

On the Yuan: Should China allow its currency to appreciate?

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What is in the US interest?

- US CA deficit is indeed unsustainable. But the cause is high BD and low NS.
- Ideally, US would reduce BD, together with \$ depreciation.
- \$ has already depreciated against G-7 currencies.
 - That leaves China & neighbors.
 - Could be a coordinated package.
- But US won't take leadership.
- Is \$ depreciation by itself 2nd-best? Would just redistribute some of the crowding out, from \$-sensitive sectors (NX) to *i*-sensitive sectors (domestic demand).

What is in China's interest?

Bottom line of my paper (May 2004):
From China's perspective as well,
it is probably time to allow
appreciation of the yuan.

Qualifications

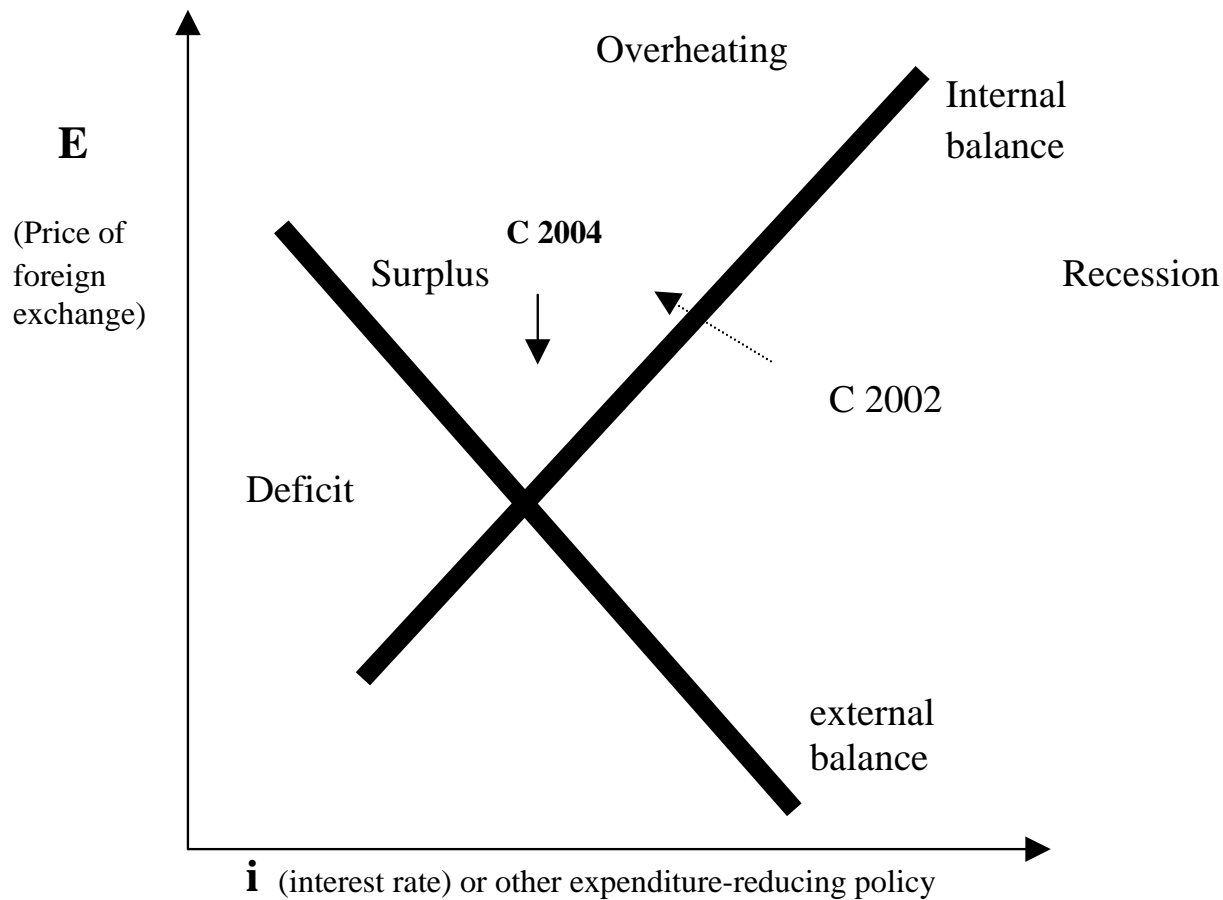
- De facto peg has done well for China for 7 years.
- Fixed exchange rates and flexible exchange rates each have their own advantages.
- A country should have the right to choose the regime best suited to its circumstances.
- That the author's recommendation for appreciation happens to coincide with urgings of American politicians is pure coincidence.

