
CHINA'S

NEW EXCHANGE RATE POLICY: WILL CHINA FOLLOW JAPAN INTO A LIQUIDITY TRAP?

BY RONALD I. MCKINNON

STANFORD UNIVERSITY

ON JULY 21, 2005, CHINA gave in to concerted foreign pressure – some of it no doubt well meant – to give up the fixed exchange rate it had held and grown into over the course of a decade. China's exchange rate anchor of 8.28 yuan per dollar ($\pm 0.3\%$) had been accompanied by declining inflation and more stable real growth. But the US Congress had threatened, and still threatens, to impose a tariff of 27.5 percent on imports from China unless the yuan was appreciated. The probability of future appreciation of the yuan against the dollar has become greater since July 21. Actual appreciation has been trivial – less than 3 percent, much less than the 20 percent to 25 percent called for by vociferous American critics.

But the move signalled that further appreciation had become more likely. American pressure on China today to appreciate the yuan is eerily similar to the pressure on Japan to appreciate the yen against the dollar that began 30 years ago. As in the case of Japan, downward pressure on interest rates from foreign exchange risk could lead China into a zero-interest liquidity trap much like the one Japan has suffered since the mid-1990s. With China's interbank rate now at 1.61 percent compared to a United States federal funds rate of 4.75 percent, a zero-interest liquidity trap is not far off.

This article, first published in the *Economist's Voice*, Volume 3 (2006) No. 5, finds that the recent abandonment of China's 'traditional parity' of 8.28 yuan per dollar makes a new credibly fixed exchange rate strategy more difficult – and certainly not possible for some time. It argues that the second-best solution is for China to continue, and possibly strengthen, its foreign exchange restrictions on liquid financial inflows, thus limiting the foreign pressure to drive interest rates down.

1. From Japan to China bashing

The US has now moved from Japan bashing to China bashing. Figure 1 shows how Japan's bilateral trade surplus with the United States, driven by manufactures, began to grow fast in the mid-1970s, peaked at about 1.4 percent of U.S. GNP in 1986, and remained substantial thereafter. 'Japan bashing' came to mean the threat of U.S. trade sanctions unless Japan ameliorated competitive pressure on impacted American industries, typically through 'voluntary' restraints on Japanese exports of steel, autos, televisions, machine tools, semiconductors, and so on, coupled with yen appreciation, as described in my MIT Press book with Kenichi Ohno.

By 1995, the Japanese economy had become so depressed by the overvalued yen (*endaka fukyo*¹), that the Americans relented and Secretary of the Treasury Robert Rubin announced a new 'strong dollar' policy. The US Federal Reserve Bank jointly intervened with the Bank of Japan several times in the spring and summer of 1995 to stop the yen from going ever higher.

Now China bashing has superseded Japan bashing. By 2000, China's bilateral trade surplus was as large as Japan's, and by 2004 it was twice as large, triggering U.S. threats of trade sanctions and demands for currency appreciation – pressure that China had felt for a least four years before giving in last July.

In the new millennium, China's emergence as a major trading nation has coincided with a new round of war-related deficit spending by the US federal government, and surprisingly low personal saving by American households – perhaps because of the bubble in US residential real estate.

This American saving deficiency resulted in an enormous overall current-account deficit of about 6 percent of American GDP in 2004 and 2005 – much bigger than the combined current account surpluses of Japan and China. The result is a substantial widening of the American trade deficit in manufactures – for which there is no exchange rate solution, as we shall see.

China bashing today primarily takes the form of pressuring China to appreciate its currency.

In the earlier 1978-1995 period of Japan bashing, American demands for a general appreciation of the yen were often coupled with the demand that Japan impose 'voluntary' restraints on exports of particular products because waves of Japanese exports were successively concentrated in heavy industries where lobbies were concentrated and politically potent.

By contrast, recent Chinese exports into the American market have been low- to middle-tech products of light industry. (The one big exception is textiles and apparel, where China's position has been complicated by the expiration on 1 January 2005, of the international multi-fibre agreement [MFA] that had limited Chinese textile exports into world markets.)

2. The exchange rate and the trade balance

America's demand that China appreciate its currency is as unwarranted now as was the earlier pressure on Japan to appreciate the yen. A sustained appreciation of a creditor country's currency against the world's dominant money is a recipe for a slowdown in economic growth, followed by eventual deflation, as Japan found to its sorrow in the 1990s. Although the net effect of appreciation on the trade surplus is indeterminate, the financial press and many influential economists argue that a major depreciation of the dollar is needed to correct America's current account and trade deficits.

