China's Macroeconomic Strategy and the International Monetary System

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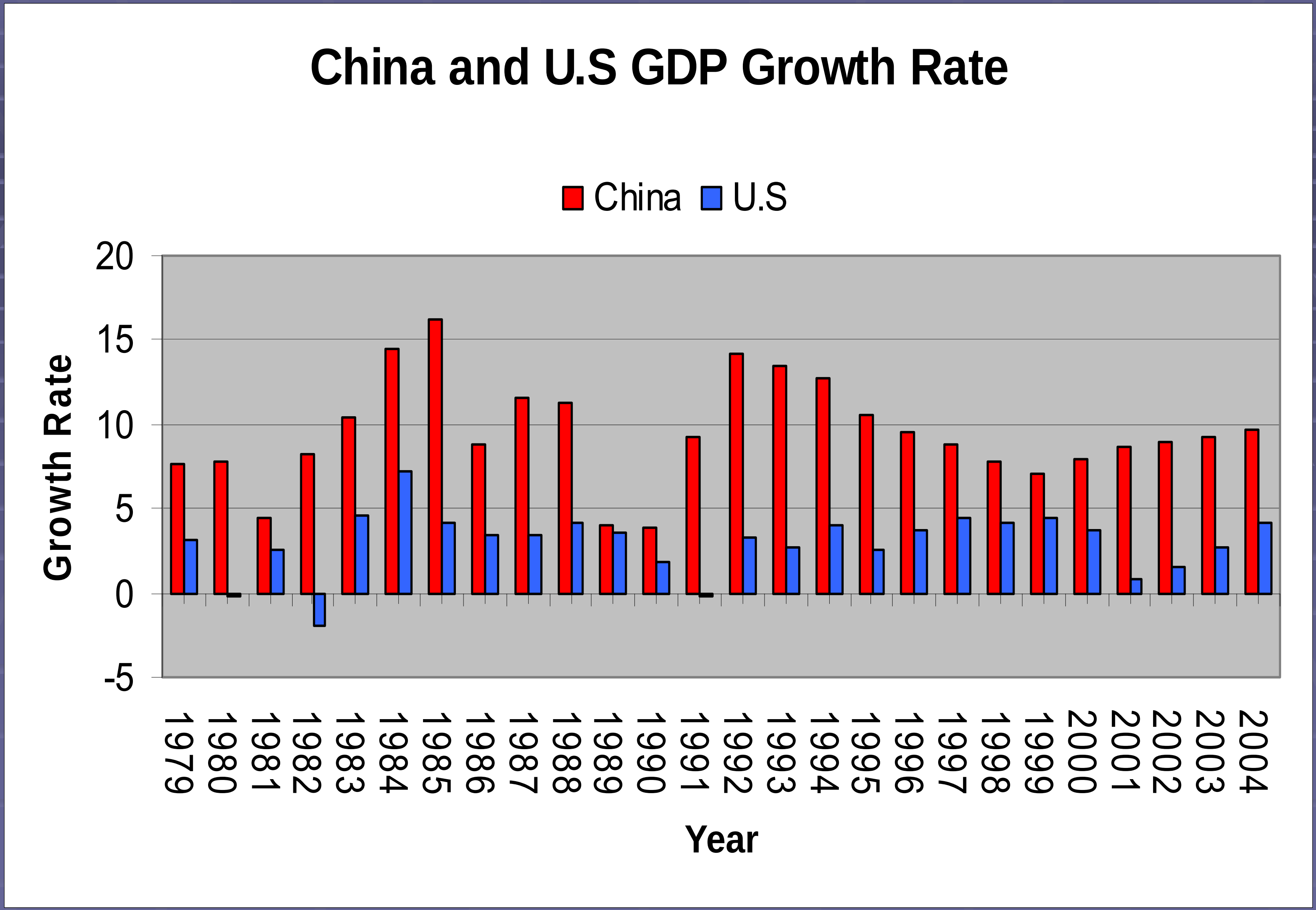
Outline

- China’s Economy Today
- Balance of Payments and Exchange Rate
- System of Fixed Exchange Rates
- China’s Exch.Rate Policies Since 1994
- The 21-07-05 Reform Measures
- China’s Macroeconomic Strategy
- Conclusions

China’s Economy Today

China′s Achievements Since 1978

- 27 Years of Growth Averaging over 8%.
- Trade over $1 trillion
- 8 % of world exports
- Price level stability and exchange rate stability
- Annual FDI over $60 billion
- Foreign Exchange Reserves over $900 billion
- Per Capita GDP over $1,300
- WTO, Space Club, Olympics, World Expo


China and U.S GDP Growth Rate
China
U.S
Growth Rate
20
15
10
5
0
-5
1979
1980
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Year

