Peterson Institute for International Economics

In Brief

The Future of China's Exchange Rate Policy

Morris Goldstein and Nicholas R. Lardy • July 2009 • 124 pp. ISBN Paper 978-0-88132-416-7 • $20.95

Four years have passed since China announced several changes to its foreign exchange regime on July 21, 2005, including abandoning the renminbi-dollar peg and pegging to a basket of currencies instead. Despite the policy change, China's currency strengthened very little for two years after reforms were announced and the current account surplus soared to an astonishing 11 percent in 2007. From November 2007 through the end of 2008, however, the pace of appreciation increased substantially. Reinforcing this appreciation were two steps the government took through mid-2008: reducing value-added tax (VAT) rebate rates for a large number of export products and imposing restrictions on the export processing regime. Some of this appreciation is also attributable to the dollar's appreciation against other currencies resulting from the global economic turmoil and the "flight to safety" of investors seeking dollar-denominated securities, with the renminbi "riding the dollar up" during this period.

Despite the more rapid pace of currency appreciation in 2008, Goldstein and Lardy conclude that the renminbi is still undervalued on a real trade-weighted (effective) basis and that a further appreciation—on the order of 15 to 25 percent—would be desirable. However, the Chinese authorities—assuming that they don't allow the sizable real appreciation of the renminbi in 2008 to be undone—are not as far "behind the curve" as they were in October 2007 and should continue their currency reforms even in the face of a global economic slowdown.

Like most of the rest of the world struggling with the global financial crisis and economic slowdown, economic growth in China has slowed markedly—from 14 percent (at an annual rate) in the second quarter of 2007 to only 6.1 percent in the first quarter of 2009 before recovering to 7.9 percent in the quarter ending in June. China faces a considerably less buoyant outlook for external demand than before the crisis, as seen in the sharp decline in China's exports beginning in November 2008. To mitigate the effects of slowing external demand and promote exports, the authorities have since July 2008 backtracked and raised VAT rebates paid to producers of exported goods.

If China allows little currency appreciation over the coming quarters, continues raising VAT rebates, and global growth converges back toward long-term potential, China's current account surplus would risk expanding once again, perhaps at the rapid pace observed in 2005–07. China's external imbalance is much bigger than it was five or six years ago: Its current account surplus in 2008 was $426 billion compared with $68.7 billion in 2004. China's foreign exchange reserves have also skyrocketed, reaching $2.1 trillion at the end of June 2009.

Goldstein and Lardy recommend that China disavow any strategy of "competitive undervaluation" of the renminbi that might be aimed at dealing with reduced global demand for Chinese exports. They call for a rejection of export promotion measures, even if such steps are technically consistent with China's World Trade Organization obligations.

CHALLENGES AND OPTIONS

An increasingly undervalued exchange rate, a rapidly expanding current account surplus and the related accelerating buildup of foreign exchange reserves, and more recently the sharp decline in economic growth pose several economic challenges for Chinese authorities. Among them are:

- maintaining progress on currency reform while trying to use monetary policy as an effective instrument of macroeconomic management;
- reducing excessive reliance on investment and external demand to sustain economic growth and increasing reliance on services and domestic demand instead;
- preventing defense of the currency regime from unduly handicapping efforts to strengthen and transform banks into truly commercial entities; and
- containing the risk of protectionism abroad in response to the emergence of China's very large global current account surplus.

To address these challenges, Goldstein and Lardy present policy options for Chinese authorities, framing the choice of exchange rate policy in terms of two competing strategies. The first, which they call "stay the course," reflects the strategy that emerged in the second half of 2008. The second strategy, which the authors call the "three-stage approach," would entail greater efforts to maintain and extend the recent progress on real effective appreciation of the renminbi. This strategy has been revised since the authors presented it in the fall of 2007 in light of the significant changes in the domestic and external environment in which exchange rate policy now operates.

Stay the Course

Under the stay-the-course strategy, the authorities would adjust the scale of their exchange market intervention to hold the renminbi virtually constant vis-à-vis the dollar, continuing the policy in place since mid-summer 2008. If the dollar continued the rapid pace of appreciation seen in 2008, the authorities might even allow their currency to depreciate vis-à-vis the dollar in order to limit the pace of renminbi appreciation measured on a trade-weighted basis. If, as anticipated by many economic forecasters, the global recession was severe, the authorities would slow considerably the pace of appreciation on a trade-weighted basis. In addition, to further mitigate the potential reduction in the contribution of exports to economic growth, the authorities would raise the rate at which the VAT on exports is rebated. This is evident in a series of announcements since July 2008 raising VAT rebates on a broad range of exported goods.

