INTERNATIONAL MONETARY SYSTEM
AND THE FUTURE OF EXCHANGE RATES

Currency War and the RMB:
Monetary Policy, Imbalances,
and the Global Reserve Currency System

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Currency War?

- Coined Sept 2010 by Guido Mantega, Brazil’s Finance Minister.
- US, ECB, IMF, Brazil and India all call for a stronger RMB.
- Currency Manipulation Bill Sept 2010 majority 348-79; difficult to prove in WTO (2007 Swiss surplus with depreciating currency – Ireland opposite); copy-cat legislation in other countries; and full-scale global trade war?
- QEs depress greenback and RMB (indirect link) – other exporting countries beggar-thy-neighbour interventions to avoid own currencies’ relative appreciation (Japan, Brazil, Korea etc).
- China’s riposte –
  - Unfair for RMB to appreciate while QEs depress value of reserve currencies;
  - Unlikely to help exports and jobs as cheap goods from other EMs handy substitute;
  - RMB already appreciated 55% since last reform 1994 but like post-1985 Plaza Accord yen appreciation didn’t help US exports or reduced US imports;
  - Net exports only 8% of China’s GDP – many high-value import components – so much higher appreciation required.
  - Geithner - inflation-adjusted RMB appreciated by 10% a year.
  - ‘China Price’ profit margins - catastrophic job losses, factory closures and social instability.
- Real issues: (a) global and domestic imbalance (b) global currency stability (c) trade to be free and fair.
Workings of China’s Currency and Monetary Regime

• **Pre-1978 hermetic exchange control;** RMB 1.86 @dollar for import-substitution.

• After *Open Door Policy*, market-oriented series of devaluations reaching RMB 5.8 @dollar 5 July 1986.

• **Unification on 1.1.1994 of official exchange rate** and an internal settlement/swap market rate - RMB8.28 @dollar.

• **1994 to 2001**, RMB *appreciated @dollar by a total of 18%*, 3 % p.a., without affecting export.

• **21 July, 2005**, fixed RMB-dollar peg switched to *peg to basket of currencies*, mainly dollar, Euro, yen, and won.

• **July 2005 to end 2008**, RMB *appreciated by 21%*, while China’s current account surplus continued to expand rapidly.

• **2009 – June, 2010, before recovery from global financial crisis**, RMB virtually *pegged to the dollar*.

• **June 19, 2010, RMB returned to ‘managed float’** to a basket of currencies with spot exchange rate moving intra-day +/- 0.5 % from a central parity.
The Petersen Institute diagnosis and recommendations

(Morris Goldstein and Nicholas Lardy, The Future of China’s Exchange Rate Policy, Petersen Institute for International Economics, July 2009)

- **2003** China’s current account surplus at 3% GDP, RMB undervaluation estimated at 15-20%.
- **2007** China’s current account surplus reached 11% GDP, undervaluation ‘conservatively’ estimated at 30-40%.

**Undervaluation**

- Inhibits *interest rate* policy - sterilized surpluses suppress rates
- *Suppressed deposit rate* hinders consumption-orientation.
- *Under-priced credit bias* for ‘tradables’ and manufacturing + hinders commercial banking.
- Perpetuating monetary *disequilibrium and external imbalance*.

**Three—stage approach** – to work more closely *with IMF* –

- **During global recession**, avoid competitive devaluation; scrap tax rebates for ‘dirty’ exports; expand transport and utility infrastructure and social provision; allow RMB to appreciate gradually 4-5% p.a.; widen daily fluctuation limits to 1 to 1.5%
- **With global recovery**, RMB to appreciate sufficiently rapidly to eliminate large current account surplus in 3-4 years; reduce exchange intervention and sterilization; dual capital flows to be gradually liberalized; resume interest rate liberalization; explore central bank independence and inflation targeting mandate.
- **When China’s current account surplus has drastically shrunk**, further curtail exchange rate intervention and sterilization; abolish daily exchange fluctuation limits; gear monetary policy towards inflation targeting; substantially liberalize capital flows.
Moot Points

(Debating China’s Exchange Rate Policy, Morris Goldstein and Nicolas Lardy, ed., Petersen Institute for International Economics, 4.2008)