Framework of policy goals and instruments

- Assume PBC has 2 instruments:
exchange rate (E), and interest rate (i).
- And 2 goals:
 - internal balance
(neither recession nor overheating) and
 - external balance (Trade Balance or BoP)
- To attain both goals,
it needs to be able to use both instruments

Figure 1

Attaining Internal and External Balance



The graph shows why you need both kinds of policy

- If TB or BP were sole objective, it could be obtained by i or other expenditure policies.
- Then no need to change real exchange rate.
- E.g., from point C, lower i .
- But there is another objective: Don't cause unnecessary overheating (or recession).
- Thus need to vary real exchange rate too.

Where is China today, on the graph?

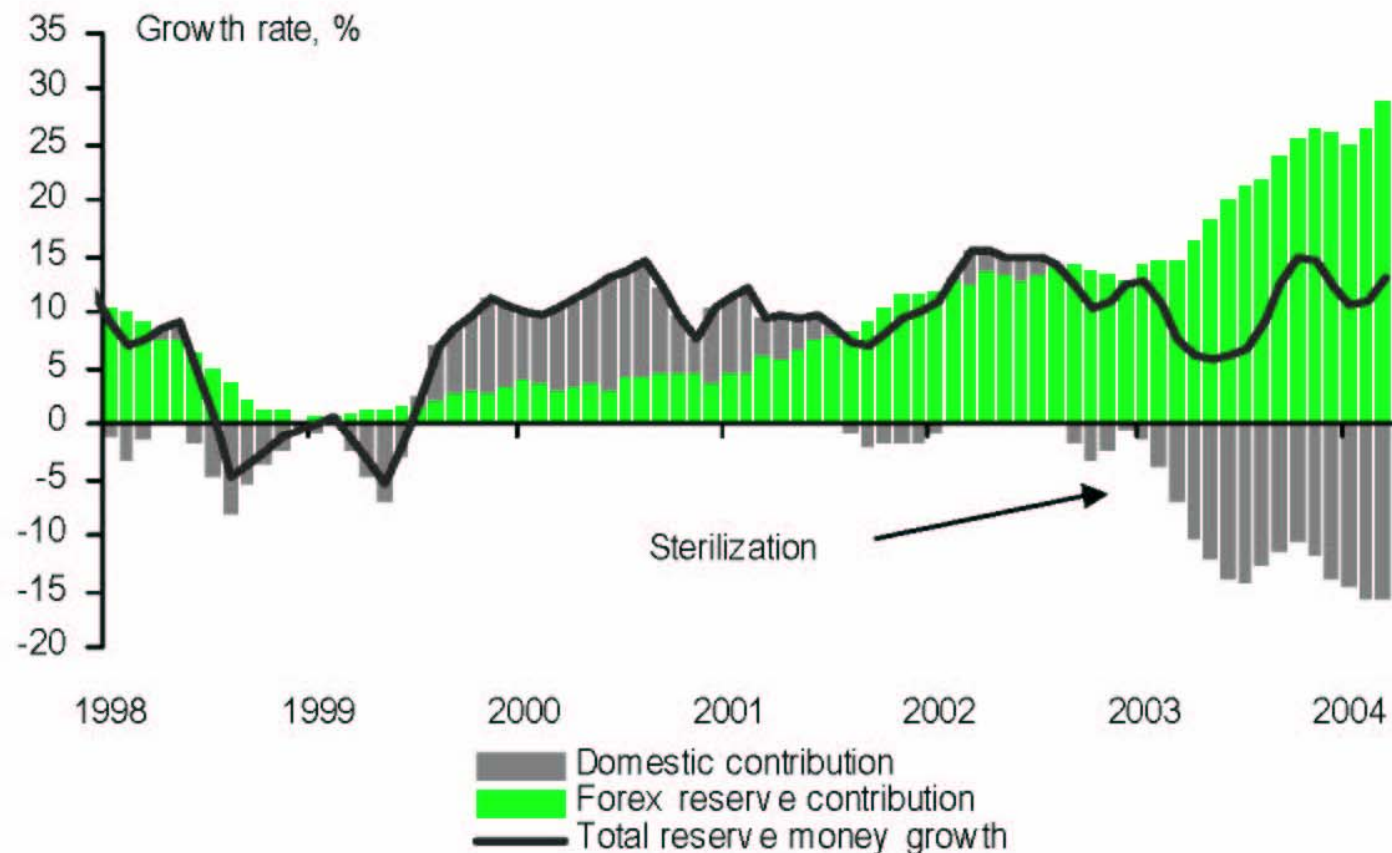
Point C

- China in 2003 crossed over from excess supply (2002) to overheating:
Now above internal balance line.
- Until recently, trade balance was in surplus.
- Still in 2004, overall balance of payments was in surplus.
- Thus above external balance line, at *C2004*.