Keeping in mind that the renminbi is still substantially undervalued, the stay-the-course strategy has a number of economic disadvantages:

- Perpetuating an undervalued currency will continue to distort domestic investment decisions.
- The stay-the-course strategy undermines government efforts to transition to more consumption-driven growth.
- Maintaining an undervalued currency and offering preferential treatment for China's most labor-intensive industries will keep investment and human resources in the lowest value-added industries, thus impeding the growth and expansion of both services and industries that China seeks to develop, such as information technology, biology, aerospace, new energy sources, and new materials.
- The stay-the-course strategy is not consistent with the pledge of China's president at the G-20 meetings in November 2008 in Washington and April 2009 in London that China would resist protectionism. In an environment of rising unemployment, and zero or perhaps negative real global growth, the stay-the-course strategy—in which currency appreciation slows considerably or stalls altogether and in which the authorities promote exports through increasing VAT tax rebates for a broader range of export products—is bound to attract growing criticism as beggar-thy-neighbor policies.
- Perpetuating the undervaluation of the currency by large-scale intervention in the exchange market will need to be accompanied by continued sterilization of the resulting increases in the money supply. If exchange market intervention and sterilization continue at high levels, the Chinese authorities will continue to foster a monetary disequilibrium that will perpetuate the large external imbalance.

Three-Stage Approach

If, based on the foregoing arguments, the stay-the-course strategy doesn't look so promising, what is the alternative? Goldstein and Lardy call for a three-stage approach that would permit China to continue to reduce the undervaluation of the renminbi as well as its very large global current account surplus while keeping a lid on domestic social pressures. In stage one, during the global recession, China should eschew competitive devaluation as a mechanism to deal with reduced external demand. It should refrain from further increases in the VAT rebate rates on export products. Otherwise, domestic investment will continue to flow disproportionately into manufacturing and the services sector, which has the greatest potential for job creation, will continue to suffer from underinvestment. Difficulties in labor-intensive export industries as a result of continued appreciation of the renminbi should be addressed through trade adjustment assistance to affected workers. At the same time the government should increase infrastructure expenditure along the lines already announced. The government should also continue to increase its own consumption expenditures and transfer payments to households. During this first stage, the government could raise to 1 or 1.5 percent the daily fluctuation limit on the renminbi with respect to the major currencies, while retaining or only modestly liberalizing restrictions on capital outflows.

Stage two begins when the global economy begins to recover and China converges toward its long-run sustainable growth. As global growth recovers, the government should allow the renminbi to appreciate sufficiently rapidly that much of the remaining current account surplus would be eliminated over three to four years. Thus the government would reduce its intervention in the exchange market along with its sterilization operations. On the financial front, the government should resume the interest rate liberalization policy that was suspended in the fall of 2004. Market-determined interest rates on deposits would reduce the degree of financial repression faced by households, raise their real incomes, and thus pave the way for greater private consumption expenditure.

In stage three, when China's global current account surplus has been dramatically reduced, intervention in the exchange market, along with sterilization operations, should be curtailed still further and the daily fluctuation limit on the renminbi should be dropped, so that the renminbi would essentially be "floating." Monetary policy should continue to evolve toward an inflation targeting framework. Depending on how much progress is made on banking reform, restrictions on capital flows could then be liberalized much more substantially.

Such a three-stage approach to renminbi reform would offer many advantages over the stay-the-course option. First, continuing appreciation of the currency in stage one during the global downturn, even if at a more modest pace, would be an important signal to the international community that China is prepared to work cooperatively and constructively to address the global recession. Second, continuing appreciation would also be a critical signal to Chinese firms that they could no longer count on an undervalued currency to prop up profitability in manufacturing. Third, the expansion/redirection of government expenditures and the introduction of a trade adjustment assistance program should help China weather the global slowdown, economically and in terms of social stability. Fourth, the increase in the daily fluctuation limit for the renminbi in stage three would permit greater flexibility of the renminbi and provide increased room for maneuver in the implementation of monetary policy. Finally, the reduction in both exchange market intervention and sterilization operations in stages two and three would not only further push the real effective exchange rate of the renminbi in the right direction but also help to correct any monetary disequilibrium and reduce the strains on the banking sector. By the end of stage three, China should have eliminated any remaining undervaluation of the renminbi. It should also be closer to achieving four of its stated long-term goals: a truly market-determined exchange rate, an effective framework for independent monetary policy, a more open capital account, and a more harmonious relationship with its trading partners.

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