

# Currency Conundrum

*Until the world economy improves,  
China has no easy way out.*

*“The U.S. blasted China for its recent currency moves, calling the decline in the yuan ‘unprecedented’. ...The Treasury Department said that the weakening of the yuan would raise ‘particularly serious concerns’ if it signals a retreat from Beijing’s publically stated policy of scaling back intervention to let market forces play a bigger role. The report stopped short of labeling China a currency manipulator, a move that U.S. administrations have avoided for the past two decades.”*

—Wall Street Journal, April 16, 2014

BY RONALD MCKINNON

Since late February 2014, the inverted scale in Figure 1 shows the recent depreciation of the yuan from 6.05 to 6.225 per dollar—a depreciation of a little less than 3 percent. Though insignificant in overall trade terms, especially when compared with the volatility of other floating exchange rate regimes, the yuan’s unexpected weakening sparked the Treasury’s furor.

The uproar was not surprising. After all, China has been under constant pressure from the American government to appreciate the yuan in the mistaken belief that a stronger currency would reduce China’s large trade (saving) surplus—and reduce the large bilateral trade deficit of the United States with China (Figure 2). And China had seemed to be complying. The inserted table in Figure 1 shows the yuan appreciating more than 3 percent per year, albeit quite erratically, from July 2005 through 2013.

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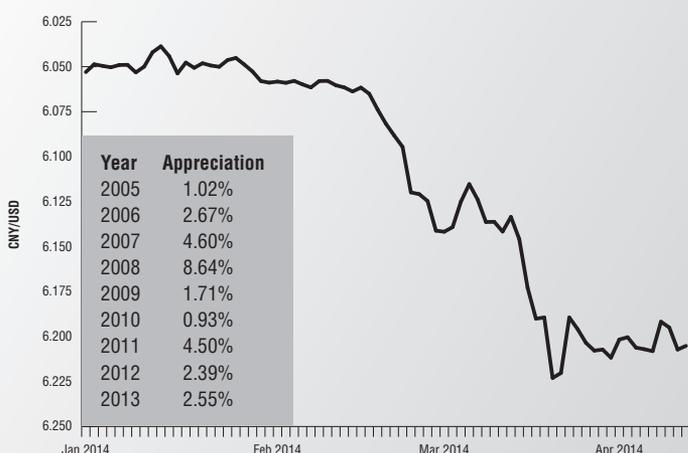
*Ronald McKinnon, Professor Emeritus of International Economics at Stanford University, is the author of The Unloved Dollar Standard: From Bretton Woods to the Rise of China (Oxford University Press, 2013).*

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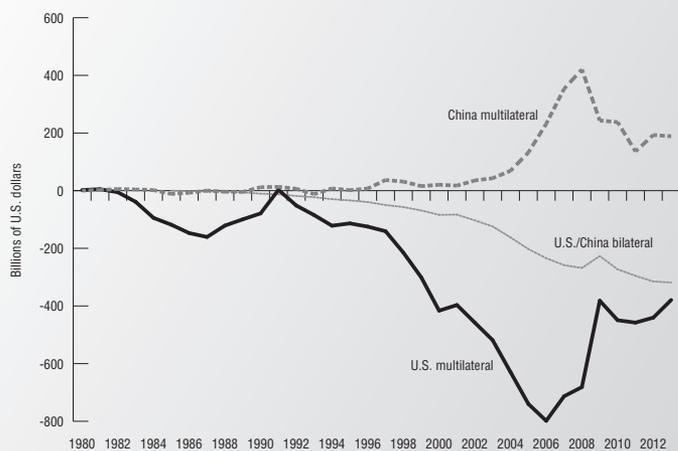
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**Figure 1: U.S. Dollar/Yuan Daily Exchange Rate (January 1 to April 9, 2014) and Average Annual Yuan Appreciation (2005–2013)**



Source: Bloomberg

**Figure 2: China/U.S. Trade Imbalances**



Source: IMF World Economic Outlook, U.S. Department of Commerce  
 Multilateral data reflect overall current-account balance in dollars. Bilateral trade balance in dollars not seasonally adjusted.