Factors in China's Growth

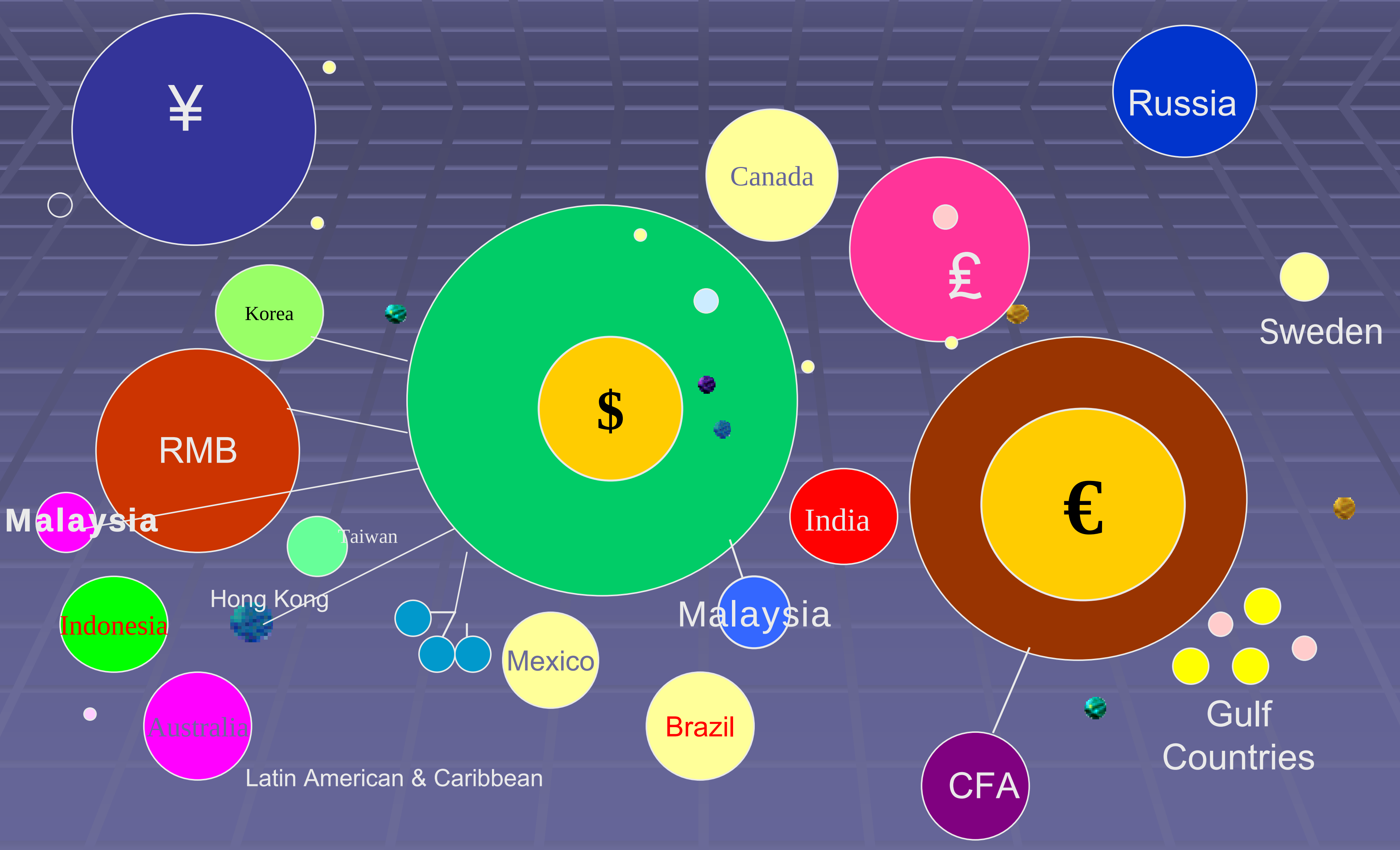
- Drive to Perform and Desire to Learn
- Large, Able Workforce
- Enthusiasm for New Technology and Innovation
- Stable political system
- International Peace
- Foreign Direct Investment
- Globalization/Modernization Strategy
- Monetary Stability
- Trade Surplus with United States
- Welcoming World

G-7 and China: National Outputs, 2004-7 (Tr$)				
	Estimated		Forecast	
	2004	2005	2006	2007
U.S.	11.7	12.5	13.4	14.3
Japan	4.7	4.8	5.2	5.4
Germany	2.6	2.7	2.8	2.9
China	1.6	2.0	2.2	2.5
U.K.	2.0	2.1	2.2	2.2
France	1.6	1.7	1.8	2.1
Italy	1.6	1.7	1.8	1.9
Canada	1.1	1.1	1.2	1.2

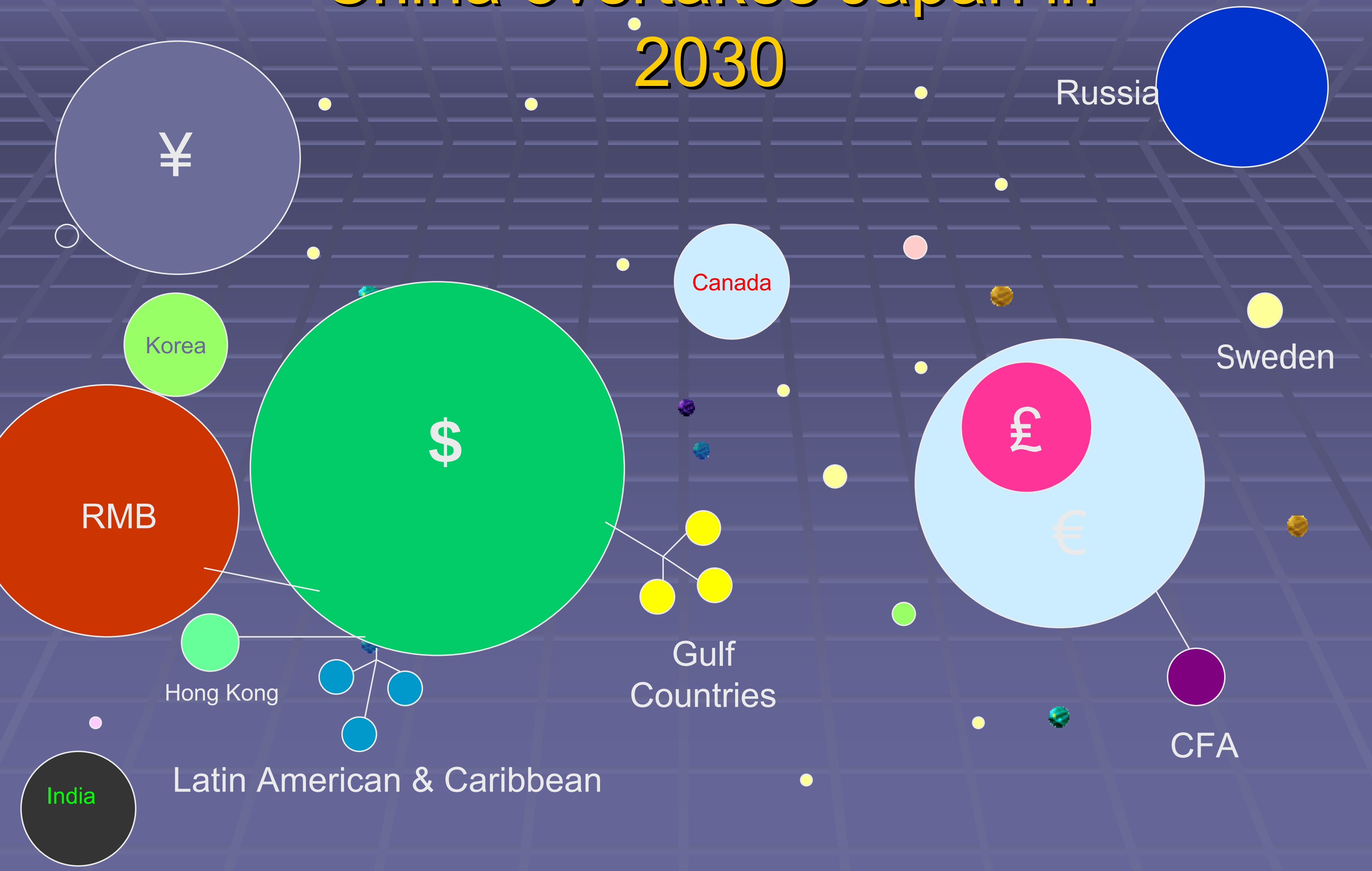
Forecasts

- By 2007, China will have overtaken all the G-7 countries in GDP except the U.S. Japan and Germany.
- By 2010 China will overtake Germany in total GDP and become the third largest country by GDP in the world at market exchange rates.
- Biggest risk to the forecast (apart from military conflict) is a substantial appreciation of the RMB.

