The Renminbi and the Global Economy

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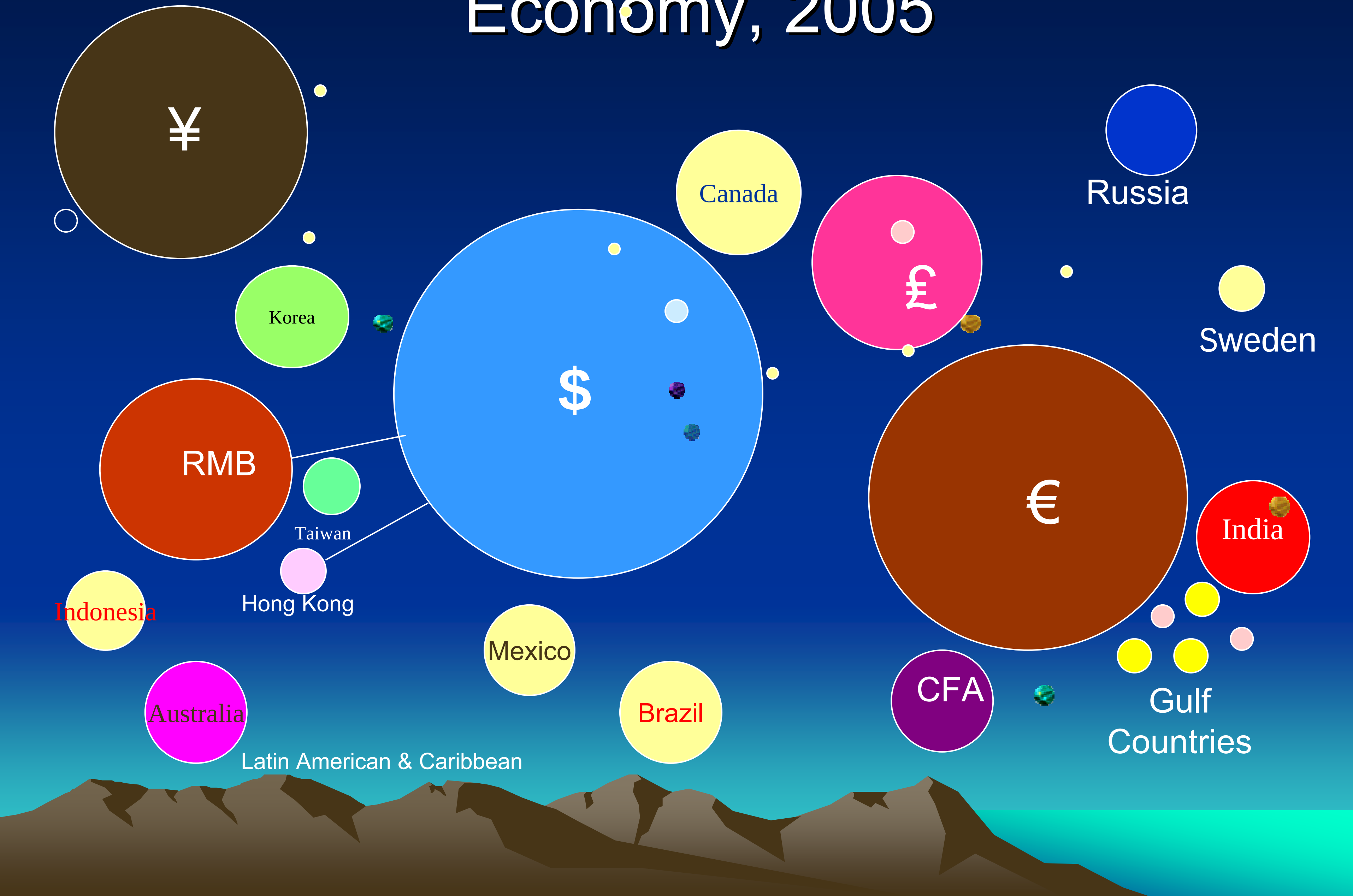
Topics

- Rise of China
- Macroeconomic Condition
- RMB Issue
- Recommendations

RMB Currency Area in the World Economy, 2005



What Started it?