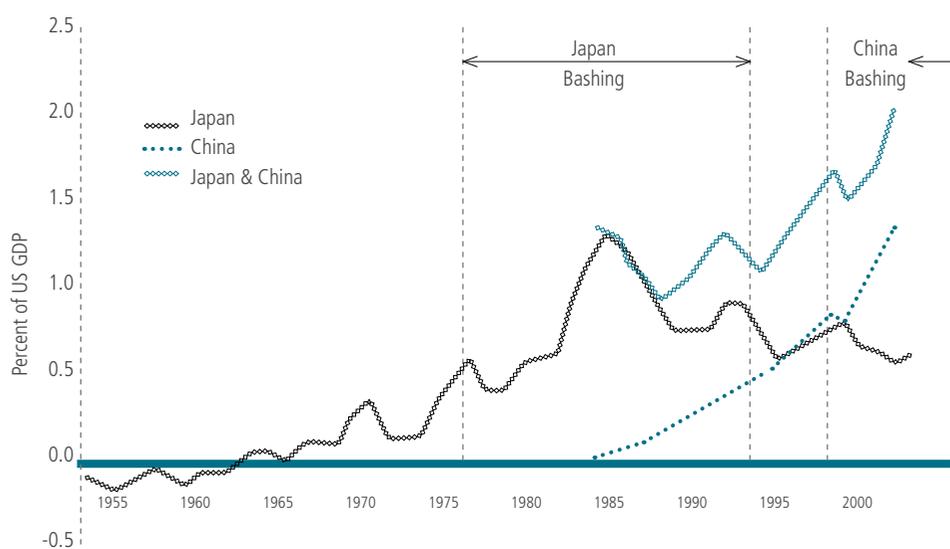
This mainstream view rests on the presumption that an appreciation of any Asian country's currency against the dollar would significantly reduce its trade surplus with the U.S. But if a discrete exchange rate appreciation is to be sustained, it must reflect expected monetary policies: tight money and deflation in the appreciated country, and easy money with inflation in the depreciated country.

There are three channels through which the deflationary pressure on the creditor economy works. First, there is international commodity arbitrage: an appreciation reduces the domestic-currency prices of imported goods whose world market prices are fixed in dollars.

Second, a substantial appreciation makes the country look like a more expensive place to invest. Third, there is a negative wealth effect as external dollar assets lose domestic-currency value. These three channels of deflation reduce aggregate demand and imports. It is true that the relative price effect of an appreciation also makes exports decline, but in theory the fall in imports could be sufficiently strong so as to leave the net effect on the trade balance indeterminate.

When Japan was cajoled into appreciating the yen, it was thrown into a decade-long deflationary slump with no obvious decline in its large relative trade surplus.

¹ High-yen-induced recessions

FIGURE 1: BILATERAL TRADE SURPLUSES OF JAPAN AND CHINA WITH THE US, 1955-2004 (PROPORTION OF THE US GDP)

Source: Kenichi Ohno

3. The exchange rate as monetary anchor

Many – including such heavyweights as the International Monetary Fund – argue for exchange rate flexibility in order to insulate domestic macroeconomic policy from the ebb and flow of international payments. But is this good advice for a rapidly growing developing country whose financial system is still immature?

Manufacturers throughout the world ‘price-to-market’ in dollars if they can. Japan is the only Asian country that uses its own currency to invoice some of its own trade – and almost half of Japan’s exports and three-quarters of its imports are in dollars. Thus each East Asian country has a strong incentive to peg to the dollar, and hitch its monetary policy to that of the centre country. In China’s immature bank-based capital market, domestic money growth is high and unpredictable, while many interest rates remain officially pegged. Thus the People’s Bank of China (PBC) cannot rely on observed domestic money growth or interest rates as leading indicators of whether monetary policy is being too tight or too easy. Whence the importance of relying on an external monetary anchor – 360 yen/dollar in the 1950s and 60s for Japan, and 8.28 yuan/dollar from 1995 to July 21, 2005 for China – as a benchmark for the national monetary (and fiscal) authorities.

Gregory Chow’s book, *China’s Economic Transformation*, documents how the Chinese lost monetary control and over issued domestic money in 1984, 1988-1989, and 1993-1994. This early Chinese experience with

highly variable rates of inflation illustrates how difficult it is for a very high growth economy to stabilise its national price level independently. From 1995 to July 21, 2005, the Chinese authorities held the now unified exchange rate constant at 8.28 yuan/dollar (plus or minus 0.3 percent). For these 10 years, they subordinated domestic monetary and fiscal policies to maintaining the fixed exchange rate – including not devaluing in the Asian crisis of 1997-98 when they came under great pressure to do so. They also further dismantled tariffs and quotas on imports faster than their WTO obligations required. This move to greater economic openness, coupled with the fixed nominal exchange rate, ended the roller coaster ride in China’s domestic inflation.