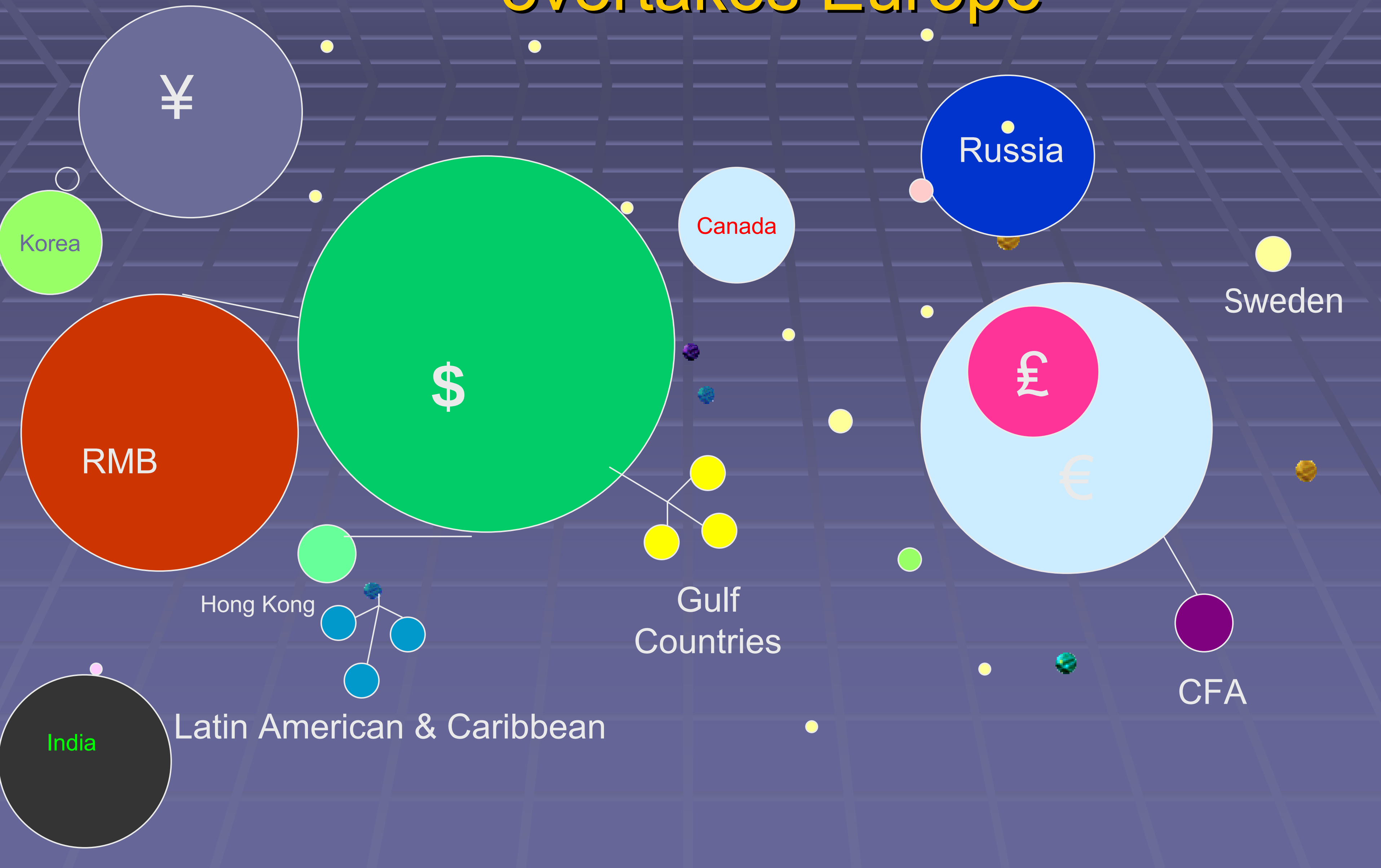
The International System: 2006



China overtakes Japan in 2030



GDP's, 2060: China overtakes Europe



Some Major Problems

- China's economy has some major problems to solve.
- 1. In the short run, energy supply and macroeconomic management, including exchange rate policy, and financial fragility.
- 2. In the intermediate run, rural poverty, educational quality, massive migration to the cities, and environmental issues.
- 3. In the long run, China, like many G-7 countries, will face a demographic/aging problem.

China's Development Strategy

- Keep attracting FDI
- Expanding Chinese firms overseas
- Increasing emphasis on quality and brand
- Economic development of interior regions
- Creation of manufacturing in the labor-abundant interior as part of supply-chain to more labor-scarce coastal regions.
- Shore up oil supplies for the present and develop safe nuclear with new technology for the long run.

Balance of Payments and the Exchange Rate

Global Disequilibrium

- What is often called global disequilibrium focuses attention on the huge current account deficit of the U.S. and the surpluses of countries like Japan and Germany and, most recently China.
- The threat to China is that she will be pressured into an appreciation that will stop China's growth and ruin her economy.

The Trade Disequilibrium

- The big imminent controversy is the huge deficit of the United States and the bilateral trade deficit of the U.S. with China.
- The issue heated up in 2006 because it is a political year, for Congressional elections in U.S.
- Democrats postponed a bill to slap a 27½ % tariff on Chinese goods unless China appreciates its currency.
- They will bring up the issue again in September 2006 in time to make political hay during the tight election campaign.

Manipulating Exchange Rate

- Such a tariff would be illegal under WTO rules, and President Bush would be likely to veto it.
- But it is not sure. The Treasury bi-annually is required by Congress to look at countries to see if they are “manipulating” the exchange rate.
- So far there has been no judgment against China. Just a couple of weeks ago, the Treasury gave China a pass on manipulation. But the pass was accompanied by a harangue from Treasury Secretary Snow.

Appreciation and Stagnation

- China needs to avoid the mistake of Japan.
- On the other hand, China cannot just do nothing. It needs to have a response.
- It needs to have a strategy for achieving equilibrium in its external accounts.
- Let's look at the accounts.