- In 2002 Vice-Minister Haruhiko Kuroda of Japan argued that China was exporting deflation and that China should revalue the RMB.
- At G-7 Meeting in Paris 2003, the Japanese Minister of Finance presented this argument to his G-7 colleagues.

Deflation Idea Refuted

- The deflation argument was false and didn’t get anywhere. The U.S. and Europe have mild inflation, not deflation.
- Japan has a flexible exchange rate and makes its own deflation by the monetary policies of the Bank of Japan.
- The G-7 colleagues did not agree with Japan’s argument, and later statistical studies showed it to be without foundation.

China’s Critics

- China’s competitive shock is a real phenomenon.
- It is not a monetary issue, and cannot be addressed by monetary measures.
- The exchange rate is a monetary phenomenon and is not the appropriate instrument to deal with what is really a competitive shock.

Real Issue is Competitive Shock

- The real issue was not deflation, but China's competitive shock.

- China possesses comparative advantages that is requiring a redistribution of world production.

Classical Economics

- Classical theory asserted that the world would gain from new growth in one country.
- This is because the new country would sell products more cheaply, improving the terms of trade of the rest of the world.
- This theorem however is true only in a special case.

Growth in Import Sector

- If the expansion in the growing country takes place in the import-competing goods industry, the terms of trade and the rest of the world is worsened.
- The whole world including the growing country gains but the “rest of the world” is impoverished.

Generalization

- Growth in the export sector of China helps the rest of the world by improving its terms of trade, but growth in its import sector hurts it.
- The rest of the world, however, is not monolithic. Growth in the export sector helps complementary countries but hurts competitive countries.

Creative Destruction

- E.g., In 1992, China greatly increased its production capabilities of children's toys.
- That helped countries that were toy importers but hurt countries that were toy exporters.
- In that year, 1992, China completely wiped out Korea's toy market in Japan. Obviously Japan (and China) gained, Korea was hurt.

Winners and Losers

- China's expansion benefits the world by lowering the prices of products and improve the terms of trade of complementary countries.
- But countries that are competitive with China see their terms of trade worsening, and are made worse off.

Competitive Threat

- China’s competitive shock has become a global affair.
- This holds also for some sectors in every country, most spectacularly by the crisis in textiles in U.S. and Europe.

China’s Textile Exports

- Last year China exported textile products worth $95 billion, accounting for 16% of China’s exports.
- Fears of China’s comparative advantage in this field led to a 10-year-old quota regime on textile exports on the part of the importing countries.
- Designed as a stopgap measure, this was intended to give countries time to adapt.
- Bu the ten-year period came to an end last year, and that is the explanation for the explosion in China’s textiles early this year.
- See the table next page!

Imports of Chinese Textile Products into the United States

	2003	2004	2005 to May 07	Projected Embargo
Cotton Knit tops	2.6	2.8	10.8	7.5 weeks
Cotton pants	2.5	2.2	10.7	7.0 weeks
Under-wear	5.4	5.2	8.6	10.2 weeks

Source: American Apparel and Footwear Association; and China Daily 24-05-2005, p. 1.

U.S. and Europe’s Response

- As a consequence of the threat to its textile markets, Europe and Germany have more or less decided to impose quotas, to take effect in the next few months.
- The quotas are likely to take place regardless of any move China made with its exchange rate.
- There is a possibility that a trade war would seriously threaten the outcome of the Doha Round of WTO Trade talks.

China's Response

- China has responded to the threat of tariffs by announcing recently that it plans to massively raise tariffs on textile exports.
- "China will raise export tariffs on 74 textile products, with a 400 per cent increase for most, beginning next month." (China Daily, May 24, 2005).
- This policy, however, is still tentative.