What is wrong with continuing to run a balance of payments surplus?

- Although foreign exchange reserves are a useful shield against currency crises, by now China has enough, and US treasury securities do not pay a high return.
- It becomes increasingly difficult to sterilize the inflow over time, exacerbating inflation.
 - Sterilization incompatible with rising capital mobility
 - Requires either financial repression (force banks to take sterilization bonds) or quasi-fiscal deficit of PBC.

DOMESTIC STERILIZATION POLICY -- China 1998-2004



Source: UBS estimates



Avoiding a currency crisis

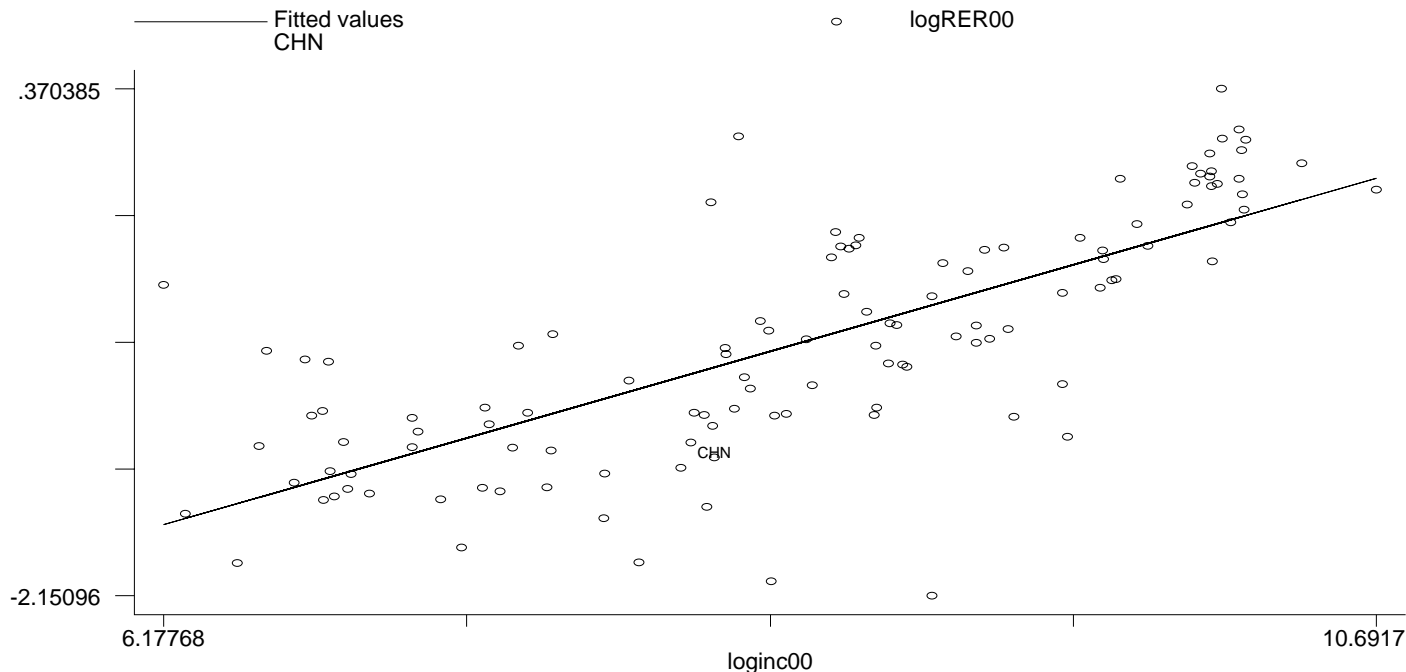
- Experience of other emerging markets suggests it is better to exit from a peg when times are good and the currency is strong (now), than to wait until times are bad and the currency is under attack.
- Admittedly, China's vulnerability is its banks.
- Watch to see if China's payments surplus persists in 2005, as US interest rates rise.

Longer-run perspective: Balassa-Samuelson relationship

- Prices of goods & services in China are low
 - not just low relative to the United States (.23)
 - but also low by standards of Balassa-Samuelson relationship estimated across countries (which predicts .36).
- In this specific sense, the yuan was undervalued by approx. 35% in 2000
 - and is by at least as much today.
 - But doesn't imply need for sudden change of this size

Estimation of B-S relationship for 2000 (118 countries, PWT)

- For every 1% increase in real income/capita (relative to US), prices increase .38% (relative)
- China's residual was .45 in logs



Does B-S relationship have predictive power?