Current Account Imbalances

	2003	2004	2005?	2006
U.S.	**-519.7**	**-668.1**	**-805.0**	**-851.6**
Japan	137.4	172.2	159.8	169.4
Germany	53.3	103.4	117.3	117.4
Russia	35.4	60.1	98.4	93.5
China(PRC)	45.9	68.7	89.2	91.1
Saudi Arabia	28.1	51.5	65.7	70.5

Moving to Equilibrium

- China now has about $900 billion in foreign exchange rates, the second highest in the world.
- China should now take some steps to bring about equilibrium in its international accounts.
- Recent steps to allow exporters to hold more forex is a good idea. Also increased procurement in the U.S.
- This is not going to solve the US deficit problem, but it will take at least some of the pressure off China.

System of Fixed Exchange Rates

The Post-War System

- Since China was forced off the silver standard in 1935, China's currency has been related to the dollar, through periods of both high inflation and exchange rate control.
- During the post-war era, all the major currencies were fixed to the dollar, which was exchangeable into gold for foreign central banks.
- The IMF had been set up to manage a fixed exchange rate system and during this period severely criticized countries that had flexible exchange rates. See especially IMF Annual Reports in 1950 and 1962.

Fixed Exchange Rates the Natural Mechanism

- A fixed exchange rate system came about naturally when currencies were attached to gold or silver. Currencies were names for different weights of one or both of the precious metals. Free trade in the precious metal brought about fixed exchange rates.
- Fixed exchange rates tied to the precious metals was the traditional arrangement, supported by all the great economists of the past.

The Monetary Revolution

- A monetary revolution was in the offing with the publication of Friedrich Knapp's *State Theory of Money* in 1905.
- Knapp was a German professor who argued that the state determined money by fiat, whether or not it was linked to the precious metals.
- In a way Keynes was a disciple of Knapp.

Keynes

- Keynes wrote in the first sentence of his *Treatise on Money* that “the unit of account property of money is the most important function of money.”
- This idea of the importance of the unit of account property held over to Keynes’ General Theory, which provided a model of the economy with wages as the unit of account.

Before 1973

- All the early international monetary systems were based metallic currencies and fixed exchange rates.
- Before 1873 there was bimetallism.
- Between 1873 and 1933, there was the gold standard.
- Between 1934 and 1971 there was the convertible dollar standard, and then, in 1971-3, there was a pure dollar standard.
- Then came flexible exchange rates.

Why the Post-War System Broke Down

- The post-war system did not break down because there was anything wrong with a fixed exchange rate system.
- It broke down because the relation of the dollar and gold got out of kilter because of the inflations from three wars.
- But political reasons made it impossible to correct the price of gold, and there was not alternative that could save the system.

Flexible Rates

- The authorities in the early 1970s did not want to move to flexible rates, which most of the rest of the world hated.
- The IMF and Committee of Thirty tried for several years to negotiate a return to fixed exchange rates and an international monetary system.
- They moved to flexible rates as a default solution because they could not negotiate the politics of fixed rates.

China's Exchange Rate Policies Since 1994

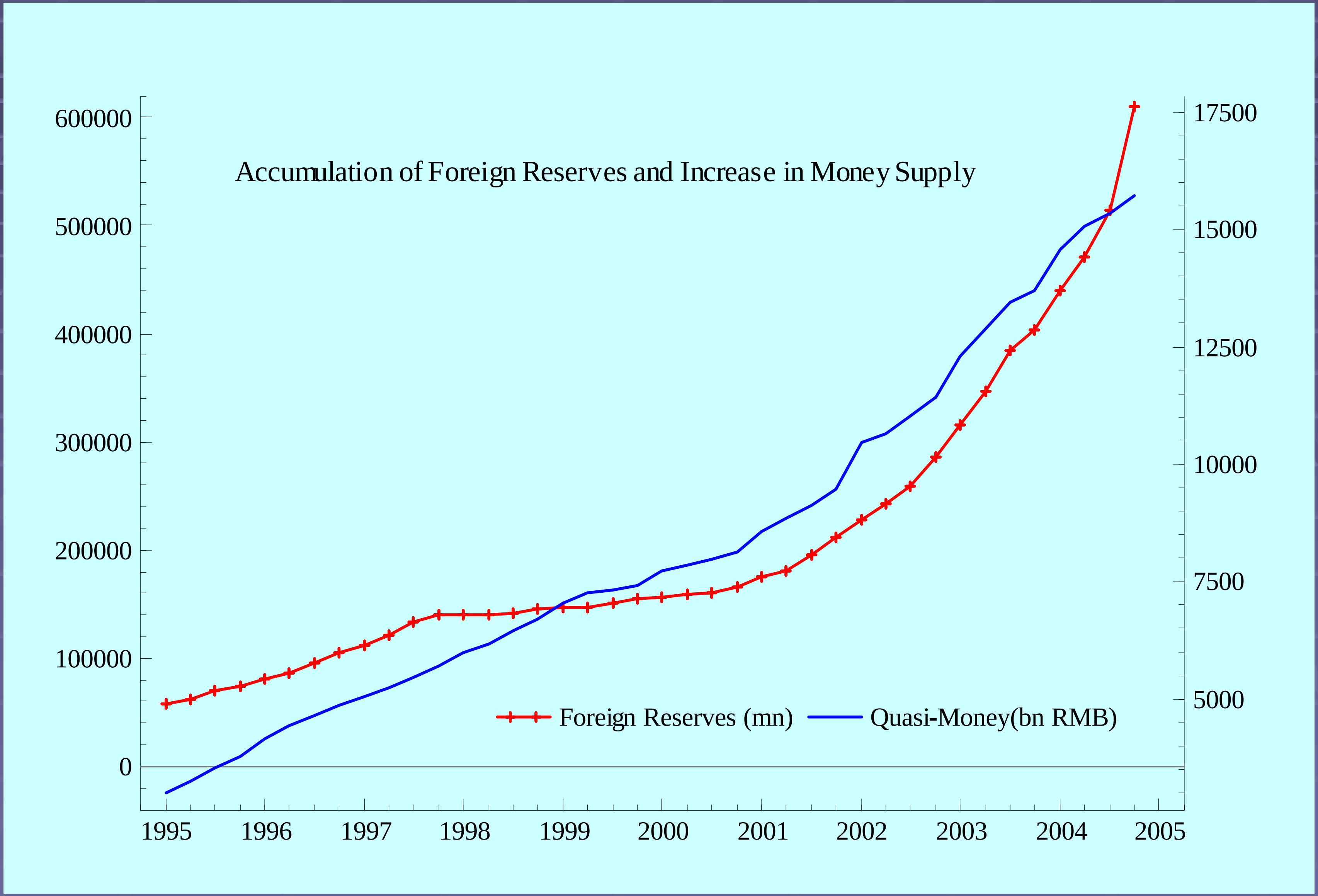
Since 1994

- Before 1994, China had devalued had several devaluations which brought the dollar down from about 2RMB to 5.5.
- Devaluation of 1/1/1994 established current account convertibility and raised the dollar from 5.5 RMB to 8.3.
- Devaluation was excessive, leading to an inflation spike in 1994-5 of 40%.
- Then inflation narrowed to zero and below as the dollar soared in late 1990s on international markets.

