The Case Against Exchange Rate Flexibility for China: The Plight of an Immature International Creditor

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China is again coming under heavy political pressure by the U.S. government, with some European officials chiming in, to appreciate the renminbi. Behind this political clamor is the academic view of many economists that exchange rate "flexibility"[1] is itself desirable—particularly as a way of correcting imbalances in foreign trade. Bowing to this foreign pressure, the People's Bank of China (PBC) announced on June 19th, 2010 that it was unhooking its two-year old peg of 6.83 yuan per dollar and would henceforth be more flexible. But since then, the yuan/dollar rate has moved very little. Today's (Sept 16) rate is just 6.73 yuan/dollar. Whence the sense of outrage among American and European politicians that they were deceived.

But China's government is trapped in two important respects.

First, government officials and many economists on both sides are in thrall to a false theory: that a discrete appreciation of the RMB against the dollar would have the predictable effect of reducing China's trade surplus and U.S. trade deficit. Once one realizes that China's trade surplus just reflects its net surplus of saving over investment, $\mathbf{S} - \mathrm{I}$, and vice versa for the saving-deficient United States, then there is no presumption as to which way $\mathbf{S} - \mathrm{I}$ would move if the RMB was appreciated. True, an appreciation would reduce China's corporate profitability and some corporate saving. However, in our globalized financial system, investment would fall sharply when China was suddenly seen to be a more expensive country in which to install productive capacity and produce from it. And China's currently extremely high ratio of investment to GDP, about 40 to 45 percent, has a long way to fall. With the greater sensitivity of investment to the exchange rate, any presumption should be that China's trade (net saving surplus) would increase with RMB appreciation[2]

Second, and the major focus of this paper, is the issue of exchange rate flexibility per se. I will argue that it is impossible for the People's Bank of China (PBC) to withdraw from the foreign exchange market and let the "market" decide what the rate should be when at the same time it has a huge net saving (trade) surplus. Many well- meaning foreign commentators, who are not overtly bashing China to appreciate its currency, still believe that greater market-

[1] "Flexibility" is a very pleasant word in the English language if only because its opposite connotes pejorative terms such as "rigid", "unbending", "uncaring", and so on . But we should not be deceived by these semantics

[2] McKinnon 2010a and 2010b, McKinnon and Schnabl 2009, and Qiao 2007.

determined exchange flexibility is warranted. U.S. Treasury Secretary Timothy Geithner seems to think so:

> "It is China's decision about what to do with the exchange rate -- they're a sovereign country," Geithner said. "But I think it is enormously in their interest to move, over time, to let the exchange rate reflect market forces, and I am confident that they will do what is in their interest," he said while visiting Boeing and other exporters in Washington State".
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Secretary Timothy Geithner's tone here is much more measured and careful than in previous episodes of American China bashing where various congressmen, journalists, industrialists, union officials, and economists have called for a large appreciation of the RMB against the dollar. Nevertheless, Secretary Geithner's more moderate and seemingly reasonable approach to let the yuan/dollar rate reflect "market forces" i.e., by floating or otherwise becoming more flexible, is still not feasible. Why?

China as an Immature International Creditor

China is in the historically unusual position of being an *immature* creditor: its own currency, the renminbi, is hardly used at all in financing its huge trade (saving) surplus. Instead the world—particularly the Asian part of it—is still on a dollar standard. The dollar is the invoice currency of choice for most of Chinese exports and imports and for open-market, i.e., nongovernment, controlled financial flows. So we have the anomaly that the world's largest creditor country cannot use its own currency to finance foreign investments.

The lag in the international use of the RMB is partly because China's domestic financial markets are not fully developed: interest rate restrictions as well as residual capital controls on foreign exchange flows, remain. But a more fundamental constraint is that the U.S. dollar has the first-mover advantage of being ensconced as "international money". World financial markets shun the use of more than one or two national currencies for clearing international payments—with the euro now in second place. But the euro's use in payments clearing is still pretty well confined to Europe's own backyard (Eastern Europe and former European colonies). Thus dollar dominance makes the internationalization of the RMB very difficult—although the People's Bank of China (PBC) is trying hard to encourage the RMB's use in international transacting on China's immediate borders.

The upshot is that China's own currency is still not used much in lending to foreigners. Foreigners won't borrow from Chinese banks in RMB or issue RMB denominated bonds in Shanghai. But, apart from direct investments abroad by Chinese corporations, private finance for China's trade surplus would have to take the form of Chinese banks, insurance companies, pension funds, and so on, acquiring liquid foreign exchange assets—largely in dollars. But their domestic liabilities—bank deposits, annuity or pension liabilities—are all denominated in RMB.

Because of this *currency mismatch*, the exchange rate risks for China's private banks and other financial institutions are simply too great for them to be international financial intermediaries, ie., to lend to foreigners on a large scale.

China's current large trade (saving) surpluses, which run at about $200 to $300 billion per year, would quickly cumulate to become much greater than the combined net worth of all of China's private financial institutions. Because these private (nonstate) institutions would refuse to accept the exchange risk (possible dollar depreciation) of holding dollar assets on a significant scale, the international intermediation of China's saving surplus is left to the central government. The problem is worsened by American "China bashing" to appreciate the RMB, the expectation of which makes foreigners even more loathe to borrow in RMB—while stimulating perverse *inflows* of hot money to China.

