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Limited Foreign Exchange Flexibility for China: A Two-Percent Solution?

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Because China could benefit from a more open foreign exchange market with decentralized transacting, it is important to pin down what the Chinese government should mean by its commitment to greater foreign exchange “flexibility”. This involves both the pace of liberalizing and rationalizing of capital controls (relaxing administrative constraints on foreign exchange transacting) and the optimal degree of flexibility in the exchange rate. Weaving these two strands together, I suggest a “two-percent solution”: slightly widening the band of exchange rate variation around 8.28 yuan per dollar, but with the important proviso that there should be no change in the central rate itself¹.

Although closely interrelated with the exchange rate question, let me first discuss the order of liberalization of the capital account of the balance of payments.

The Capital Account

In one respect China has been, and remains, very open to foreign capital flows. Inward foreign direct investment (FDI) at over US\$40 billion per year since 2000 has been higher than China’s multilateral trade surplus of about 3 percent of GDP. FDI has been an important vehicle for introducing the modern technology underlying China’s rapid industrial transformation. It has also been a major contributor to the buildup of China’s liquid dollar assets, both held privately and increasingly as official exchange reserves—about US\$660 billion as of March 2005. And outward FDI may be beginning in a significant way, as with Lenovo’s purchase of IBM’s PC division in 2005, and with large numbers of less publicized investments in African infrastructure projects.

However, there are two distortions in official Chinese policy that unduly amplify the financial magnitudes of inward FDI. First, the tax treatment of foreigners investing in China, particularly in special economic zones, is still more favorable than that accorded domestic investment—although much equalization has occurred. While entirely rational at the beginning of China’s opening to international trade in the 1980s, such favoritism for foreign FDI is now counterproductive for encouraging domestic entrepreneurship. The second distortion is to limit foreign firms borrowing from domestic Chinese banks to help fund their operations in China. China wants and needs foreign technical expertise,

¹ Ronald I McKinnon *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, MIT Press 2005 (Chinese translation, China Financial Publishing House, 2005) and in the *Shanghai Securities News* 2005 ???

but with its high domestic saving, it does not need foreign finance. Thus allowing foreign firms to borrow domestically would reduce unwanted financial inflows.

In foreign trade more generally, China has followed, and is following, the optimal order of (gradual) economic liberalization². In the mid 1990s, China consolidated its exchange rate system and achieved full current account convertibility for the renminbi in the sense of satisfying the IMF's Article VIII. In the new millennium, China is rapidly satisfying its WTO obligations by eliminating quota restrictions and drastically cutting tariffs. On capital account, it has liberalized relatively illiquid FDI flows *before* eliminating restrictions on shorter term and more liquid financial flows. All this is according to what is now received textbook theory.

But this last stage, that of liberalizing liquid international financial flows, which can all too easily become “hot” money, is best done very carefully in conjunction with an appropriate regulatory framework— or not at all. The most important principle is to contain (latent) moral hazard in financial institutions, implicitly or explicitly insured by the Chinese government, by limiting their ability to assume risk. In particular, undue foreign exchange exposure in banks and other financial institutions can imperil both themselves and the economy. *And foreign financial institutions should always be subject to the same stringent regulatory constraints as domestic ones.*

What is the best way to proceed with this delicate last stage in the liberalization process? One way is to assign foreign exchange trading exclusively to authorized banks that must keep their exposure in any foreign currency against renminbi within well defined limits. The State Administration for Foreign Exchange (SAFE) or the People's Bank of China (PBC) would then continuously monitor the net foreign exchange positions of these authorized banks relative to their capital positions. Only after this interbank foreign exchange market between renminbi and dollars is well established would further liberalization be considered. For example, free foreign exchange trading between major foreign currencies, such as yen against euros, would remain restricted until a later stage. See Box 1 for a summary of my main points.