Fixed Rates and the Money Supply

- A country under fixed rates lets the money supply adjust with the balance of payments, as if there were a monetary union with the anchor country.
- A country with a deficit should contract its money supply, and a country with a surplus should expand it.
- This is the policy China has followed.

Money Supply and Foreign Reserves



Information Technology Revolution in U.S. Anchor

- China's currency was de facto fixed at about 8.3 to the dollar.
- The great expansion of the US economy during 1995-2000 was associated with the IT Revolution and tremendous productivity gains for the U.S.
- This meant that the dollar had to appreciate in real terms against other currencies.
- So the dollar soared against the yen and the mark, because the exchange rate was flexible.

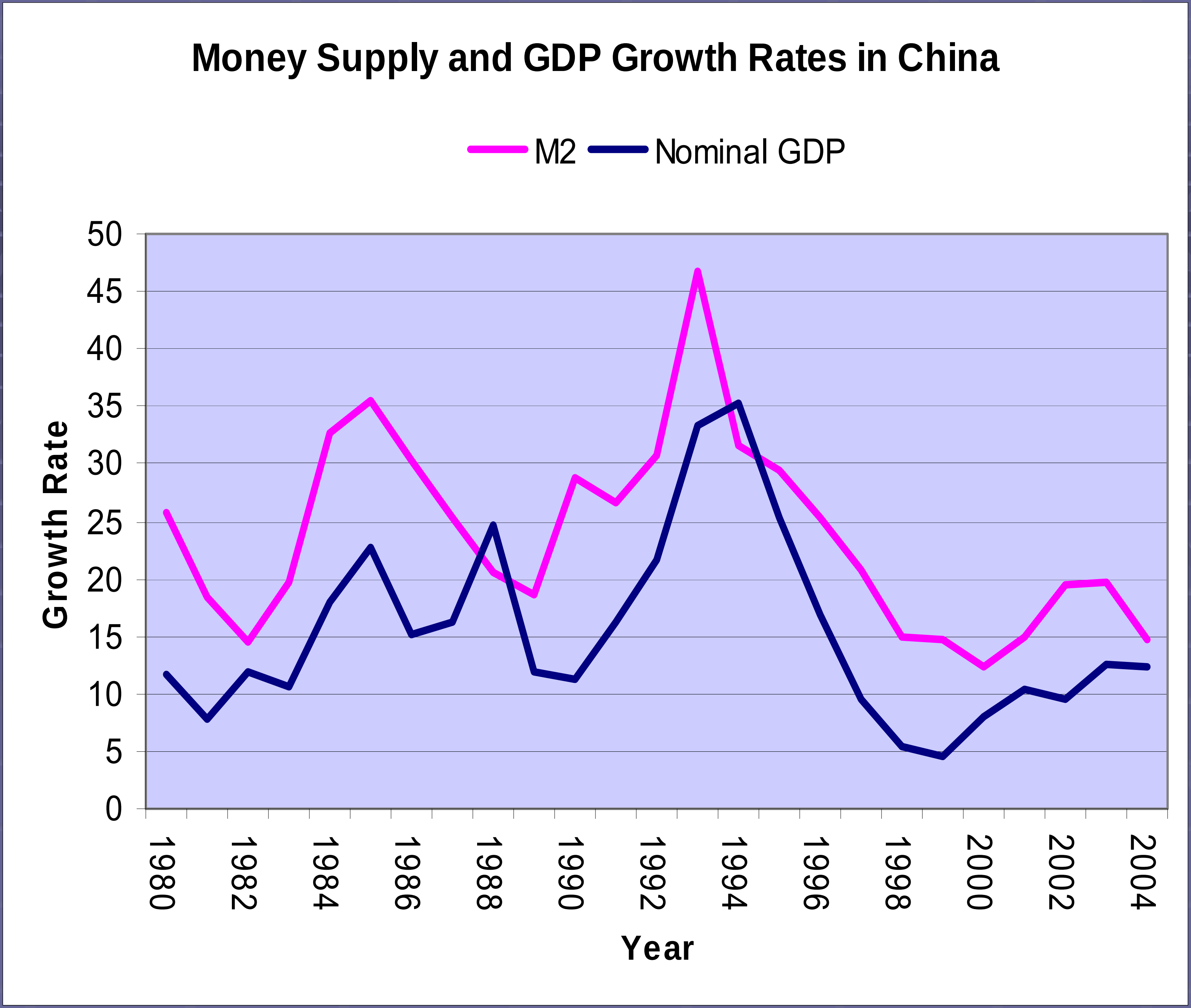
Mild Deflation in China

- But against currencies like the RMB, which was fixed to the dollar, the only way the dollar could appreciate in real terms was by US inflation or by deflation in the countries where the currencies were fixed.
- As a result, China and other countries with fixed rates to the dollar suffered some deflation in the period 1997-2000.
- Every country that had fixed rates with the dollar had, like China, some mild deflation over the period 1995-2000.

Dollar Depreciation

- When the dollar depreciated, it meant that all countries that had fixed rates with the dollar had to have some inflation.
- So in 2002-4, China's deflation ended and mild inflation began.
- The inflation rate peaked in August 2004 at a monthly inflation rate of 5.8%
- But inflation for the year, according to IMF figures, was 3.99%.

- In 2004, pressure continued on China to appreciate its currency.
- It was said that China would have to appreciate its currency for its own good.
- This was incorrect. The inflation rate since that peak has been dropping steadily and in 2005 was below that of the U.S.


Money Supply and GDP Growth Rates in China
M2
Nominal GDP
Growth Rate
0
5
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35
40
45
50
1980
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1984
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2000
2002
2004
Year

The 23-7-05 Reform Measures

Events of 23-07-05

- On July 21, 2005 China moved from a system from its de facto fixed exchange rate system to a new system.
- The new system allowed flexibility within a range and a new relation of the RMB to a large basket of Asian currencies including the dollar.
- New system not very transparent in that it provides a guideline for future monetary policy. Policy.

