CHINA'S EMERGING FINANCIAL MARKETS

CHALLENGES AND OPPORTUNITIES

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The RMB Debate and International Influences on China's Money and Financial Markets*

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Abstract Section 2 explores a number of aspects of the debate about China's exchange rate policy. The focus is not to recommend specific policies but to expose a number of false arguments that have been made in the debate in order to separate out the serious considerations on which discussions should be based. While we argue that the adoption of a floating rate is not a panacea, we suggest that exchange rate adjustments can play a productive role as part of a coordinated policy strategy.

Section 3 deals with the effects of the large payments surpluses and international capital flows on China. We find that the People's Bank of China (PBOC) has been able to successfully sterilize most of the effects of the payments surpluses on the domestic money supply so that these have not been a major cause of inflation. Speculation on currency appreciation has not been as disruptive as some expected, and international capital flows have not been a major cause of the rise and fall of China's stock market. Thus, while China has become a major force in the global economy, it has managed to maintain considerable domestic monetary and financial autonomy.

Keywords Exchange rate policy · International reserves · Capital flows · Money supply · Stock market · Inflation

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1 Introduction

In Section 2, we offer a perspective on the recent debates over revaluation of the RMB. Few issues in economics have generated as much controversy and conflicting arguments as the recent debates about whether there should be a substantial appreciation of China's RMB and whether the failure of this to occur has been a major cause of worrisome global imbalances. The Chinese government's recent policy of small gradual appreciations against the dollar has done little to reduce the debate on this subject and, if anything, pressures in the US Congress to take retaliatory actions have increased.

Far too often commentators on these subjects have engaged in delivering debating points rather than balanced assessments. The forcefulness with which various points are often argued distorts the complex nature of these issues and the uncertainties about some of the key empirical parameters involved. Sadly arguments sometimes even fail to follow the rules of simple logic.

A balanced analysis suggests that both China and the United States have contributed importantly to global imbalances. China's currency remains substantially undervalued and further appreciation is in the longer-run interests of both China and the rest of the world. Short-run and special interests provide major obstacles to needed adjustments, however. Exchange rate adjustments alone will not be sufficient to restore global balance, but they are an important part of the lowest-cost policy mix for doing so.

One of the major arguments that substantial revaluation is in China's own interest is the potential disruption that continuing large surpluses generate for the domestic economy. In Section 3, we analyze key aspects of such concerns. Relevant here are both the direct effects of international capital flows on domestic financial markets and the potential indirect effects of reserve inflows on excessive expansion of the money supply and credit if these inflows are not effectively sterilized. We find that to date international capital flows have not played a major role in the fluctuations in the Chinese stock markets nor have they been a major cause of domestic money and credit expansion, i.e., the PBOC has been able to effectively sterilize the large majority of these inflows. We also find that contrary to expectations, hot money flows based on expectations of RMB appreciation have not been highly disruptive.[1] These findings help explain why the Chinese government has continued to strongly limit RMB appreciation. We caution, however, that sterilization is becoming increasingly difficult, and financial liberalization is contributing to an increase in China's financial interdependence with the global economy. Thus past success in managing the limited appreciation of the RMB is no assurance of continued success.

[1] Studies have, however, found that exchange rate expectations affect the price differentials of Chinese stocks denominated in different currencies. See, for example, Burdekin (2008).

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2 Sense and Nonsense in the RMB Debate

In this section, we analyze some of the key aspects of this debate, with an eye to highlighting questionable and false statements in order to help clarify the issues. The arguments we analyze are not always stated in the recent debates as starkly as they are summarized below, but this presentation is most definitely not just attacking a group of straw men. Sometimes the non sequiturs are implied rather than explicitly stated. To illustrate the nature of these non sequiturs the general format will be to begin with a true (or at least likely true) statement, followed by a false inference often made from the first statement. Some of the latter statements may in fact turn out to be true but are not valid conclusions in the sense that they logically follow from the previous premises. Each true and false statement is then followed by explanatory comments.

1. ***True*:** Much of the pressure coming from the US Congress for China to revalue or have a large tax be placed on US imports from China is based on protectionist motives and/or shaky economics.

***False*:** Therefore, China should not revalue.

Comment: This is a classic non sequitur. Showing that a particular argument against a proposition is false does not logically imply that the proposition is therefore true. The same holds with respect to arguments that the current China-US imbalance is all the fault of the United States. The policies of both countries have clearly contributed to the problem, and just blaming each other is not helpful (except for domestic political consumption). Clearly a solution requires action by both countries (and others as well).

2. ***True*:** The huge US trade deficit cannot all be blamed on China.

***False*:** Therefore, China should not need to adjust its exchange rate.

Comment: This is another non sequitur. Adjustments by China, the US, and a number of other countries are all needed if global imbalances are to be reduced to safe levels.

3. ***True*:** Exchange rate adjustments alone will not correct the imbalance.