## THE HOT MONEY PROBLEM

However, the international outcry obscured another, unintended but perhaps more troubling, feature of China's previous exchange rate policy: the tendency for sporadic yuan appreciation (even small movements) to trigger speculative inflows of "hot" money. With short-term interest rates in the United States near zero, and the "natural" interbank interest rate in faster-growing China at near 4 percent, an expected 3 percent annual appreciation, for example, translates into an "effective" interest-rate differential of 7 percent. This is an

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enticing spread for currency speculators who borrow in dollars and circumvent China's capital controls to buy yuan assets.

The hot-money problem is only made worse by the ongoing international political clamor for further yuan appreciation, usually from Western economists and politicians who blame the ostensibly *undervalued* yuan for China's current-account surplus with the United States and other developed economies. In reality, the trade imbalance reflects the difference between China's large savings surplus and the even bigger U.S. saving deficiency—largely explained by the U.S. fiscal deficit. Indeed, China's producer price index—the best measure of tradable-goods prices in China—has fallen about 2.5 percent

in the past year, which suggests that the yuan may now be slightly overvalued.

Simply put, exchange rate movements cannot correct net trade (saving) imbalances between open economies, but they can increase hot money flows. So, in 2014, the

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*China is caught in a currency trap.*

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People's Bank of China resolved to upset speculators by introducing more uncertainty into the exchange rate system, as occurred with February's surprise mini-devaluation. In mid-March, the People's Bank of China announced that the daily movement in the yuan/dollar rate would be increased from plus or minus 1 percent to plus or minus 2 percent to further dampen the enthusiasm of hot money speculators. While this is all well and good, speculative inflows would be further dampened if the central rate, say, ¥6.2 per dollar, was stabilized so as to eliminate the one-way bet on future yuan appreciation.

**WAGE GROWTH VERSUS EXCHANGE RATE APPRECIATION**

There is another, less-discussed, justification for holding the currency stable. In a rapidly growing economy such as China's, necessary real exchange rate adjustments—which could be provided by flexibility in nominal exchange rates—can be better delivered by wage changes. Only in more sluggish industrial economies, where wages are assumed to be inflexible, might nominal exchange-rate movements may be necessary to overcome wage stickiness—as conventional theory would have it.

However, in rapidly growing emerging markets, wages are often sufficiently flexible on the upside. For example, if a Chinese employer (particularly an exporter) fears future yuan appreciation, he may hesitate to raise wages in line with productivity increases in order to keep his costs under control. But if he can be confident that the exchange rate will remain stable, he will have less need to restrain wages—and China has experienced 10–15 percent annual wage growth for decades. From higher wage growth at a stable nominal exchange rate, China's real international competitiveness would be better balanced by having its unit labor costs for tradable goods calibrated to converge to those in more slowly growing developed economies.

True, higher wage growth would lead to some domestic inflation in the prices of nontradable services, where productivity growth is generally less than in tradable manufactures. But the prices of tradables them-

selves—including primary commodities and manufactured goods—would be pinned down to world levels by a fixed nominal exchange rate. Increases in relative prices of non-tradables in rapidly growing economies, past and present, have been a natural “equilibrium” consequence of high growth—and is often called the Balassa-Samuelson effect.

**CHINA: AN IMMATURE INTERNATIONAL CREDITOR**

In addition to inflows of hot money because of near-zero short-term interest rates in the United States and other industrial countries, there is a second major reason why the People's Bank of China must continually intervene in the foreign exchanges to buy dollars in order to keep the nominal yuan/dollar rate fairly stable. China is a large international creditor with a saving (trade) surplus, but one whose domestic financial system is still too immature to properly offset it by “automatic” outflows of private financial capital. In effect, the Chinese government—with the People's Bank of China acting as its agent—must step in as the international financial intermediary by building up dollar claims on foreigners (largely official exchange reserves) to finance China's trade surplus.