Effects of Appreciation

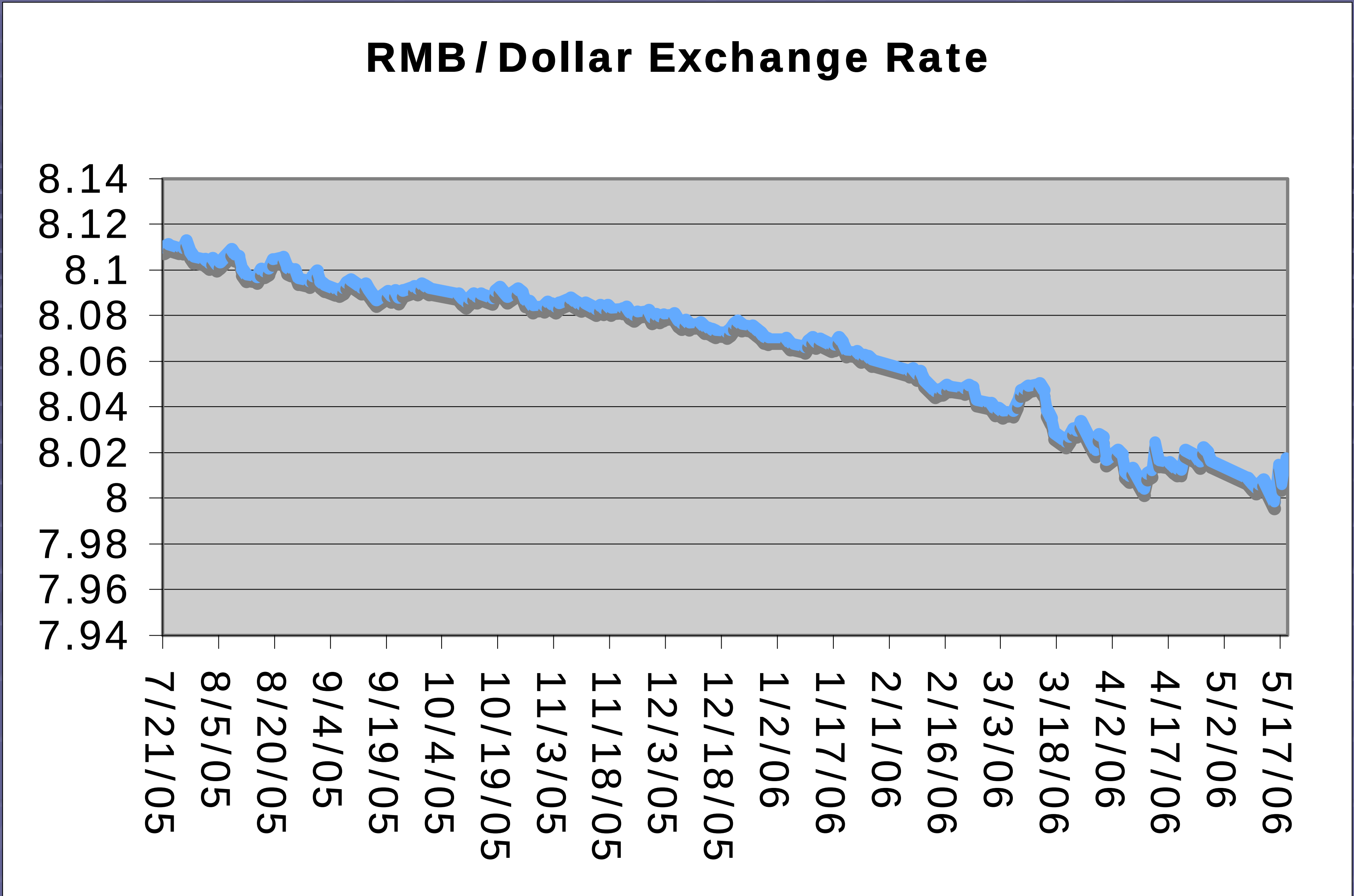
- Initial 2% appreciation combined with very slow further appreciation.
- Changes so far have been too small to do much harm except for increase in uncertainty.
- A large appreciation would have a number of unfavorable effects.
- Housing markets would go into recession.
- Prices of international goods and farm products would fall.
- NPL burden would increase.

Effects of Appreciation, cont'd

- FDI would diminish.
- Growth would plummet.
- Profits of export firms will fall.
- Export markets will decline.
- Rural poverty with falling farm prices.
- Loss of prestige for RMB with excess supply

Inflation Targeting not a Panacea

- Inflation targeting would be much more difficult for China than exchange rate targeting.
- China has no experience with inflation targeting.
- The euro area does inflation targeting but it has resulted in a 40% drop in the euro followed by a 70% rise.
- Similarly fluctuations in the RMB-$ rate would be ruinous for China.