***False*:** Therefore there is no point in adjusting exchange rates.

Comment: This is a third common non sequitur. Just because a change in the exchange rate cannot do everything it does not mean that it cannot help. The theory of economic policy shows that in general we need as many policy instruments as we have policy objectives. Both China and the United States today have internal as well as external imbalances. China has insufficient domestic spending relative to its savings, while the United States is in just the reverse position. Combining domestic policy adjustments with changes in exchange rates will allow these multiple imbalances to be reduced at lower costs than if fewer policies were used.

4. ***True*:** In monetary models, exchange rate changes will have only very temporary effects at most.

False: Therefore China should not alter its exchange rate.

Comment: The monetary model gives us many insights, but it also leaves out important considerations. The monetary model correctly shows that exchange rate changes cannot be used to create permanent disequilibrium, but the role of exchange rate adjustments is to remove disequilibrium or keep it from emerging, not create permanent disequilibrium. Economists such as McKinnon (2003, 2004), who draw heavily on the monetary model but argue that China should not undertake a major revaluation sometimes forget to point out that where a country is running a large surplus, the longer run alternative to revaluation in the monetary model is higher inflation. Contrary to the standard assumptions of the monetary model, China has been largely successful so far in keeping its surplus from substantially increasing domestic inflation. Most economists think that this has been a wise choice, but it cannot be continued indefinitely. Thus to many economists, a major argument for greater appreciation is a way to avoid high inflation.

5. ***True***: The recent large US deficits have been a major stimulant to global demand and economic growth.

Questionable: Therefore they have been good for the world.

False: And therefore there is no reason to try to reduce them.

Comment: There is no question that the US deficits have been an important engine of global growth in recent years. In many ways the short-run effects have been favorable for the US and the world. But these short-run benefits are coming at the cost of future problems. It is like someone on a spending spree using borrowed money. It is fun while it lasts, but it will eventually have to come to an end, and when it does, it will be painful.

Current account deficits of the size the US has been running are not sustainable in the judgments of the vast majority of international monetary experts. The question is how the necessary adjustments will eventually be made. The longer they are postponed, the more likely is a major crisis, and the more painful and perhaps even destructive will be the final adjustments. The US needs to start bringing its excessive spending under control and countries that have been running large current account surpluses need to begin relying more on domestic stimulants to growth.

6. ***True***: Even though it is quite large in absolute size, the US current account is not a high proportion of total world savings.

False: Therefore, we do not need to worry about continued international financing of large US deficits.

Comment: Only a proportion of global savings are effectively mobile internationally, and we cannot confidently estimate how large this proportion is. Thus we do not know how large a US current account deficit would be sustainable over the medium term. A frequently used guess is that a deficit of 2 to 3% of US GDP would be sustainable, while the current deficit is on the order of 6%.[2]

[2] For a more optimistic view of the sustainable size of capital inflows and hence US current account deficits see Cooper (2005).

Views vary considerably about the medium-term sustainability of capital inflows. There is strong evidence that international financial flows do not typically behave like either the farsighted fully efficient markets so popular in economic models or the wild irrationality frequently asserted by market critics. Experience does suggest that market attitudes can change swiftly, as evidenced by the frequency of sudden stops in capital flows to emerging markets. Thus it is not safe to assume that because financing for the US current account deficits has been easily forthcoming so far, we can count on their continuing for the indefinite future.[3]

7. ***True***: Economists' models do not agree on how much the RMB is undervalued.

False: Therefore it does not make sense to revalue the RMB.

Comment: Estimates of the amount of RMB undervaluation, given current policies, does vary by a huge amount – from almost zero to as much as 60%. An extremely useful illustration of our inability to precisely estimate the equilibrium value of the RMB has recently been provided by Cheung et al. (2007).

Their one standard deviation confidence bounds for their estimates are around 50% of the current value of the RMB, and the two standard deviation ranges are almost 100%, including possible undervaluation. Other types of models will give different point estimates and confidence bounds, but we clearly should not put much faith in any point estimates of the degree of RMB undervaluation.[4]

This does make official management a great deal harder, but is not a valid argument against the need for substantial further revaluation. Simple measures of equilibrium exchange rates such as calculations of purchasing power parity can be way off the mark both because of problems with price indices and changes in equilibrium real exchange rates. The strongest evidence of substantial overvaluation or undervaluation is a sustained surplus or deficit in the balance of payments. Through 2003 or so it was possible to argue that China's surplus was not a fundamental disequilibrium, since it was due largely to capital inflows that could be judged to be based only on short-term speculation that would later reverse. The continued evolution of China's balance of payments, detailed in the following section, makes this argument no longer credible.

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[3] A number of useful papers on global imbalances were presented at the following conferences: "Revived Bretton Woods System: A New Paradigm for Asian Development?" held at the Federal Reserve Bank of San Francisco on February 4, 2005, under the joint sponsorship of the Bank's Center for Pacific Basin Studies and the University of California at Berkeley's Clausen Center for International Economics (details available at http://www.frbsf.org/economics/conferences/0502/); and "Global Imbalances and Asian Financial Markets" held at University of California, Berkeley, September 29–30, 2005. (details available at http://elsa.berkeley.edu/users/eichengr/af/agenda.html).

[4] For a valuable review of recent studies and their methodologies see Cline and Williamson (2008).