But more was involved than just stabilising inflation in China. Figure 2 shows that, after 1994, China’s very high growth in real GDP also became more stable. No doubt other explanations of the end of China’s roller coaster ride in both inflation and real growth rates are possible. However, the data are consistent with my hypothesis that fixing the nominal exchange rate provided the much-needed anchor. Behind the scenes in this remarkable convergence of Chinese to American rates of price inflation is the high rate of growth in money wages in China. In China’s ‘catch-up’ phase, where the level of output per person is much less than in mature industrial economies, growth in productivity per worker is naturally very high.

However, as long as money wages grow very fast to reflect this productivity growth, currently 10 percent to 12 percent per year, then international competitiveness remains balanced. And this is what happened in China in the past 10 years.

4. A liquidity trap for China?

China's 'liberalisation' has both an internal and external dimension. The government wants to move toward the decontrol of domestic interest rates, a more robust domestic bond market, and finally the liberalisation of capital controls. These are important and laudable objectives for improving the efficiency of China's capital markets. Now, however, with China's economy threatened by ongoing appreciation of the yuan, liberalising the financial system could have perverse short-run consequences.

In the face of undiminished foreign exchange risk (the probability that the yuan could appreciate), a near zero interest rate liquidity trap is possible – even likely. In a liberalised capital market, investors must be compensated by a higher interest rate on dollar assets because of the risk that the yuan might appreciate.

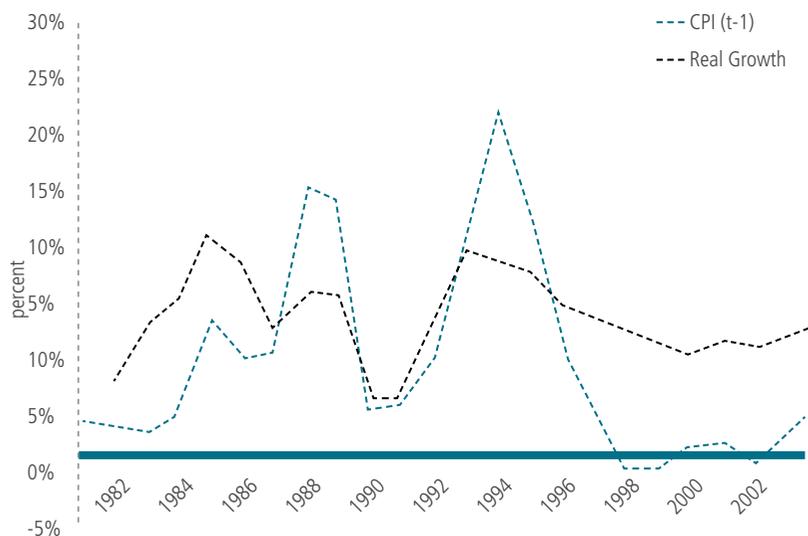
But interest rates on dollar assets are given in world markets independently of what China does. Thus, the only way in which the market can establish the necessary interest differential is for interest rates on yuan

assets to fall below their dollar equivalents. The huge build-up of dollar foreign exchange reserves, now almost US\$800bn, and consequential internal expansion of the domestic monetary base then drives down domestic short-term interest rates – at least until they hit zero. In March 2006, the fairly free interbank rate in China was just 1.61 percent when the U.S. Federal Funds rate was 4.75 percent.

Note that just letting the yuan float upward does not resolve the dilemma. Actual appreciation would lead to actual deflation with further downward pressure on domestic interest rates. From Japan's earlier experience of an erratically appreciating yen, we know that interest rates on yen assets were compressed toward zero in the ensuing deflation. And since actual appreciation need not reduce China's trade surplus, American pressure on China to appreciate further would only continue – as it did on Japan before 1995.

The first-best solution is to fix China's exchange rate in a completely credible way so that there is no fear of currency appreciation. Then financial liberalisation could proceed with market interest rates remaining at normal levels. But the recent abandonment of China's 'traditional parity' of 8.28 yuan per dollar makes a new credibly fixed exchange rate strategy more difficult – and certainly not possible for some time. Failing this, the second-best solution is for China to continue, and possibly strengthen, its foreign exchange restrictions on liquid financial inflows – thus limiting the foreign pressure to drive interest rates down.