Macroeconomics: Sixteen Approaches to the Balance of Payments

Current Account Balances: Selected Countries

	2004	2003	2002
U.S.	-665.9	-530.7	-473.9
Japan	150?	136.2	112.5
Euro Area	52.9	25.5	55.7
Russia	60.1	35.4	29.1
China	68.7	45.9	35.4
Switzerland		43.6	24.7
Canada	25.9	17.3	14.4
Saudi Arabia		28.1	11.9
Norway	34.4	28.3	24.5
Singapore	28.2	18.9	16.1
Source: IMF International Financial Statistics, May 2005			

China’s Balance of Payments (billions of $)

	2004	2003
Current Account Surplus	+ 68.7	+ 45.9
Capital Inflow	+ 111.0	+ 53.0
Purchase of Reserves	206.0	117.0

Consumer Prices (% Increase)				
	2004	2003	2002	2001
U.S.	2.7	2.3	1.6	2.8
Euro Area	2.1	2.1	1.8	2.1
Japan	-0.1	-0.25	-0.92	-0.73
U.K.	3.0	2.9	1.6	1.8
China	4.0*	1.2	-0.8	0.5
Source: IMF International Financial Statistics, May 2005				

Comment on Macroeconomic Situation

- China's price level completely stable between 1997-2003.
- Inflation rate increased in 2004 to 4% because of dollar depreciation against euro, etc.

Recent Inflation

- Inflation rate peaked in August 2004 at (year-on-year) 5.3%.
- Since December 2004, inflation rate has been coming down.
- March 2005 inflation (y-o-y) was 2.7%.
- April 2005 inflation (y-o-y) was only 1.8%, lower than in the U.S. or Europe.

RMB Appreciation

- The RMB has been appreciating in the past few months.
- The euro hit a peak of 11.2 RMB in 2004.
- But it has since declined to 10.2 RMB, an RMB appreciation of 10%.
- The RMB and dollar are expected to continue to appreciate against the euro in the coming months.

The RMB Controversy

What Do They Want?

- Two different aspects of this controversy.
- One group argues that China should revalue its currency to a new higher level, but keep the fixed rate system.
- Another group argues that China should float its currency and let speculators and the market decide the exchange rate.

What About Revaluation?

- Big controversy over how much is desired.
- One group says its should be large. IMF calculates that the ppp exchange rate for the dollar is 2.2 RMB = $1.
- Others argue for revaluation of much smaller amounts, e.g., 20-25%, lowering the $ to 6 or 5 RMB.
- Still others suggest a small revaluation of not much over 10-15%, lowering dollar to 7 RMB.

What does this Show?

- The controversy suggests there is no solid model. None of the protagonists have produced their model and subjected it to rigorous criticism.

- IMF reports and the recent (May 2005) Treasury Report contain strong assertions but no analysis whatsoever.

What does Greenspan Say?

- Greenspan said last Saturday that revaluation of China’s currency would not improve the US balance of payments on current account.
- It would merely shift the source of U.S. imports to competing countries.
- So even the US official position is divided.

My Position

- My position has since 1994 been strongly against changing the exchange rate.
- In 1997-98 when China was pressured to devalue or float downward, I argued that China should keep its exchange rate fixed.
- Now the pressure is just the opposite. China is pressured to revalue.

China's strategy

- As the Chinese saying goes, the best strategy for China to deal with these changes is not to change anything.
- 以不变应万变

Update the Principles

- In the past few years, the Chinese press has summarized my position on the RMB issue as “Mundell’s Eight Principles” (Eight Harmful Effects of RMB Appreciation).

- I want now to update these principles with four additional ones.

"Mundell's Twelve Principles": Harmful Effects of Substantial Revaluation

- 1. Delay convertibility
- 2. Cut down FDI
- 3. Big Drop in Growth Rate
- 4. Aggravate NPL problem in Banks
- 5. Increase Unemployment
- 6. Deflation Distress in Rural Sectors
- 7. Reward for Speculators.
- 8. Destabilize Southeast Asia
- 9. Weaken external role of RMB.
- 10. Undermine WTO compliance.
- 11. Aggravate indebtedness of neighbors (e.g., Mongolia).
- 12. Cause Slowdown in Asia.

Second Controversy: Float the RMB?