<Box 1 about here>

The Exchange Rate

Assuming that these prudential regulatory restraints on financial institutions are in place, what should be the range of variation of the yuan/dollar rate itself? In the 1960s during the old Bretton Woods system of fixed dollar parities for Western European countries and Japan, market rates varied within a two percent band around their central rates. Indeed, the foreign exchange margins (one percent on either side of the official parity rate) were officially announced under Article IV of the original IMF Articles of Agreement. On most trading days, central banks did not have to intervene and the

² As set out in Ronald McKinnon *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy* Johns Hopkins Press, 2nd Edition, 1993.

clearing of international payments devolved to the authorized commercial banks. But the system was punctuated by occasional crises when official intervention became necessary.

In China today, allowing a similar two-percent band around the central rate of 8.28 yuan per dollar, within which the market rate could fluctuate freely daily or weekly, would efficiently decentralize the foreign exchange market. Indeed, as capital controls are replaced by careful prudential regulation over the *net* foreign exchange exposures of authorized commercial banks, a widening of the band to, say, 1 percent on either side of the “parity” rate of 8.28 yuan per dollar would make the foreign exchange market more flexible. Within such a 2-percent band, commercial banks would now be able to set bid-ask spreads for both spot and future quotations of the renminbi against the dollar that reflect their transactions costs and the risks involved.

The current (defacto) margins of just 0.3 percent on either side of 8.28 are so narrow that they unduly limit the profitability of foreign exchange transacting by commercial banks and other financial institutions. Indeed, if the PBC were to set the rate exactly at 8.28 yuan per dollar, commercial banks would have no room to clear international payments profitably. Then all international currency exchanges would be completely centralized within the PBC.

However, if the proposed two-percent band is fully credible because the PBC announces what the band limits are and bends domestic monetary policy to keeping them, it need seldom intervene. On normal trading days, exchange rate expectations will be regressive: any deviation of the market rate away from 8.28 would be expected to move back toward 8.28. If the rate moved toward the top of the band, say, 8.4 yuan/dollar, then authorized banks would voluntarily intervene to drive it back down. When these banks know that the PBC is prepared to intervene decisively at either the upper or lower boundaries of the band, they will act as dealers (stabilizing speculators) to nudge the rate toward the middle of the band. This ensures that the PBC need not itself intervene much in practice, and the clearing of most international payments would devolve to commercial banks or other authorized financial institutions that would make hedging markets in foreign exchange, both futures and options contracts, for their nonblank customers.

However, if there is a crisis, as when foreigners are put heavy political pressure on China to appreciate leading to hot money inflows, then the PBC has little choice but to intervene by however much is necessary to preserve the central rate.

<Box 2 about here>

Changes in the market exchange rate within such a narrow band would not significantly affect—or be intended to affect—a country’s competitiveness in international markets for goods or services. The “two-percent solution” is simply a device for providing flexibility in decentralizing China’s foreign exchange market. But the central rate of 8.28 yuan per dollar would remain securely fixed to anchor China’s price level so that its inflation rate converges to that in the United States and high growth in

domestic money wages—reflecting China’s very high growth in labor productivity—would remain the dominant mechanism for balancing international competitiveness.

Box 1: Constrained Foreign Exchange Flexibility for China: The Capital Account

Suggested order of foreign exchange liberalization:

- Current account convertibility with repatriation of export proceeds (as China has)
- Free inward and outward FDI (as China has)
- Authorize currency trading by major domestic banks subject to strict limits on their net foreign exchange exposure
- Subject foreign financial participants in the currency markets to the same prudential regulations (regulatory burdens) as domestic ones

For the indefinite future

- Keep restraints on individuals, enterprises, and other financial institutions, from borrowing or lending foreign exchange on a substantial scale
- Limit offshore foreign exchange transacting not involving renminbi

Box 2: Constrained Foreign Exchange Flexibility for China: The Exchange Rate

Suggested band of variation in the yuan/dollar rate

- Keep the central rate of 8.28 yuan per dollar indefinitely.
- Widen slightly the current defacto trading range of 0.3 percent on either side of 8.28.
- Introduce a 2-percent band of variation around 8.28 yuan/dollar that would allow the clearing of international payments to devolve from the PBC to commercial banks—as under Bretton Woods regime of the 1960s.
- If the central rate of 8.28 yuan/dollar and 2 percent band remain credible, the PBC need not directly enter the foreign exchange market—except in “crisis” periods