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More flexible exchange rate: is this an imminent need for China?

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From China's standpoint, "imbalances" and monetary policy flexibility do not provide imminent economic rationale for more flexible exchange rate, given the rate elasticity of the trade and the state of its financial markets. There is also the risk of accelerating capital inflows or destabilizing the dollar. But if China still decides to review the peg based on political factors or longer-term merits, it would not like to trigger (1) expectations of CNY appreciation or (2) a collapse of the dollar. To satisfy the first, adopting a currency-basket provisionary in a discretionary manner would be an option, as discussed in the markets. To satisfy the second, China should conduct it when the dollar is rising.

Introduction

Since the global financial crisis began to worsen in the summer of 2008, China has maintained an effective dollar peg for the CNY. In 2010 there are growing expectations that they will restore a more flexible exchange rate regime.

That said, most arguments are based on what for China is "rest of the world (RoW)" logic—eg expectations that it will serve as the engine for a global recovery. But we need to remember that it is China that will decide how to manage the CNY. In this report I consider the way for China to adopt a more flexible exchange rate regime by reexamining the relevant arguments from China's standpoint.

Revisiting the debate on a flexible rate regime (1) Correcting trade imbalances

Most of the arguments from the "RoW" seeking a more flexible rate are based on the view that China's trade surpluses are the result of "unfair" currency policy, and that this policy should be abandoned. Many also argue that while the dollar peg may have been needed as an emergency response when the financial crisis caused export demand to plunge, its justification is fast disappearing.

But it is not clear whether an appreciation would lead to a sharp correction of the imbalance. For example, empirical studies show that Japanese and European exporters set prices based on the prices of competing goods in the US market (Pricing To Market) when their own currencies rise against the dollar. In China as well, it would be rational for industries with declining costs due to fixed expenses or the learning curve. Even if the CNY did appreciate, China would still have an advantage in terms of labor costs. When the above is taken into account, it is hard to argue that China's exports have a high exchange rate elasticity.

What would happen by the appreciation is that exporter earnings would be squeezed. That could create greater uncertainty in the labor market, which the government would not be able to ignore. From China's standpoint, therefore, there is not sufficient justification for quickly adopting a more flexible rate regime to correct the trade imbalances.

(2) Achieving monetary policy flexibility

Another argument made by the "RoW" is that a more flexible rate regime would ensure greater flexibility in monetary policy and enable China to manage the domestic economy more efficiently. In other words, China faces a "tri-lemma" in which, if it tries to peg the CNY against the dollar while allowing flexibility in capital flows, its monetary policy must necessarily become one with that of the US. They argue that achieving monetary policy flexibility is important for a country like China, where the role of domestic demand is expanding along with the growth of the middle class.

While such arguments appear to have China's interests at heart, I think monetary policy flexibility remains a low priority for China, at least for the time being.

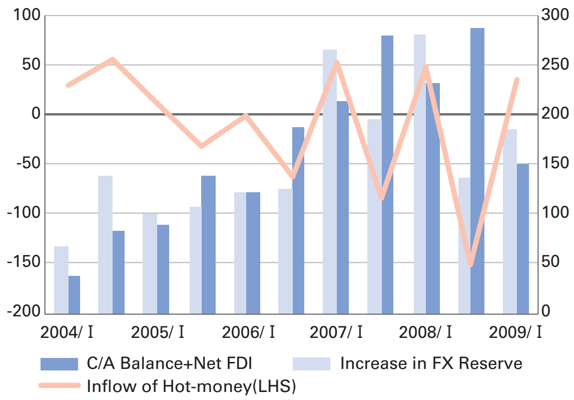
Although China's financial markets continue to develop, they have yet to reach the stage where an adjustment to the central bank's policy rate impacts on economic activity through market mechanism. You would recall that even in the developed nations, conventional monetary policy lost its influence when markets stopped functioning during the crisis, forcing central banks to utilize the unconventional tools of buying various assets and supplying large quantities of reserves. As PBOC Governor Zhou Xiaochuan recently noted, given the current state of China's markets, it will continue to be both necessary and effective to utilize such tools as changes in reserve requirement ratio, changes in the regulation surrounding loans and deposits, and "window guidance" in addition to adjustments in the policy rate.

At present, therefore, I do not think arguments that China should adopt a more flexible rate regime to achieve greater freedom in monetary policy are convincing.

(3) Restraining speculative capital inflows

Without doubt, a key problem for Chinese authorities is how to restrain speculative investment. Excessive real estate speculation can strike a heavy blow to the financial system when prices drop, and the overheating of capital investment risks creating overcapacity, leading to deflation for years. While constraints on available data make it difficult to gauge the macro-level impact of speculative investment, the PBOC's use of "window guidance" , when domestic bank lending rose markedly, is consistent with this supposition.

Exhibit 1. Estimated inflow of "hot-money"(in Bil USD)



Source: SAFE
Note: "Hot-money" is estimated as explained above.

Speculative inflows of foreign capital have increased since then. As a proxy, I used the sum of the current account surplus and inward direct investment less the increase in foreign reserves. By this measure, inflows are growing again (Exhibit 1). Persistent rumors that inward investment is being disguised as trade or FDI also suggest that China is in fact experiencing significant inflows of speculative money.

