

China's Exchange Rate

by

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U.S. Treasury Secretary John Snow recently raised eyebrows when he suggested that “the Chinese government is interested in moving toward market-based, flexible exchange rates,” and Washington would support such a move. His June 16 remarks caused a stir in the foreign exchange markets, and probably accelerated the conversion into yuan of privately held dollar assets in China--thus increasing the pressure on the yuan to appreciate from its current rate of 8.28 to the dollar.

That only goes to show how, with respect, Mr. Snow is wrong and moving to a flexible exchange rate is far from desirable. Under the present circumstances, floating the yuan would lead to repetitive appreciation. If China stops stabilizing the exchange rate, the yuan will float upward without any well-defined limit--posing possibly severe domestic deflationary consequences.

Because further appreciations then become more likely, floating could have more serious effects than a one-time appreciation in the yuan. That is evident from the Japanese experience. From the 1970s through to the mid 1990s, a series of appreciations in the yen sent the Japanese economy into a deflationary tailspin and zero interest-rate liquidity trap, from which it has yet to recover.

Why would allowing the yuan to float freely lead to repetitive appreciation? China has become an important international creditor, with an ongoing balance of payments surplus from large inflows of foreign direct investment coupled with a small multilateral trade surplus. Because the dollar is the dominant international currency for borrowing and lending, that results in a continual buildup of liquid dollar claims on foreigners--a surprisingly high proportion of which are privately held, outside the direct control of the central government.

These ever-accumulating dollar balances need not disequilibrate the portfolios of Chinese savers holding both dollar and yuan assets as long as the yuan/dollar rate remains fixed within a narrow band. That's because a stable exchange rate means Chinese savers will see dollar assets as just as safe as those in yuan.

But once the exchange rate begins to fluctuate (even if the yuan does not immediately appreciate), the dollar assets will look riskier and private holders will begin to dishoard them, forcing an appreciation in the value of the yuan. And this appreciation will repeat itself as China's balance of payments surplus--large inflows of FDI plus small current-account surpluses--continues to produce liquid dollar assets that China's private sector will be less and less willing to hold.

As the appreciation continues, domestic price levels in China--which are now finely balanced between inflation and deflation--will begin to fall. And as China's financial markets begin to anticipate an ever appreciating yuan and falling prices, interest rates will be pushed down to zero, making it impossible for the People's Bank of China to stop the deflation--very much like the trap in which Japan now finds itself.

There's already mounting evidence that China's modest internal interest rates--a deposit rate of about 2% and a standard loan rate of 5.3%--have become too high. As dollars are converted into yuan, the People's Bank of China has been rapidly expanding its domestic monetary base so that the overall supply of new deposits of Chinese households and firms held by the commercial banks now greatly exceeds the demand for new loans. As in Japan, this puts the banks in a perilous position. And with interest rates unable to fall below zero, the room for rate cuts to correct this supply-demand imbalance is very limited.

While many observers ask what the right level for the yuan/dollar exchange rate should be, that's really missing the point. What's far more important than the precise exchange rate--whether it be seven, eight or nine yuan to the dollar--is that it remains stable, eliminating foreign-exchange risk and so making Chinese savers more willing to continue to accumulate an indefinite future stream of dollar assets.

Fortunately, the Chinese government has a lot of credibility invested in the present rate of 8.28 yuan per dollar, which it has now maintained since 1994. And it is important not to squander that credibility by making this central rate more "flexible."

Apart from mercantilist considerations, what is the main analytical argument used by supporters of an appreciation in the yuan? China has had a trade surplus since 1995, except for the first few months of this year when its trade happened to be roughly balanced multilaterally. However, many, if not most, economists believe that China's trade surplus could be reduced--and even become negative--if an appreciation in the yuan made Chinese exports more expensive in dollar terms, so that fewer are sold abroad.

But this conventional wisdom is misplaced. China's trade surpluses reflect its surplus savings, just as America's huge ongoing trade deficit reflects the extraordinarily low net savings within the American economy--zero net personal savings and now large government dissaving from extraordinary fiscal deficits. Changing an exchange rate does not change these net savings propensities in any obvious way. However, in a deflationary world, if one country is forced to appreciate its currency against all its neighbors, the fall in its domestic-currency prices of tradable goods and services will create a downward deflationary spiral in prices and output with a consequent fall in imports. Thus, there is no predictable effect on China's net trade surplus from appreciating the yuan.

However Mr. Snow could be right if he defines flexibility more narrowly, allowing the market value of the yuan to fluctuate within a narrow soft band around 8.28 yuan to the dollar. This would have the big advantage of devolving the task of clearing of China's international payments to the clearing banks, and away from the People's Bank of China. But just as diamonds are forever, so too should be the central rate of 8.28 yuan to the dollar.

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