- **Appreciation not necessarily reduces surplus** (Deutsche mark (since 1971) and Japanese yen (since 1977) (Wu Xialing, Deputy Governor, PBOC).
- Trade surplus due less to export than to **falling imports** (Jonathan Anderson, MD UBS Investment Bank); growing **import substitution (rising productivity)** (Fang Gang, Director NERI, China Reform Foundation).
- High savings due more to **corporate savings** (household savings ratio fairly constant); so low deposit rate not main reason for depressed consumption.
- Bias towards ‘tradables’ and heavy industrial sector – ‘steel, machinery, chemicals’ (Productivity rise concentration in tradables - Belassa & Samuelson (1964) Not outcome of under-priced credit but natural course of industrialization and urbanization (MGI – Preparing for China Urban Billion, Feb 2009)? Financial repression a price for cheap labour, land, credit?
- Need to revalue in line with **productivity** but equilibrium a myth in changing world economy + QEs (Fang Gang).
- Need to focus not on just single exchange rate but a **multilateral system of exchange rates** (Simon Johnson, Director, Research Department, IMF) EU now replaced US as China’s largest trading partner. Increasing trade with EMs.
- Exchange rate flexibility not equate to real exchange rate or current account adjustment. Some evidence that less flexibility may lead to faster real exchange rate adjustment (stability + productivity?). De facto $ peg not bad for price stability. (Shang-jin Wei, N.T. Wang Professor of Chinese Business and Economy at Columbia University’s Graduate School of Business).
- Capital inflow promotion may have exaggerated appreciation pressure. Now outflow (ODI) – promoting structural reform package will make exchange rate adjustment more effective (‘Open Economy Trilemma’ - Exchange Rate, Monetary Policy and Capital Mobility, Jin Zhongxia, Chief Rep of the PBoC for the Americas).
- No real consensus on **degree of RMB undervaluation**. ‘Crossing the river by feeling the stones’. (Andrew Crockett, President, JP Morgan Chase).
- **Nobel laureates** R Mundell + J Stiglitz skeptical about desirability of RMB revaluation.
- **Monetary policy** (or central bank) **total independence unrealistic** in state-capitalism?
- IMF **primary focus is rebalancing China’s economy**, though exchange rate appreciation important (Steven Dunaway, Deputy Director, IMF Asia Pacific Department)
Figure 1  China's trade balance with East Asia, the United States, and the European Union, 1998–2005

billions of US dollars


Figure 2  Breakdown of US trade balance (US statistics), 1998 and 2005

Note: East Asia includes Malaysia, the Philippines, Indonesia, Korea, and Singapore.
Source: People's Bank of China.
IMF 2010 Article IV Consultation Report on China 9 July 2010

- Past two years, China’s current account surplus halved as global demand collapsed. China’s imports of commodities and capital goods continued unabated. As external demand recovers, larger current account surpluses likely to recur.
- RMB real exchange rate back to the late 1990s level despite significantly higher productivity gains. RMB remained substantially undervalued in line with long-term fundamentals.
- China reckoned that the current account surplus would settle at about 4% of GDP as structural reforms, rising wages, and gradual RMB appreciation combine to boost consumption.
- It is arbitrary to judge exchange rate by referencing a particular point when currency may or may not be in equilibrium. RMB more than 50% higher than when unified in 1994 and 22% higher than low point in 2005. Real exchange rate very flexible over past decade, moving significantly in both directions.
- However, RMB real exchange rate was back to level in 1999–2003, with no decisive imbalance in the external accounts. In the interim, cumulative productivity differentials had been substantial.

US Treasury Report to Congress on 5 February 2011

- Without labeling China a currency manipulator, took a tougher line saying the RMB is "substantially undervalued," warning "progress thus far is insufficient and that more rapid progress is needed."

G20 - Not mentioned at G20 Finance Ministers Summit in Paris 20 February, at G20 in Nanjing 31 March, RMB criticized as artificially low to boost exports. Carrot of including RMB in the IMF’s SDR if China achieved flexible exchange rate systems, independent central bank and free movement of capital flows.
China’s Approach

• Only partially in line with the Petersen Institute recipe

• 12th Five Year Plan (2011-15) re-balancing - balanced and sustainable development, equality, social justice, social re-distribution including education, healthcare, welfare and wage increases, technological upgrading, innovation, ecological conservation, renewable energies, agricultural productivity, regional balance, and domestic consumption. GDP target of 7% p.a. (7.5% in the 11th FYP).

• Slower growth + accelerated ODI should reduce surplus.

• To promote consumption, RMB likely to continue to appreciate gradually e.g. a few percentage points a year, pace and extent adjusted in the light of changing circumstances

• China’s inflation rate of 5.4% April 2011 exceeds average of 4.6% over past 2 decades. To control inflation, monetary policy stance from ‘moderately loose’ to ‘prudent’ plus a flexible arsenal of monetary, fiscal and administrative measures - banking capital reserve requirements, interest rate hikes, loan quotas, credit tightening, mortgage down-payment requirements, restrictions against second or third homes, possible capital gains tax

• No rigid inflation targeting to avoid inflexibility for an economy still in transition. Inflation-targeting subject to much debate after global financial crisis especially in the EU.
Economy more than economics

(Classical consensus – for market economy to mature, necessary to achieve full convertibility in capital account to enable currency to become international. Tendency to subsume currency internationalization under convertibility. For a rising China with challenges on all fronts, ‘Economy too serious to be left entirely to economists’ – Clemenceau


Since 1944, the dollar has lost 97% of value against gold. Following continuing bouts of QEs, 13 March, 2009, Premier Wen Jiabao openly worried about China’s $1 trillion in US Treasuries. To some in China, US monetary policy a central pillar of US ‘economic hegemony’ and floating rate as ‘a mechanism for plunder.’

Exchange rate very heart of China’s economy, which underpins political survival. Hence suspicion that it is a myth of quantitative economics to believe that exchange rates are beyond country’s control, to be fixed through the market in response to some rational criteria.

