Chinese Monetary Policy and Global Financial Cooperation

Olivier Jeanne

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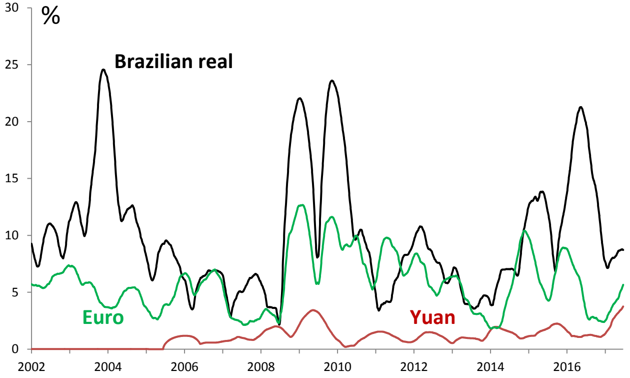
Introduction

- New conventional wisdom: emerging markets should move towards "IT+F" (Inflation Targeting plus Floating) and liberalize their financial accounts
    - with caveats about capital flow management (CFM)
    - 2017 Jingshan Report largely consistent with this view
- I will share some doubts and concerns about how well this conventional wisdom applies to China

A floating yuan?

The Yuan has remained a very managed float

Figure: One-year volatility of exchange rate with US dollar



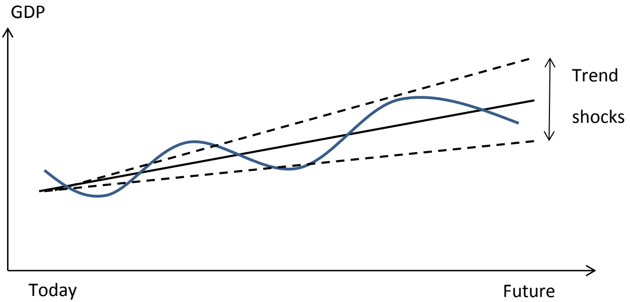
Volatility in y-o-y change in exchange rate over a one-year rolling window (daily data).

A floating yuan?

- How much volatility should we expect to see in a (cleanly) floating Yuan?
- My tentative answer: a lot, and probably too much
- The nature of fundamental uncertainty is not the same for China as for advanced-economy currencies
  - trend vs. cycle
- This is in addition to other influences (risk aversion, financial frictions, behavioral)

Trend growth shocks and exchange rate

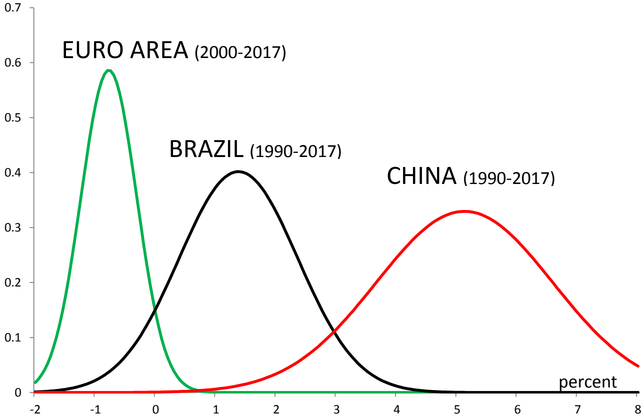
Figure: Trend vs. cycle



There is evidence that trend growth shocks are more important than business cycle shocks in emerging market economies relative to advanced economies

Trend growth shocks and exchange rate

Figure: Distribution of expected trend growth rate relative to US



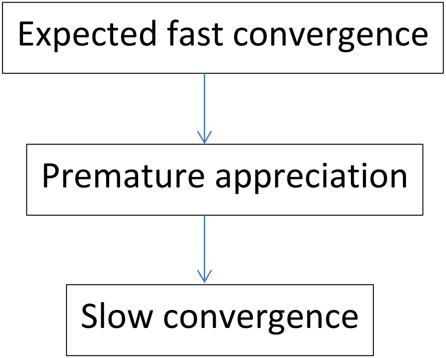
Distribution of five-year-ahead predicted real GDP growth rate relative to US in WEO. A normal distribution is assumed.

Trend growth shocks and exchange rate

- Under capital mobility an increase in *expected* trend growth brings *immediate* appreciation pressure on the exchange rate
- Assume that expected growth increases for ten years
- The real exchange rate will appreciates in ten years (Balassa-Samuelson)
- The domestic real interest rate increases in the next ten years
- Dornbusch-overshooting $\rightarrow$ the real exchange rate must appreciate more today than in ten years

The risk of premature appreciation

For countries that are far from the technology frontier capital mobility can make convergence more difficult because of the risk of premature appreciation



This may contribute to the middle-income trap

The risk of premature appreciation

Historically, the Asian countries that successfully caught up to the frontier had relatively low level of financial openness

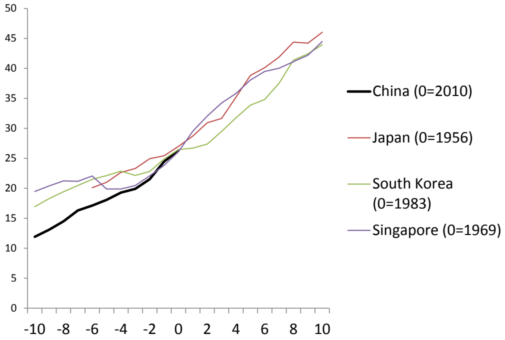
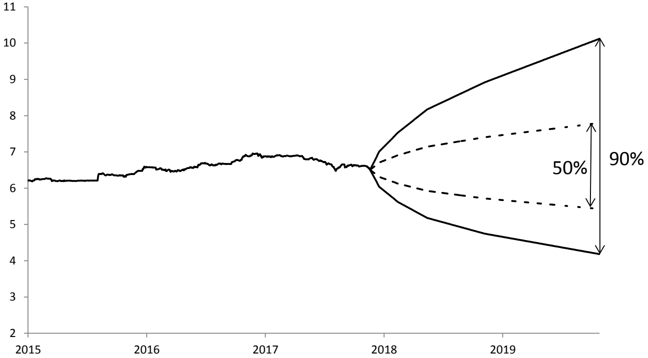


Figure: GDP per capita as a share of US GDP per capita (%, source: Maddison)

Volatility

Figure: Post-2017 distribution of CNY/USD exchange rate assuming same volatility as for Brazilian real



CNY/USD exchange rate in 2015-17, and confidence intervals in 2018-19 under the counterfactual assumption that the CNY/USD exchange rate is as volatile as the BRL/USD exchange rate.

Are China and the rest of the world ready to live with this range of exchange rate variation?

Conclusion

- Data and theory suggest that a (cleanly) floating CNY would be very volatile...
- ...with problematic consequences for China, and multilaterally
- Arguments for capital flows (and exchange rate) management apply with greater force to China than for the average EM