- Typically across countries, gaps are corrected halfway, on average, over subsequent decade. \Rightarrow 2.2% /yr. for China
- \Rightarrow 4 % real appreciation per year, including effect of further growth differential of 6%
- Correction could take the form of either inflation or nominal appreciation, but the latter is preferable.

How should changes in real exchange rate, when necessary, be achieved?

- For a very small, open economy,
 - advantages of keeping E fixed are large; Adjustment can take place via prices instead.
 - Example: Hong Kong.
- For a large economy like China, it makes more sense to adjust E than to adjust prices

What would new regime be?

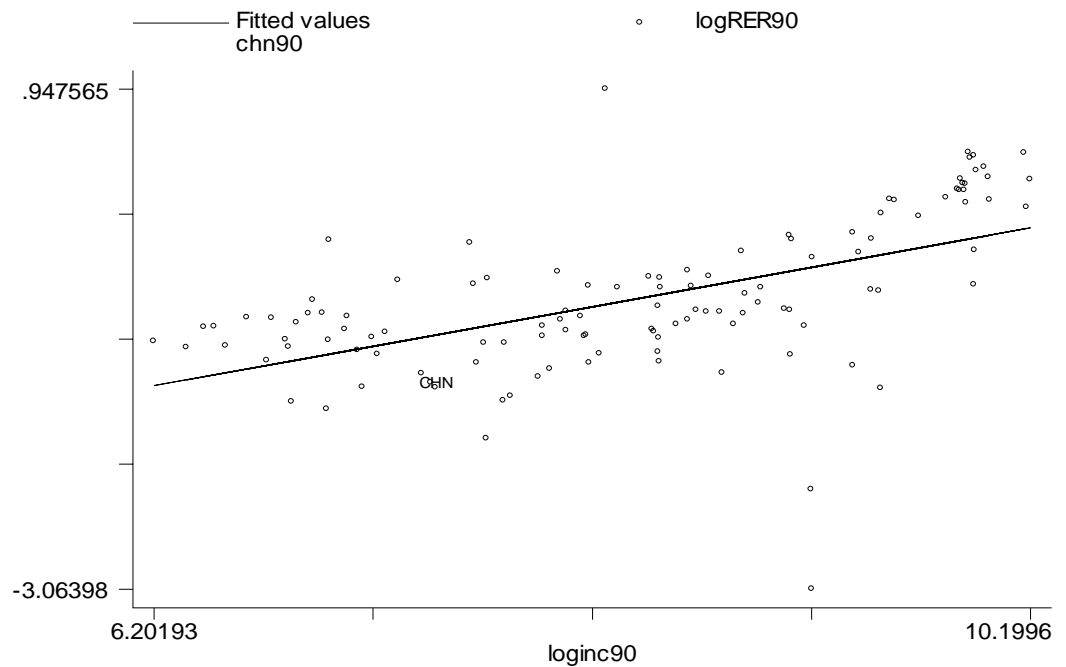
- No need for pure float.
- China is an example of why the Corners Hypothesis is wrong.
- Band or target zone may be best.
- With what as anchor?
 - Advantage of dollar: simple and transparent
 - Advantage of basket: better diversification
 - Asia currently lacks a good anchor currency.

Predictions

- Dooley, Folkerts-Landau & Garber are right that the current system bears some resemblance to Bretton Woods, with Asia playing Europe's role.
- But they are wrong if they think this can go on forever, or even for ten years. We are closer to the end (1971) than the beginning (1944 or 1958).
- Asian central banks may cut their purchases of US securities.
- At the moment, the US bond market is *more* vulnerable to a crash, even though the dollar is also still somewhat vulnerable.

Appendix: One can estimate the B-S relationship for 1990

- In 1990, incidentally, the gap for China was approx. same size as in 2000
- But not for other countries



Predictive power of deviations from the 1990 B-S regression

To examine whether the 1990 deviations have predictive power, we regressed logRER in 2000 vs.:

- a) deviations from the 1990 regression and
- b) the fitted values of the 2000 regression.

118 obs R2 = 0.73

| logRER00 | Coef. | Std. Err. | t |
|-----------|-------------|-----------|-------|
| ehat90 | .474 | .057 | 8.26 |
| logRERhat | .981 | .065 | 15.15 |
| cons | -.017 | .064 | -0.26 |

| ESTIMATING UNDER-VALUATION OF YUAN | Price level relative to US = 1/RER (in logs) | Predicted Price level by the B-S regression (in logs) | estimated real “under-valuation” (% in log terms) | implied fall in RER needed for B-S equil. (% in absolute terms) |
|------------------------------------|---|---|---|---|
| 1990 | -1.448 | -1.026 | 42.2% | 34% |
| 2000 | -1.464 | -1.015 | 44.8% | 36% |