

“China’s Exchange Rate Regime”

by  
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Committee on Financial Services  
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Mr. Chairman, thank you for the opportunity to testify before this committee on the important issue of China's exchange rate regime and its effects on the U.S. economy. My IIE colleague, Nicholas Lardy, and I have recently been analyzing China's currency regime and this afternoon, I would like to share with the committee five of our main conclusions.<sup>1</sup>

First, so long as China maintains controls on capital outflows, runs surpluses on both the overall current and capital accounts in its balance of payments, and accumulates international reserves in large amounts, there is a compelling case that the Chinese currency, the renminbi (RMB), is significantly under-valued. Our preliminary estimates suggest that the under-valuation of the RMB is on the order of 15-25 percent. These estimates of RMB misalignment can be obtained either by solving a trade model for the appreciation of the RMB that would produce equilibrium in China's overall balance of payments, or by gauging the appreciation of the RMB that would make a fair contribution to the reduction in global payment imbalances, especially the reduction of the U.S. current-account deficit to a more "sustainable" level. Both approaches produce similar answers.

Those who argue that the under-valuation of the RMB is much larger – 30-40 percent or more – often confuse China's large bilateral trade surplus vis-a-vis the United States (\$100 billion in 2002) with its much smaller overall current-account surplus (\$35 billion). Adjusting for the overheating of the economy and other factors, China's "underlying" current account surplus in the first half of this year was probably about 2 ½ or 3 percent

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<sup>1</sup> In drafting this testimony, I have drawn heavily on two recent op-eds done jointly with Nicholas Lardy: (i) "A Modest Proposal for China's Renminbi," Financial Times, August 26, 2003; and (ii) "Two Stage Currency Reform for China," Asian Wall Street Journal, September 12, 2003. I have attached the latter as an appendix to this testimony.

of GDP. Equally relevant, China's surplus on foreign direct investment (4 percent of GDP on average during the 1999-2002 period) has been considerably larger than the surplus on the overall capital account (1 ½ percent of GDP). It is the overall current and capital-account positions that matter for judging the extent of exchange rate misalignment – not bilateral trade balances or components of the current and capital accounts. In a similar vein, those who conclude that the degree of under-valuation of the RMB is small – 10 percent or less – often ignore the fact that China makes extensive use of imported inputs to produce exports. China's role as a regional processing center means that it takes a larger revaluation to change the trade balance in China than it does in economies where imported inputs figure less prominently in exports. Admittedly, when China does decide to liberalize significantly capital outflows, it won't take a huge degree of international diversification of household savings deposits to put strong downward pressure on the RMB – but that doesn't alter the conclusion that right now the RMB is under-valued.

Second, a revaluation of the RMB is in China's own interest as well as in the interest of the global economy. If China does not revalue the RMB, net capital inflows and the large accumulation of international reserves (about \$135 billion over the past 18 months alone) will continue. With its mountain of bad loans, China should not permit capital inflows and reserve accumulation to exacerbate the already excessive expansion in bank lending, money supply growth, and investment. In the first half of 2003, the increase in bank loans outstanding relative to GDP rose to 38 percent– an all time high, while the investment share of GDP rose to 42 percent – also an all time high. Although the process of “sterilizing” the effects of reserve increases on the base money supply has so far been less onerous in China than in many other emerging economies, experience shows

that sterilization typically becomes more costly and less effective the larger it is and the longer it goes on. The primary domestic risk of an undervalued exchange rate is that it will handicap China's efforts to rein-in the pace of credit expansion and to improve the quality of bank lending decisions.

An appreciation of the RMB is likewise in the interest of the United States and the wider global community. Unless China permits the value of its currency to rise, it will be much more difficult to obtain the broader realignment of key exchange rates in Asia and elsewhere needed to produce a marked correction in global payments imbalances. The uncomfortable truth is that the U.S. current-account deficit (projected to be about \$550 billion this year) is much too large, that a further decline in the broad trade-weighted value of the dollar is necessary to reduce our deficit to a more sustainable level (say, \$300 billion or so), and that a rise in the value of the RMB is an important catalyst for achieving both a broader-based decline in the dollar and a better global "sharing" of the adjustment burden.

Third, urging China to adopt a flexible exchange rate regime and to open its capital markets – as U.S. Treasury Secretary Snow and others have suggested – is sensible advice for the longer term. But that advice is not appropriate for China's current circumstances – especially its weak banking system, and therefore is not likely to be heeded anytime soon, providing little relief for current exchange rate and payments problems. China is justifiably concerned that if it floated the exchange rate and opened its capital markets today, the weakness of the domestic financial system could generate large-scale capital flight and sharp currency depreciation in response to bad news. In addition, the government still dominates foreign-exchange transactions to a degree that

precludes the market functioning properly. These obstacles should recede over time but they are binding at present.