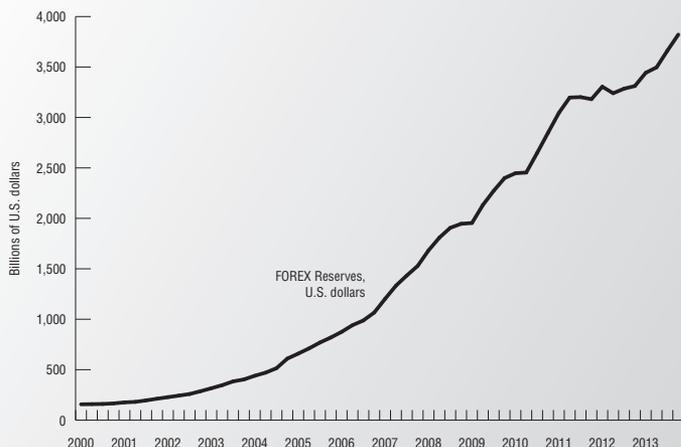
Under the world dollar standard, other countries (outside of Western Europe) cannot lend abroad much in their own currencies. As an immature international creditor, China would not be able to offset its trade surplus by making yuan loans abroad. Moreover, foreign firms remain reluctant to borrow from Chinese banks in yuan, or to issue yuan-denominated bonds in Shanghai, especially if they fear outside political pressure to appreciate the yuan.

Nor would Chinese financial institutions want to make dollar-denominated loans on a large scale. Private (non-state) banks, insurance companies, pension funds, and so on have limited appetites for building up liquid dollar claims on foreigners when their own liabilities—deposits, insurance claims, and pension obligations—are in yuan. The potential currency mismatch would be too risky. Thus, the People's Bank of China (which cares little

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and dampen domestic credit expansion  
also have adverse consequences.*

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**Figure 3 China's Foreign Reserves, 2000–2013**

Source: Bloomberg

for exchange rate risk) steps in as the principal international financial intermediary by buying liquid dollar assets on a vast scale (Figure 3).

### FLOATING IS NOT AN OPTION

Instead of such massive foreign exchange interventions, couldn't the People's Bank of China just let the yuan float without official intervention or controls on capital inflows? Again, this would inevitably trigger hot-money inflows, as speculators take advantage of the spread between Chinese interest rates and the near-zero, short-term rates in developed economies, thereby driving the yuan up the further (and creating yet more opportunities for speculation). Even without hot-money inflows, the yuan's dollar value would still face upward pressure owing to the absence of net outflows of financial capital

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to balance China's trade (saving) surplus because of China's status as an immature creditor. Under a free float, no well-defined market equilibrium, or upper bound, for the dollar value of the yuan need exist.

### STERILIZATION

As a result of People's Bank of China's continual (but necessary) interventions to buy dollars to stabilize the yuan/dollar rate, China's State Administration of Foreign Exchange has now accumulated reserves far exceeding the need to cover any possible emergency. Figure 3 shows China's official exchange reserves rising from just \$250 billion in 2000 to about \$4 trillion in 2014—largely U.S. Treasury bonds with extremely low yields. Worse, the very act of currency intervention can undermine the People's Bank of China's control of monetary policy. Buying dollars increases the

stock of domestic base money, and, on a massive scale, the resulting expansion of bank credit risks price inflation and asset price bubbles.

However, efforts to "sterilize" these purchases and dampen domestic credit expansion also have adverse consequences. The People's Bank of China frequently does this by selling bonds to commercial banks or raising their reserve requirements to reduce excess liquidity from its foreign exchange purchases. But this has reduced these banks' effectiveness as financial intermediaries, while encouraging the rise of shadow banking to circumvent the restrictions.

### TRAPPED

China is caught in a currency trap because of its own saving surplus (American saving deficiency) and near-zero interest rates on dollar assets. If China tries to liberalize its financial markets and eliminate capital controls on financial inflows, hot money finance flows the wrong way—into the economy rather than out. Although fully liberalizing China's domestic financial markets and "internationalizing" the renminbi—China's national currency—may be possible some halcyon day, that day is far off.

In the meantime, high-growth China best retains controls on inflows of financial capital while the People's Bank of China intervenes to stabilize the yuan/dollar rate. Until conditions in the world economy improve substantially, China's policymakers will have no easy way out. But the economy can continue its fast growth even if its policymakers are trapped. ◆