- People who propose floating always refer to the advantages of letting “the market decide.” This is a good idea for companies producing products. But it is wrong-headed in the case of money, which is a measure of value.
- For measures of value, fixed relations are better. E.g., the relation between kilometers and miles is fixed. So is the relation between Celsius and Fahrenhiet measures of temperature. It would be absurd to have floating rates between them.

Fixed Relationships

- Even in money, produced by central banks, we have traditionally fixed relationships. For example, 2 five-dollar bills exchange for 1 ten-dollar bill. Why should we let the market decide the value of the two types of notes?
- Historically, we have always had 100 copper cents exchanging for one dollar.
- And the British, for over a thousand years, had a fixed relationship among pence, shillings and pounds, such that 240d. = 20s.= £1.

Different Currencies

- Central banks are government monopolies that determine the quantity of money to be produced. They are quantity-fixers. There is nothing “free market” about quantity fixers.
- There is no marginal cost to determine their policies. They produce quantities of money that are an expression of government monetary policies.
- The free market idea doesn’t apply.

Who Gains if China Floats?

- Floating pushed by IMF and US Treasury
- China would not gain. Floating is not necessary to bring about macroeconomic balance in China.
- No case made about how the rest of the world would gain.
- Floating would destabilize Asian economies.

Floating Not a Policy

- It is the removal of a mechanism for achieving monetary stability.
- Alternative to fixed rate system is inflation targeting, which is an alternative system of monetary control.

Choice for China

- Choice between targeting the dollar or targeting the euro (or a basket of currencies).

- Or targeting the Chinese basket of goods with flexible exchange rates.

Three Comments

- China has had a dollar anchor for over 10 years.
- China successfully resisted international pressure to devalue or float during the Asian crisis.
- Dollar anchor has brought China as good or better price stability in 1997-2003 than any G-7 country using inflation-forecast targeting.

The Case against Inflation Targeting (and Floating)

- 1. Swings of yuan-dollar exchange rate, like the dollar-euro rate, aggravated by speculation.
- 2. Shifts back and forth between domestic and international goods industries.
- 3. Arbitrary changes in international indebtedness.

Case Against…

- 4. Shift from RMB to dollar as unit of account in housing, asset markets.

- 5. Loss of Anchor for Monetary Policy.

- 6. Political difficulties in making monetary policy decisions without an anchor; regional conflicts within China.

Case Against…

- 7. RMB would become a victim of Speculation/Derivatives.
- 8. Shifts in real burden of taxation.
- 9. Disruptive for Hong Kong.

Case Against…

- 10. Movement away from monetary integration in Asia.

- 11. When Japan floated, it became the victim of "Japan-bashing." China could become vulnerable to permanent China-bashing.

- 12. Appreciation or floating would aggravate the problem of dumping criterion evaluation and adjudication.

Case Against…

- 13. Inflation-targeting really inflation-forecast targeting.

- 14. Regional disparities: coastal-interior; urban-rural; employer-worker; government-private.

- 15. Destabilizing for East Asia, blocks progress toward East-Asian monetary area.

Case Against…

- 16. Floating would weaken China's monetary leadership position in East Asia.

- 17. Inflation-targeting is a soft option. Unlike the fixed exchange rate, the inflation target can be fudged.

- 18. Stabilizing RMB against a basket of 3.3% of world economy is inferior to keeping it stable in terms of the 33% represented by the dollar area.

Conclusions

- Floating is not a policy for achieving monetary stability. Relevant option is inflation targeting.
- Large swings in $-RMB exchange rate, like $-€ exchange rate very damaging to China.
- Costs of large swings in exchange rate greatly exceeds any benefits.

- As long as the dollar is stable, it is better for China to stabilize the RMB to the dollar.
- Dollar area basket represents 33% of world economy.
- Almost 10x better than China’s 3.3%.
- China needs to continue its growth, not shut it down by floating or appreciation.

- China should remain in the dollar area rather than shifting to the euro.
- China needs to have the RMB controversy issue discussed in open forums in China, with world experts on all sides of the question.
- If China perseveres with its policy, while continuing to open up its capital account and comply with WTO requirements, it will gain acceptance of it.
- It is a win-win policy for both China and the rest of the world.

Thank You!

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