RMB / Dollar Exchange Rate
8.14
8.12
8.1
8.08
8.06
8.04
8.02
8
7.98
7.96
7.94
7/21/05
8/5/05
8/20/05
9/4/05
9/19/05
10/4/05
10/19/05
11/3/05
11/18/05
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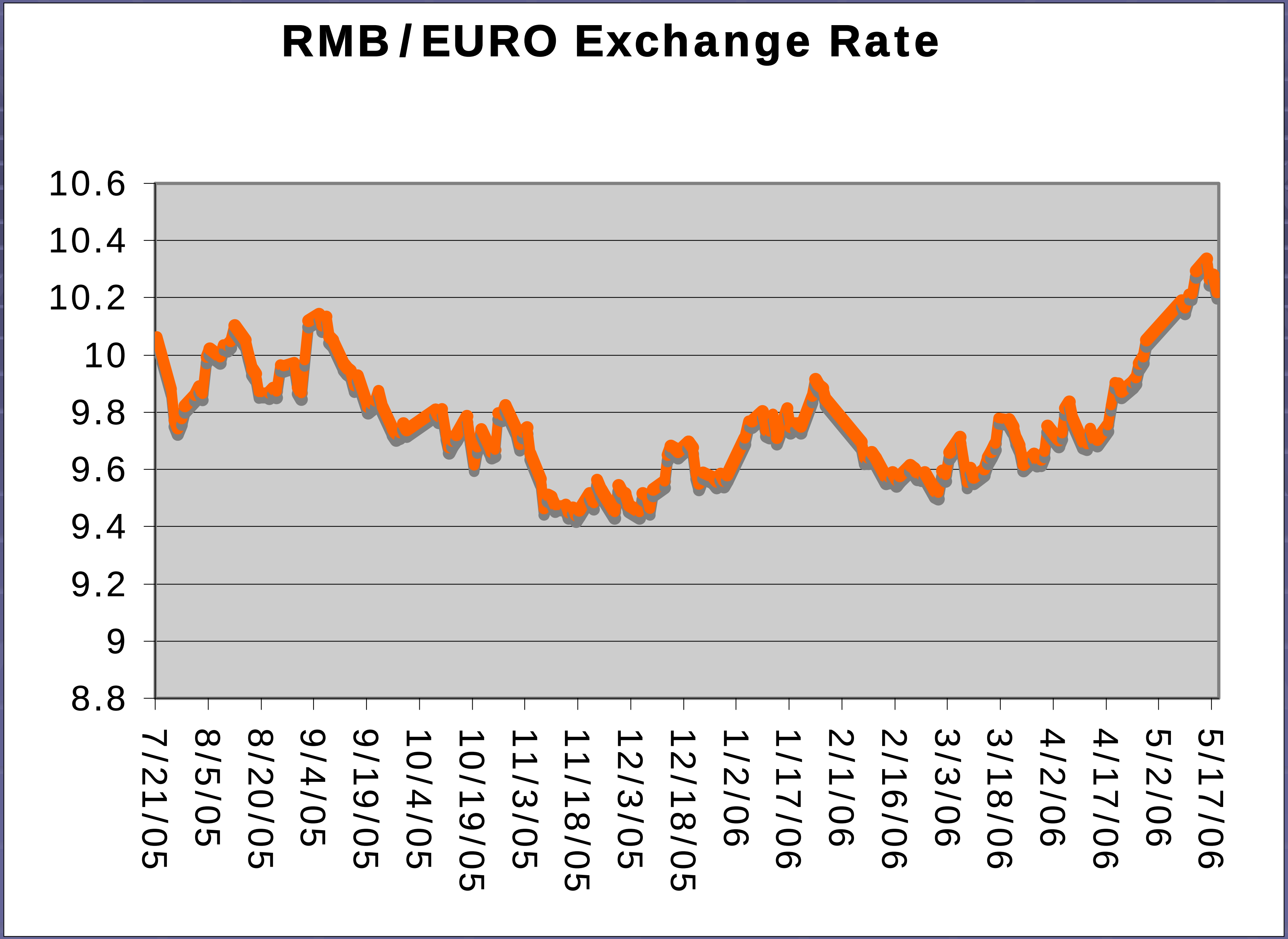
RMB/EURO Exchange Rate
10.6
10.4
10.2
10
9.8
9.6
9.4
9.2
9
8.8
7/21/05
8/5/05
8/20/05
9/4/05
9/19/05
10/4/05
10/19/05
11/3/05
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12/3/05
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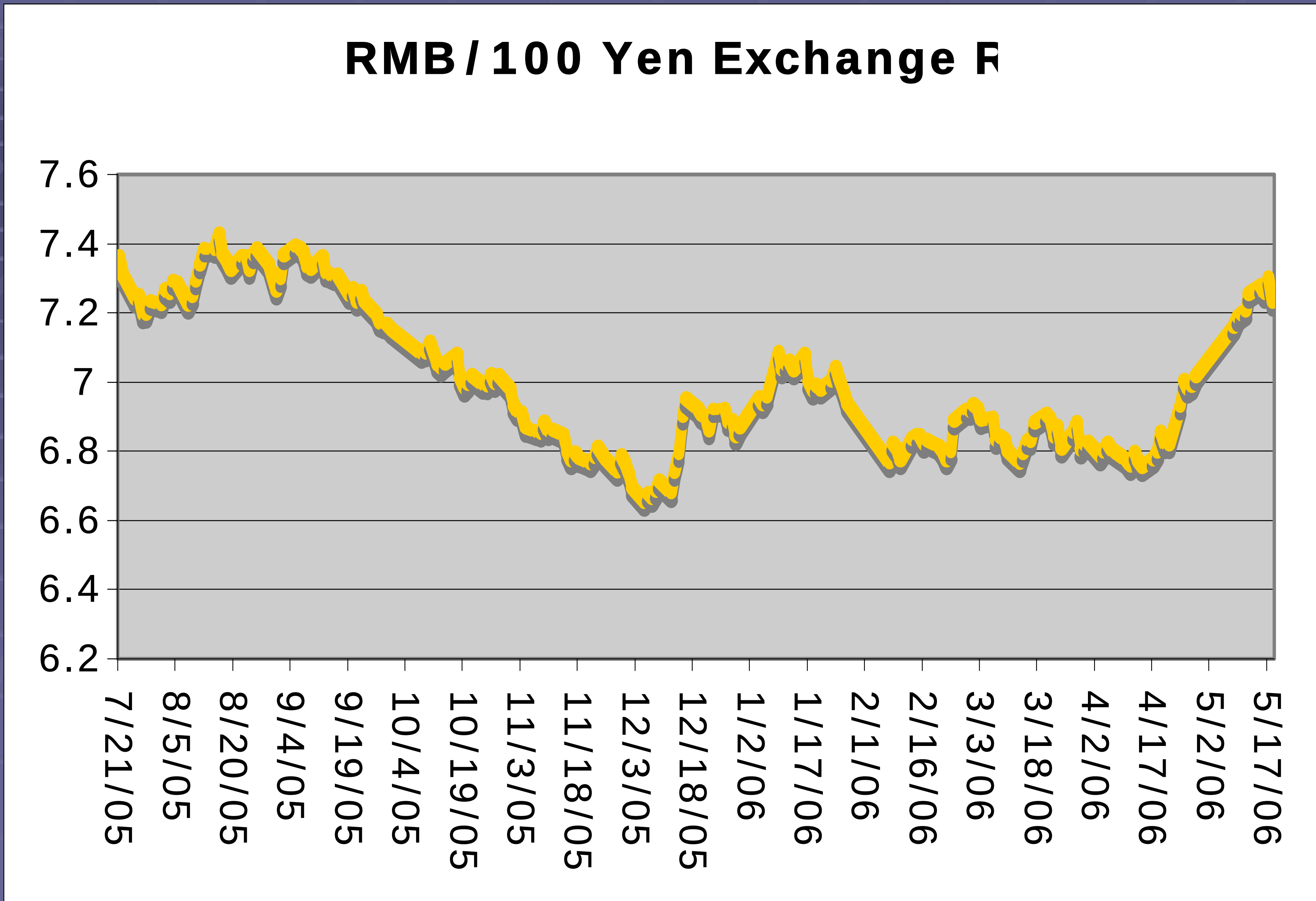
5/17/06


RMB / 100 Yen Exchange R
7.6
7.4
7.2
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8/20/05
9/4/05
9/19/05
10/4/05
10/19/05
11/3/05
11/18/05
12/3/05
12/18/05
1/2/06
1/17/06
2/1/06
2/16/06
3/3/06
3/18/06
4/2/06
4/17/06
5/2/06
5/17/06

The Convertibility Option

- The equilibrium in china's accounts can be reached without changing the exchange rate.
- China can increase its procurement in the U.S. and relax import restrictions in compliance with WTO.
- This involves reducing exchange controls, thus allowing increased imports and some capital outflows.