A more practical approach is to urge China to reform its currency regime in two steps. In the first step, China would immediately revalue the RMB by 15 to 25 percent, it would widen the currency band (to between 5-7 percent, from less than 1 percent), and it would switch from a unitary peg to the dollar to a three-currency basket peg (with roughly-equal weights for the dollar, the euro, and the yen). This would remove the incentive for further speculative capital inflows and reserve accumulation. No longer would the foreign component of the money supply be working at cross-purposes with the needs of domestic stabilization. A three-currency basket would increase the stability of China's overall trade-weighted exchange rate, and the basket would also permit the U.S. dollar to depreciate further against the RMB without a series of RMB parity changes. This can't happen if China retains its present unitary peg to the dollar; instead, the RMB would follow the dollar down, much as it has done since early 2002. Step two should be adoption of a managed float, after China takes further reforms to put the domestic financial sector on a sound enough footing to permit significant liberalization of capital outflows. A managed float is the preferred long-run regime because capital mobility in and out of China will increase over time (making a publicly-announced exchange rate target more vulnerable), and because China will want to exercise greater monetary policy independence for stabilization purposes.

The advantage of this two-step approach is that it neither asks the rest of the world to live too long with a misaligned RMB, nor does it ask China to ignore a key lesson of the Asian financial crisis by prematurely opening its capital account. The key to reconciling

China's desire for exchange rate stability with the need for the RMB to play its proper role in global balance-of-payments adjustment is to recognize that a fixed rate for the RMB need not be at the present parity, that "stability" of China's currency should be viewed against a wider set of reserve currencies than the U.S. dollar alone, and that the transition from "fix" to "flex" for the RMB need not occur all at once, since liberalization of China's capital account will almost surely proceed in stages.

Fourth, the United States should take a multilateral tack in persuading China to alter its exchange rate policy and should eschew unilateral trade measures directed against China's exports. Other countries – including members of the European Union and many emerging economies in Asia – also have a strong interest in seeing the RMB rise closer to the level implied by fundamentals. If China resists a rise in the RMB, too much of global exchange rate adjustment will fall, for example, on the euro, exacerbating Europe's anemic growth performance. Conversely, if China does allow the RMB to rise, its emerging-market neighbors would be able to more easily accommodate a rise in their own currencies since then, the loss of competitiveness would be smaller than if each acted alone. The U.S. Treasury should therefore continue to enlist the support of other countries in convincing the Chinese authorities that a more appreciated exchange rate for the RMB is in the common interest. Recall that China received plaudits during the Asian financial crisis for conducting a responsible exchange rate policy and for taking the interest of the region as a whole into account. At that time, China allowed the RMB to appreciate on a trade-weighted basis. China now has another opportunity to demonstrate responsible leadership.

As the institution charged with overseeing the international monetary system and with exercising “firm surveillance” over the exchange rate policies of its member countries, the IMF should take a more activist stance in monitoring exchange rate misalignments and in applying a mix of persuasion and pressure –both private and public --to reduce the duration of such misalignments. It is not useful to identify large-scale, prolonged, exchange market intervention in one direction, and behavior of the exchange rate inconsistent with underlying fundamentals, as implicit pointers of a “wrong” exchange rate and then do little when these pointers signal a problem. In this connection, it is regrettable that the Fund has very rarely made use of a provision to hold (or even discuss holding) special consultations with countries that are undergoing exchange rate problems. Endorsing a vague G-7 call for more exchange rate “flexibility” is not exercising “firm surveillance.”

Multilateral does not mean everybody but the United States. The United States also needs to do its part to contribute to global adjustment by improving our savings-investment balance, and in particular, by adopting a workable plan to reverse the now-projected long string of U.S. budget deficits. If we want other countries to act in a cooperative way on exchange rate policy and in implementing macroeconomic policies to promote growth, we too must be willing to put something positive into the package.

What the United States should not do is impose a unilateral import surcharge on China’s exports. This would be both misguided and ineffective. As suggested above, bilateral trade imbalances are a bad indicator of overall payments imbalances. China is not the only country to have used -- or now using -- prolonged, large-scale, uni-directional exchange market intervention to maintain an undervalued exchange rate.

China's imports more than quintupled between 1995 and 2002 and its import ratio (to GDP) now stands at a level three times higher than Japan and twice as high as in the United States. An import surcharge directed exclusively at China's exports might well invite retaliation against U.S. exports to China and could risk a wider upsurge in protectionism when the opposite is needed to support global growth. Note too that much of China's exports to the United States compete primarily with exports from other emerging economies – and not so much with U.S. domestic producers. An improvement in U.S. competitiveness calls for a broad-based decline in the value of the dollar (among other measures) – not for a tax on one side of one developing-country's foreign trade.