FIGURE 2: REAL GROWTH AND INFLATION IN CHINA, 1980-2005



Source: Gunther Schnabl

5. Conclusion: slowdown in financial liberalisation?

The unhinging of China's exchange rate as of 21 July 2005 must slow progress in liberalising China's financial markets if it is to avoid falling into a Japanese-style liquidity trap. By 'slowdown' I mean retaining capital controls on inflows of highly liquid 'hot' money from dollars into yuan, and continuing to peg certain interest rates such as basic deposit and loan rates in China's banks – in order to better preserve their profitability. This slowdown is, of course, an unfortunate detour.

If China does fall into a zero interest rate trap like Japan before it, then the PBC, like the BOJ, will be unable to offset deflationary pressure in the economy should a large exchange appreciation actually occur. The ongoing threat of further appreciation would continue because China's trade surplus need not diminish as its currency appreciates. Then, with short-term interest rates locked at zero, the PBC would be helpless to re-expand the economy. True, China's economy is now growing robustly and is not likely to face actual deflation anytime soon, but the PBC would be in poor shape to offset deflationary pressure should it occur.

China is now in a nebulous no man's land regarding its monetary and foreign exchange policies – and its experiment with inconsistent basket pegging does not help. Instead of clear guidelines with a well-defined monetary (exchange rate) anchor and a clear mandate to finish liberalising its financial system, China's macroeconomic and financial decision making will be ad hoc and anybody's guess – as was, and still is, true for Japan.

6. References and further reading

Bernanke, Ben, The Global Saving Glut and the U.S. Current Account Deficit, At the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005.

Bergsten, C. Fred, and the Institute for International Economics, The United States and the World Economy, Institute for International Economics, Washington D.C. 2005.

Chow, Gregory, China's Economic Transformation, Blackwell, 2002.

Goyal, Rishi, and Ronald McKinnon, "Japan's Negative Risk Premium in Interest Rates: The Liquidity Trap and Fall in Bank Lending," *The World Economy* 26, 3, 339-63, 2003.

McKinnon, Ronald, "Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue," MIT Press 2005. (Translations: Chinese 2005, Japanese forthcoming 2007).

McKinnon, Ronald, "Exchange Rate or Wage Changes in International Adjustment: Japan and China versus the United States", *The Weekly Economist*, Mainichi Press, Tokyo, September 2004.

McKinnon, Ronald, and Gunther Schnabl, "The Return to Soft Dollar Pegging in East Asia: Mitigating Conflicted Virtue", *International Finance* 7:2, 2004.

McKinnon, Ronald, and Kenichi Ohno, Dollar and Yen: Resolving Economic Conflict between the United States and Japan MIT Press, 1997 (translations: Japanese 1998, Chinese 1999).

Qiao, Hong, "Exchange Rates and Trade Balances under the Dollar Standard" SCID Working Paper, Stanford University, August 2005. *Wall Street Journal*, October 7, 2005.

ComMark stands for Making Commodity and Service Markets Work for the Poor in Southern Africa. ComMark was established in 2003 as an independent trust with funding from the UK's Department for International Development (DFID) and is managed by ECIAfrica, a Southern African economic development consultancy.

ComMark is active in three sub-sectors of the economy: textiles and apparel, agribusiness and tourism. These were chosen because of the large number of people engaged in them and because of the potential for pro-poor growth.

The aim of the Trust is to reduce poverty in the region by putting into practice the development approach known as "making markets work for the poor" (MMW4P), which has become increasingly prominent within the international development community.

Much of ComMark's work concentrates on working with government, industry players and business rather than setting up and implementing specific projects. Its primary role is as a thought leader, innovator and catalyst. Where the Trust does engage in specific markets it works through established partners to implement its vision by providing grant funding and technical assistance. ComMark does not believe in distorting the market and therefore has a clear exit strategy.

The MMW4P approach recognises that the poor have far more assets, are far more entrepreneurial and are more deeply involved in markets than is usually acknowledged. Building on local experience and existing market activities is essential to this approach. ComMark's project to increase Joburg's cross-border retail trade has grown out of an existing market, in which more than one million people are coming to the city each year, bringing more than R8bn to the local economy. However, cross-border shoppers face constraints which, if addressed, would see this economic sector grow to new heights.

The Survey of Accommodation for Joburg's Cross-border Shoppers, conducted in 2005 by Fanaroff & Associates in association with Urban Inc. for ComMark Trust, formed part of the initial scoping for this intervention.

For information about ComMark's projects, see www.commark.org