Conclusions

Best Strategy

- China's best strategy is to bring its own accounts closer to balance at the existing exchange rate of 8 RMB = $1.
- With reserves larger than any other country, China can afford to ease up on foreign exchange restrictions and allow increased absorption (spending) in China.

Hong Kong

- When the dollar fell below 8 RMB momentarily last week, it raised questions about what policy Hong Kong should follow.
- Some people, including some banks, argued that Hong Kong should shift away from its currency board system with the dollar as anchor and fix instead to the RMB.
- This would be a mistake.

Fix $HK to the RMB?

- RMB is inconvertible. A fix to the RMB would undermine Hong Kong convertibility.
- Dollar area is 30% of world economy. China is only 4%. The Dollar is a much more solid anchor.
- Fix to the RMB would destroy Hong Kong as a financial center.

Conclusions 1

- A fixed exchange rate is a valid system that has operated for most of world history.
- A fixed exchange rate is a monetary rule that gives the country an inflation rate more or less equal to the inflation rate of the anchor country. E.g., Hong Kong’s inflation rate matches the U.S.

Conclusions 2

- A flexible exchange rate is not a monetary rule. Moving from fixed to flexible exchange rates involves giving up a monetary rule.
- Correct comparison is between exchange rate targeting and monetary targeting.

Conclusions 3

- China should keep its exchange rate fixed to the dollar.
- It could allow some margins around the central parity of 8 RMB to allow foreign exchange dealers some profit, but this is largely for cosmetic purposes.
- It is better for China to bring its balance of payments into equilibrium than it is to have allow a strong appreciation of its currency.

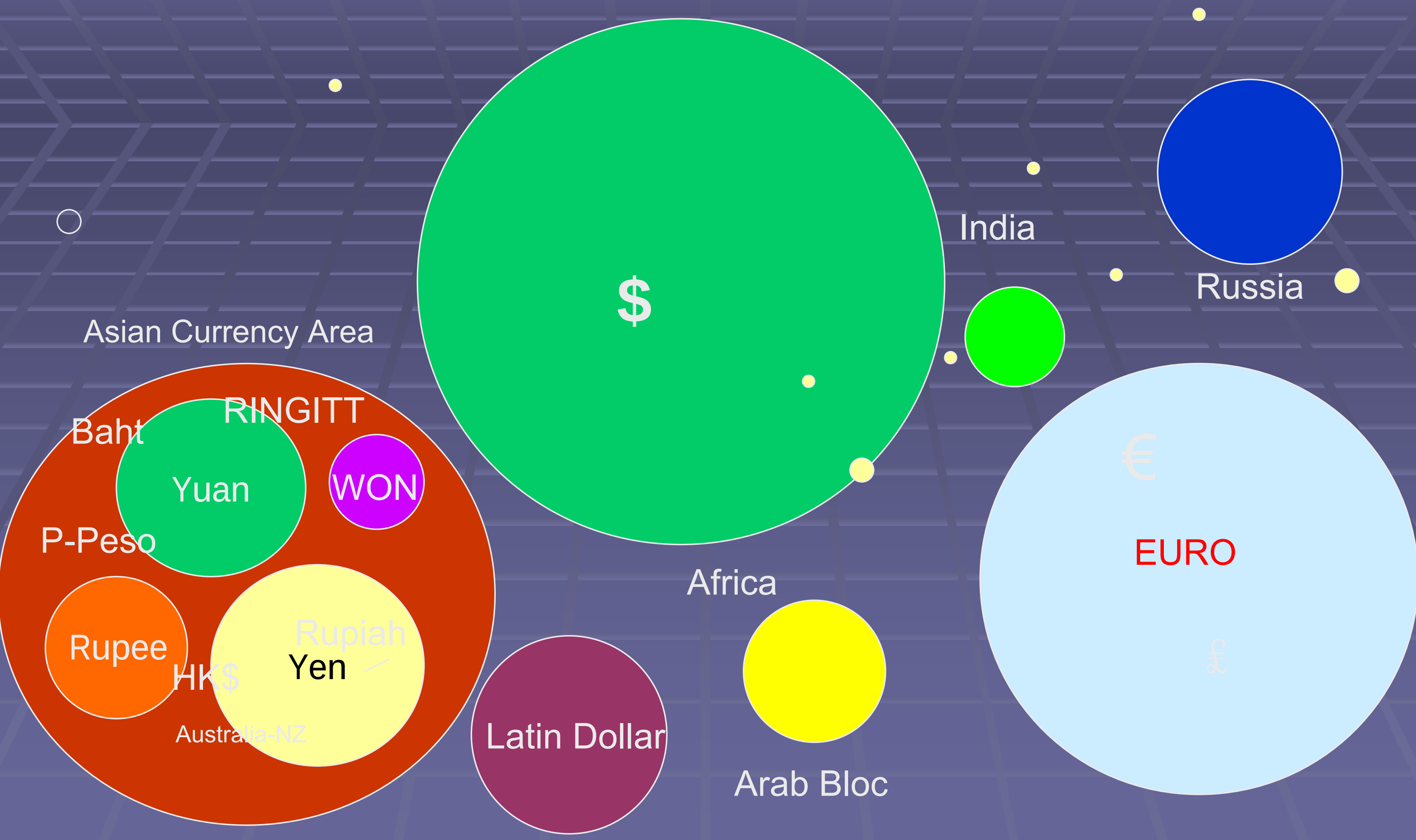
Conclusions 4

- Hong Kong should keep its currency board system with the fixed anchor to the dollar at a central parity of US$1.00 = $HK 7.8.
- Macau should maintain the status quo following Hong Kong's lead.
- China should engage with S. Korea and Japan in dialogue on the formation of an East Asian Monetary Standard, with a view to eventual inclusion of APT group of 13+ areas.

Conclusions 5

- China should join with other Asian countries in seeking a fairer distribution of votes in IMF.
- China should support movements toward international monetary reform and a restoration of the international monetary system.

Asian Currency Area, 2015



谢谢