(Redbacks for Greenbacks: The Internationalization of the Renminbi, Francois Godement et al., China Analysis, European Council on Foreign Relations and Asia Centre, November 2010)
Internationalizing the RMB

Escape route out of the Dollar Trap

- RMB increasingly promoted for *international settlements*. China becoming largest trading partners worldwide. ASEAN-plus-3, the world’s largest trade bloc by population.
- 5 measures to *boost cross-border trade* (Xinhua, BJ, 25.9.10) - (a) 20 provinces + all nations (b) marketization of interest rates (c) commercial banks to offer RMB trade and project finance overseas (d) RMB exchange rate mechanism for small currencies (e) HK RMB offshore market
- Issuing more *RMB-denominated bonds*, using Hong Kong as a launching pad
- *Exporting capital*, acquiring foreign assets and resources + joint-ventures and partnerships, letting off some steam on RMB

To create a de facto RMB global -currency space

- Increases international *mobility of RMB capital and investments*.
- *Reduces vulnerability* of China’s reserves
- Mitigates *dollar fluctuations*
- Counterweighs power of *Western financial centres*
- Creates *revenue from RMB transactions*
- But undue haste *risks* unstable capital flows v financial system reform

‘Nature moistens quietly’ (*runwu xi wusheng* 润物细无声), *Chen Daofu*, Director of Institute of Financial Studies, Centre for Development Studies, PRC State Council. ‘*Internationalization by stealth* ‘political realities’ -*Francois Godement*

Likely to take longer than you think

- *Internationalization likely to take 15-20 yrs* (x=full convertibility) -*Dai Xianglong*, ex-PBoC Governor and Chairman of National Social Security Fund, 2 April 2011)
Global Currency Security

Capital Account Convertibility

- **Global Financial Crisis** Non-convertibility helped *insulation*

- **Asian Financial Crisis** Steadfast non-devaluation helped stabilization.

- **Stability and independent control - key imperatives** against growing global uncertainties – QEs, ME turmoil, Japanese nuclear implosion, energy and resources scarcity, climate change, European sovereign debt, currency security, fragile global markets, rising middle-class aspirations, at critical stage of growth with more equitable society

  - Before euro, *Germany able to internationalize deutschmark without entirely giving up control* over capital movements and without switching completely to a floating exchange rate.

  - So likely to move with measured pace *(‘feeling the stones’)*

World Reserve Currency System

- **IMF SDR - Zhou Xiaochuan**, PBOC Governor, 23 March, 2009

- ‘**Triffin Dilemma**’ – 1960s Belgian-American economist Robert Triffin - Reserve currency-issuing countries suffer large trade deficits to supply enough currency for foreign exchange reserves. *Conflict of interest* plus *tension* between national monetary policy imperatives of reserve currency issuer and what is best for global currency stability.

  - *No substitute yet for dollar.* SDR idea to await traction post-Nanjing G20.

  - Dollar *as long term storage of value increasingly called into question* by surplus and energy-rich countries after financial crisis and Qes.

  - **RMB international acceptability gathering** pace, supported by gigantic currency reserve (now $3T) and status as 2nd largest economy

  - **Ding Zhijie**, Co-director, College of Finance, Chinese U of Economics and Foreign Trade, - *Article 8 of IMF to be amended* for membership on condition of current, and not capital accounts, convertibility.
Addressing Imbalances

Systemic imbalances

- **Asian surpluses** feeding *West’s unbridled consumption*. Pushed Asian exports + surpluses, more invested in US Treasuries to fund more debt-driven consumption.
- **West over-consuming while China and other surplus countries over-saving.**
- **Whole pack of cards collapsed** from the financial crisis, rather than curbing consumption (which would have worsened the economic downturn), the West **tried to jump-start it with massive dose of liquidity**. The outcome not very reassuring.
- The West wants China to import more, but what China wants (technologies) the West not always wants to sell and what the West can sell is not always competitive.

China re-balancing

  - Partial reimbursement (about 30%) of healthcare costs registered 20-fold increase by 2007, covering 730 million people, quadruple 2005;
  - Health insurance extended the coverage to 90% of population by 2011.
  (Government pays half or more costs, up from 16% in 2001)
  - Old Age Pensions for retirees averaged RMB 1,173 January 2009 (> national average wage but still below urban wage)
  - Minimum living standard guarantee program – boosting monthly payments from RMB50 in 2002 to RMB140 by 2008.
- **Income tax threshold raised** from $305 to $460 p.m. v minimum wage $178
- **New 12th FYP (2011-15)** set to diminish current account surplus and foreign currency reserve, and permit gradual RMB appreciation (to grow Middle-Class).
- China’s **financial system expected to open further, as will her interest rate regime**.
- Outward and inward investments further liberalized - QDII and QFII schemes
- Monetary policy highly flexible against inflation, asset bubbles and external shocks.
- RMB increasingly accepted for international settlements, enhancing its status
- To promote RMB as international currency, but to remain extremely cautious in not giving up too soon financial protection of a non-convertible capital account.
Thank you

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