The upshot is that China's central government steps in to intermediate and control the country's saving surplus in several different ways.

1. The accumulation of huge liquid official reserves of foreign exchange, currently about $2.5 trillion, in the State Administration of Foreign exchange (SAFE).

2. The creation of sovereign wealth funds, like the China Investment Corporation (CIC) which invests overseas in bonds, equities, or real estate.

3. Encouraging China's large state-owned enterprises such as SINOPEC to invest in, or partner with, foreign oil companies in exploration and production.

4. Quasi-barter aid programs in developing countries which generate a return flow of industrial materials.

Under 4, China does not give "aid" to African or Latin American countries in the conventional form of liquid dollar deposits. Instead, China's overseas investments are combined with aid under the fairly strict government control of China's Export-Import Bank or the Department of Commerce. In return for using state-owned construction companies to build large scale infrastructure for ports, railways, power plants, and so on, the recipient country agrees to repay China by giving it a claim on a future stream of copper or iron ore or oil or whatever mineral that the infrastructure investments make possible. Whence the "quasi barter" nature of the deal. Because these foreign aid—investment projects are under the control of state-owned financial intermediaries, they become effectively *illiquid*: they will not be suddenly sold off and become part of hot money flows back into China.

Each of these techniques for intermediating China's saving surplus internationally generates claims on foreigners that are in "safe" government hands. That is, they won't be suddenly liquidated if, say, there is suddenly a new scare that the RMB will be appreciated. This

minimizes, but does not eliminate, the possibility of hot money inflows back into China that could destabilize the exchange rate and make monetary control more difficult.

Tiny Singapore is also an immature creditor whose own currency is not used for international lending and whose government, like China's, tightly controls overseas financial intermediation. Singapore's net saving (current account) surpluses have been persistently the world's largest at about 15 to 20 percent of its GNP. To prevent hot money flows, it essentially nationalizes the internal flow of saving by requiring all Singaporeans to deposit what had been as much as 30 percent of their personal incomes into the Singapore Provident Fund—a state-run defined-contribution pension scheme. Then, beyond financing internal investments within Singapore, the proceeds from the Provident Fund are lent to two giant sovereign wealth funds: the Government Overseas Investment Corporation (GIC), which invests in fairly liquid overseas assets, and Temasek, which is more of a risk taker in foreign equities and real estate.

Both the GIC and Temasek are Singapore's answer to minimizing currency risk from international investing. Although their domestic liabilities to the Provident Fund are all in Singapore dollars, and their large foreign assets are in various foreign currencies—mainly U.S. dollars— both agencies are government owned with (implicitly) large capital reserves so that they can disregard the currency risk. Because the country's large overseas assets are in safe government hands, hot money flows are minimal. The Monetary Authority of Singapore (MAS) controls a gentle "float" of the Singapore dollar against U.S. dollar while holding little overt official exchange reserves. (The country's unofficial international reserves are the huge assets held by the GIC and Temasek.) The stable exchange rate then anchors Singapore's national price level.

This "Singapore Solution" to international financial intermediation by an immature creditor country, while preserving monetary control, was described in McKinnon (2005, ch. 8). Singapore is too small for Americans and Europeans to complain about its disproportionately large trade (saving) surplus, and demand that the Singapore dollar be appreciated. China (and Japan before it) are not so lucky. Although China's trade surpluses are proportionately much smaller than Singapore's, their large absolute size draws the ire of American mercantilists in the form of "China bashing" for the RMB to be appreciated. Although the common theory that exchange rate appreciation will reduce a saving surplus of a creditor country is wrong (Qiao 2007, McKinnon 2010b, fear of appreciation still induces large hot money inflows into China despite the immunization of its overseas investments—as described by points 1 to 4 above

Surplus-saving Japan is also an immature international creditor because the yen is not much used to denominate claims on foreigners. But, unlike China's or Singapore's, the Japanese government does not dominate the international intermediation of its saving surplus as much. How then is Japan's saving (current account) surplus financed internationally?

Large Japanese corporations make heavy overseas direct investments in autos, steel, electronics, and so on. But, in addition, Japanese banks, insurance companies, and pension funds, have become big holders of liquid assets, at different terms to maturity, denominated in many foreign currencies such Australian, New Zealand, as well as U.S. dollars —which until fairly recently had much higher yields than yen assets.

This part of the Japanese system for overseas investment is vulnerable to hot money flows. Over the last 20 years, carry trades out of low yield yen assets have been commonplace with a weakening yen. But they can suddenly reverse as in 2008. The Japanese economy is then vulnerable to sudden runs from dollars (largely owned by private Japanese financial institutions) into yen that create damaging sharp appreciations in the "floating" yen/dollar exchange rate. Investment within Japan is inhibited while making it more difficult for the stagnant economy to escape from its zero-interest liquidity trap (McKinnon 2007).

China, through measures 1. through 4. above, has mitigated—although not escaped from—the immature creditor dilemma. If it tried to float the RMB, so that the PBC was neither a buyer or seller of foreign exchange, then non-state Chinese banks would not accept the risk of financing the huge trade (saving) surplus by accumulating dollar claims. There would be no net buyers of the dollars thrown off by China's large export surplus. The RMB would spiral upward indefinitely against the dollar with no well defined upper bound until the PBC was dragged back in to reset the rate. Unlike what Secretary Geithner would suggest, there is no market solution for the exchange rate for a large immature creditor country.

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