Fifth, the impact of a medium-size revaluation of the RMB on the external accounts of the United States should not be exaggerated. Even if China did revalue the RMB by say, 20 percent, and even if other Asian emerging economies and Japan followed China's lead by allowing their currencies to appreciate by say, half that amount, the trade-weighted value of the dollar would only decline by roughly 5 percent. This in turn might produce an improvement in the U.S. current account on the order of \$50 billion dollars; to reduce the U.S. current-account deficit by say, almost half (\$250 billion), would require a much larger and more broadly-based further depreciation of the dollar (in the neighborhood of 25 percent on a trade-weighted basis). The long-running decline in U.S. manufacturing employment started well before the Chinese currency became undervalued and has a much wider set of origins (including rapid productivity growth) than exchange rate factors. Given that the political campaign leading up to our presidential elections is now in full swing, it is perhaps not surprising that the China exchange rate issue has taken on increased visibility. But overblown expectations are apt to produce disappointment. An



appreciation of the RMB will be helpful but not sufficient for reducing concerns about U.S. external imbalances and their effects.

To sum up, as one of the four largest trading countries in the world, it is important that China take seriously its obligation (under IMF rules) to avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other countries. There is also a powerful domestic reason for seeking an early end to the existing medium-size under-valuation of the RMB: exchange rate under-valuation will increasingly handicap China's efforts to achieve and maintain long-term financial stability – to say nothing of potential protectionist threats against its exports. By adopting a two-stage reform of its currency regime, China can become part of the solution to the unsatisfactory global pattern of payments imbalances – not part of the problem. The currency regime that served China well over most of the last decade is not the currency regime that will serve China best today or in the future. If the United States wants to persuade China to reduce the serious under-valuation of the RMB, it should drop its doctrinaire insistence that China move in one great leap forward to a free float and to completely open capital markets in favor of a currency and capital market regime that China could actually adopt now with good effect and that could contribute now to reducing serious global imbalances. I believe the Goldstein-Lardy proposal for a two-step currency reform passes that test. The United States can push the ball forward by working in a multilateral fashion with other concerned countries to convince the Chinese authorities that RMB revaluation is seen as a legitimate remedy for a widely perceived imbalance, by refraining from unilateral protectionist measures, and by demonstrating a readiness to address its own longer-term saving-investment imbalance in the public

sector. It's also long past time for the IMF to do more seriously one of the things it was created for –namely, to monitor the agreed international “rules of the game” on exchange rate policy, to provide objective assessments of exchange rate misalignments for important currencies, and yes, to help mobilize some pressure on countries that resist correction of under-valued or over-valued exchange rates. With some compromise by all parties and with the right sequencing of China's currency reform, a workable solution can be achieved.

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September 12, 2003

COMMENTARY

## Two-Stage Currency Reform For China

By MORRIS GOLDSTEIN and NICHOLAS LARDY

It was the unstoppable force meeting the immovable object. During his recent visit to Beijing, U.S. Treasury Secretary John Snow stated that his objective was to get China to commit to moving to a "free-floating" currency, while senior Chinese officials stressed the contribution that a "stable" yuan had made to economic stability and development in China, Asia and the world. How then to square the circle that seems to call for three objectives: a near-term revaluation of the yuan, greater stability of the yuan in the medium term and greater flexibility and market determination of the yuan a little later down the road?

Most proposals for Chinese currency reform fall prey to one of two problems. If revaluation of the yuan has to wait until China is willing to undertake full capital-account liberalization, then the rest of the world has to live for too long with a misaligned yuan. Alternatively, if China is asked to free float the yuan and adopt capital-account convertibility before it puts its domestic financial sector on a firmer footing, it would be casting aside one of the main lessons of the Asian financial crisis.

Our answer to this dilemma is that China should view reform of its currency regime as a two-step process. The first step should be a medium-size (15% to 25%) revaluation of the yuan, a widening of the currency band (to between 5% and 7%, from less than 1%), and a switch from a unitary peg with the dollar to a three-currency basket peg, with weightings of roughly a third each for the dollar, euro and yen. Step two should be adoption of a managed float, after China strengthens its domestic financial system enough to permit a significant liberalization of capital outflows.

The Chinese leadership implicitly recognizes the yuan is undervalued. But they apparently believe the disequilibrium in the foreign-exchange market can be ameliorated by selective liberalization of current- and capital-account transactions while leaving unchanged the current fixed parity with the dollar.

The authorities recently increased the amount of yuan that Chinese tourists can convert to

foreign currency and began to allow Chinese firms with certain types of foreign-exchange earnings to retain them rather than surrender them to the central bank. They have given the green light for a state-owned bank to issue its first dollar-denominated bond on the domestic market and have already signaled that requests for outward foreign direct investment are now more likely to be approved.

