responding to a shift in market expectation on the RMB movement, or at least the reserve accumulation and the exchange rate speculation feed on each other. However, if it took only four years for China’s FX reserve to triple in value, it may take only another four years for it to lose 60 percent of the value once the exchange rate expectation starts to reverse itself. Economic history books are full of examples of seemingly sudden shifts in market sentiment. A tight credit market in developed countries, such as the one
we are seeing today, has in the past engendered a reversal of global capital flows, and a concomitant shift in the valuation of emerging market currencies.

Figure 1. Spot and forward rates of the US dollar and RMB

Figure 2. China’s current account and foreign reserve, 1985–2006 (percent of GDP)

Would a Flexible Regime Vastly Improve the Effectiveness of China’s Macro Policies?
To appeal to China’s self-interest, advocates of a more flexible exchange rate regime say it will greatly enhance the effectiveness of China’s domestic macroeconomic policy. A more flexible regime, as the logic goes, would free the domestic interest rate to serve as an instrument for domestic macroeconomic stability, and may benefit other policy objectives as well, such as financial reform and addressing future shocks. While I agree that a shift to a more flexible exchange rate regime is a net positive for China, I would caution that the benefits of doing so for China should not be overrated.

First, China’s current monetary policy still has room for maneuver. Fundamentally, China’s capital controls, while leaky, are binding at the margin. The gap between lending and deposit rates can be widened further. The required reserve ratio might also be raised if desired.

Second, China’s fiscal policy still has room for maneuver. True, there are a lot of contingent liabilities that should and may show up on the country’s balance sheet. On the other hand, state-owned firms collectively are making a profit that is not currently counted in the government budget. The state may require these firms to pay up more dividends to augment existing fiscal management tools.

Third, to the extent that the *de facto* dollar peg constrains the conduct of China’s monetary policy, it may not be a bad thing. The most important goal of a good monetary policy is to maintain price stability. The *de facto* peg to the US dollar has served China well—beyond its role in promoting exports—as it has provided an anchor for its monetary policy. Once the country switches to a substantially more flexible exchange rate regime, it will by definition lose this nominal anchor. One might prescribe an inflation targeting framework. But one could question how faithfully China will follow such a framework.

China’s recent monetary history has clear bouts of double-digit inflation, as shown in figure 3. So resisting political pressure to deviate from maintaining price stability isn’t necessarily a strong suit for the central bank. The current leadership at the Central Bank, Governor Zhou Xiaochuan and his deputies, happens to be superb. But leadership at the central bank could change, and a look at the recent history doesn’t inspire absolute confidence that an inflation targeting framework will be faithfully followed. So a less stable domestic price is a risk that cannot be easily ruled out if and when the country shifts to a more flexible exchange rate regime.

**Figure 3. China’s CPI Inflation, 1987–2006**
Conclusion

I have stressed two points. First, the notion that a flexible exchange rate regime would facilitate a faster current account adjustment is in fact not well supported by empirical evidence. Second, the virtue of a flexible exchange rate regime in enhancing the effectiveness of China’s macroeconomic policy may also be overrated.

I still think that the benefits of moving to a more flexible exchange rate regime likely outweigh the costs for China. On the other hand, China faces many challenges in its economy, including environmental degradation, rising income inequality, pervasive corruption, mining production safety, food production safety, and a constant threat of massive unemployment, to name just a few. In the grand scheme of things, when ranking all the reforms to do on the basis of benefit to cost ratio, how much priority this particular reform—the shift of the exchange rate regime—should be given is a separate question.

References