Fund inflows are not always linked directly to speculative investment. But inasmuch as monetary easing via fund inflows can amplify speculation, I think the Chinese authorities will naturally want to restrain those inflows.

But the impact of the CNY rate on fund inflows is not a simple one. An economist at the Chinese Academy of Social Sciences argued that if the CNY appreciates enough, reduced expectations of further appreciation could lead to a decline in such inflows. But it is hard to determine how much of appreciation would be enough. If the market presumes that the currency needs to rise enough to eliminate the trade imbalances, no increase (as we saw in (1) above) will be sufficient, and fund inflows could continue along with expectations of additional appreciation.

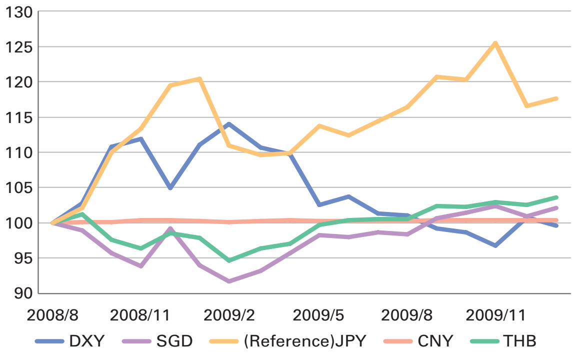
This is similar to the trap into which Japan fell and is something that China would like to avoid. As such, adopting a more flexible rate regime as a means of reining in capital inflows entails significant risks.

(4) Achieving global financial system stability

Many economists in the RoW are unhappy with China's argument that a stable CNY makes an contribution to the global stability. If one assumes that a lack of rate flexibility led to trade imbalances, and that China's investment of its foreign reserves in US Treasury securities helped keep US yields low and therefore contributed to the financial crisis, one would have to conclude that the policy of maintaining a stable rate did help destabilize the global system. However, as seen above, the relationship between the CNY rate and the balance of trade is not that simple. It can also be argued that excess consumption in the US was the real source of the imbalances, implying that it would not be fair to place all the blame on China's currency policy.

What the Chinese authorities really want to say would be that they will manage their currency carefully because it affects Asian currencies. This view might be born during the Asian crisis, when the CNY did not participate in the competitive devaluations and served as an anchor. It was also in evidence in July 2005, when China allowed a more rate, in the form of the phrase "consideration for neighboring countries." This argument still holds weight, in my view. During the current crisis not a small number of Asian countries sought to stabilize the value of their currencies against the dollar, in light of export competitiveness and the risk of capital flight (Exhibit 2). As such, an attempt by China to adopt a more flexible rate might be followed again by other nations. Thus, many Asian currencies could appreciate against the US dollar, resulting in "systemic" impact on the USD.

Exhibit 2. DXY and Asian Currencies against USD (August 2008=100)



Source: Thomson Reuters

Directions for greater RMB flexibility

From China's perspective, therefore, there is little economic rationale for rushing to adopt a more flexible rate regime. That said, China has now passed Japan to become the second-largest economy and has overtaken Germany to become its largest exporter, and it cannot continue to maintain beggar-thy-neighbor policies if it hopes to achieve greater influence in the international community. From a longer-term economic standpoint, the significance of a flexible monetary policy increases as China's domestic demand grows and its markets develop. In that sense, it would be worthwhile for China to reconsider its emergency-style peg against the US dollar and consider policies to allow a more flexible currency.

As the above makes clear, strategy to enhance the currency's flexibility needs to satisfy two conditions: (1) it should not prompt expectations of CNY appreciation; and (2) it should not trigger broad-based dollar weakness.

Regarding the first, it is important not to give the impression that the CNY is being managed solely to eliminate the trade surplus. Inasmuch as the exchange rate elasticity is unclear, that would risk sustaining expectations of CNY appreciation and encouraging continued fund inflows. Instead, the government should emphasize that the management of the CNY is just one aspect of monetary policy in a broad sense. Such a strategy would be consistent with the PBOC's stance of conducting monetary policy with a wide range of tools.

One option discussed in the markets is to peg the CNY against a basket of currencies in a highly discretionary manner. If China were to manage its currency with a focus not just on the trade surplus but also on domestic conditions, it would restrain expectations of CNY appreciation. And by boosting domestic demand, the textbook inverse correlation between the balance of trade and the domestic economy would come to apply to China as well. That would help disperse market forecasts.

Naturally, a currency basket is no magic wand. In the event that fund inflows accelerated, China would also have to make use of tools such as bank supervision and changes in regulatory rates. Nor would a currency basket be the final destination. Once domestic demand has developed substantially, China's economic structure will be different from that of a small, open economy, and it becomes necessary to apply monetary policy more flexibly.

At this stage, completely flexible rate like the advanced economies would be beneficial for China.

Regarding the second condition, developments in the dollar will have to be taken into account, as adopting a flexible rate regime when the dollar is experiencing broad-based weakness could lead to a systemic impacts as noted in (4) above. It is therefore important that the Chinese authorities choose a time when the dollar is relatively firm to allow more flexibility in CNY.

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