They are also discussing a reduction in the value-added tax export rebate rate to 11%, down from its current level of 15%. And they may allow mainland residents and certain financial institutions to purchase limited amounts of foreign securities. The authorities hope that these steps will either increase demand for, or reduce supply of foreign exchange, thus relieving the upward pressure on the currency.

While the go-slow approach presumably appeals to the leadership because of its limited short-run effect on China's exports, incoming FDI, and trade-related jobs, it is likely to do little to remove the misalignment of the yuan that has pushed China's overall balance of payments into a larger surplus, fed a huge reserve accumulation over the past 18 months, and increasingly concerned many of China's trading partners, including the United States, Euroland, Japan and South Korea. Very small adjustments could simply stoke further capital inflows by persuading market participants that speculation on the yuan is a one-way bet. Although the low interest rates paid on domestic central bank bonds has meant that sterilization of international reserves has so far been less onerous in China than in many other emerging economies, experience shows that sterilization becomes more costly and less effective the larger it is and the longer it goes on.

With its mountain of bad loans, China cannot afford to let capital inflows exacerbate the already excessive expansion in bank lending, money-supply growth and investment. The recently announced increase in reserve requirements for banks indicates that overextension of the financial system is now clearly visible on the central bank's radar screen.

In contrast, consider the advantages of our proposal for a medium-size revaluation. This would immediately deal with the existing undervaluation of the yuan and remove the incentive for further speculative capital inflows and reserve accumulation. No longer would the foreign component of the money supply be working at cross-purposes with the needs of domestic stabilization. It would show trading partners that China is not attempting to manipulate its exchange rate, thereby lessening the threat of protectionist measures against China's exports. It would make the yuan part of the solution to the global pattern of payment imbalances -- not part of the problem.

In doing so, it would add to the plaudits that China received during the Asian financial crisis for conducting a responsible exchange rate policy and for taking the wider interest of the region into account. It would also increase the odds that Japan and emerging economies elsewhere in Asia would be willing to allow their exchange rates to appreciate, reducing the burden on the euro contributing to the needed downward adjustment of the dollar and limiting the deterioration in China's competitiveness. By adopting a wider band, China would gain valuable experience in allowing the exchange

rate to be more responsive to market forces.

Just as important, by moving to a three-currency basket peg, China would increase the stability of its overall trade-weighted exchange rate. In a context where the dollar needs to depreciate further to help reduce the unsustainable U.S. current-account deficit, a basket peg would permit the dollar to depreciate against the yuan without a series of yuan parity changes. That could not happen if China retains its present unitary peg to the dollar.

The key to reconciling China's desire for exchange-rate stability with the need for the yuan to play its proper role in global balance of payments adjustment is to recognize that a fixed rate for the yuan need not be at the present parity. Stability of China's exchange rate should be interpreted against a wider set of reserve currencies than the dollar alone. The transition from "fix" to "flex" need not occur in one fell swoop, since liberalization of the capital account will proceed in stages.

Looking farther down the road, China will find it in its interest to move to a regime of managed floating because capital mobility in and out of China will increase and because it will want to exercise greater monetary-policy independence for stabilization purposes. It would be unwise to float now because the domestic financial system is still far too fragile to rule out large-scale capital flight in response to bad news. In addition, the government still dominates foreign-exchange transactions to a degree that precludes the market functioning properly. But these obstacles to floating the exchange rate should lessen as China reduces its large stock of nonperforming loans in the banking system, government involvement in the credit-allocation process declines in favor of market forces, and the progressive dismantling of restrictions on international capital flows widens and deepens the scope and liquidity of foreign-exchange trading.

As a host of emerging-market crises of the past decade have demonstrated so dramatically, high capital mobility vastly increases the vulnerability of a publicly announced target for the exchange rate. With China's public debt burden rising under the weight of bank recapitalization and assumption of pension liabilities, fiscal pump priming will be more constrained and monetary policy is likely to take on an increased share of stabilization duties. Thus China will want to increase the flexibility of its exchange rate regime.

But this need not mean slavish adherence to a pure float. If and when market forces push the yuan beyond the levels consistent with its economic fundamentals, China, like other countries, should retain the option to manage the float by intervening in the exchange market -- so long as that intervention is not prolonged and not just in one direction. In short, a managed float should be the preferred regime choice for the second stage of reform.

The currency regime that has served China well in the past is not the currency regime that will serve China best today or in the future. Likewise, if the U.S. wants to persuade China to reduce the serious undervaluation of the yuan and to play a larger role in the global

adjustment process within the next year or so, it too will have to alter its opening negotiating position by dropping the suggestion that China move in one great leap forward to a free float and completely open its capital markets. With some compromise by all parties and with the right sequencing of China's currency reform, a workable solution is in sight.

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