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A Larger Room for RMB Reform

China has always been named and shamed as “currency manipulation.” Its critics claim that China intentionally suppresses the RMB value below a fair level through massive market intervention, to raise the competitiveness of its exports. The market, however, has a quite different perception. RMB has appreciated by 30% since the 2005 exchange rate reform, and the market for non-deliverable forwards (NDFs) starts to move in both directions, which indicates that the value of the currency has started to level off. At the same time, China’s surplus has come way down. China’s current account surplus, after reaching record levels of around 10 per cent of GDP in 2007, has dropped to 2.6 percent of GDP in 2012.

People’s Bank of China (PBOC), the central bank in China, changed its course silently. Before the global financial crisis, PBOC used to purchase large amount of US dollar to stabilize the RMB exchange rate. Now it cleans its hand and sits aside. From early 2005 to Q3 2011, about \$100 billion assets will be added to the balance sheet of the PBOC every quarter on average, but from Q4 2011 to Q4 2012, only \$2.4 billion USD assets shows up every quarter on average. It is a clear signal that the PBOC has abandoned the clumsy direct intervention of the market. The way PBOC managing the market now is setting the mid-price daily, which the market takes as the starting point for that day’s trading.

It’s good news. It helps to free the hands of the PBOC and increase the autonomy of China’s monetary policy. The PBOC does not need to have the worry as before: when it bought more USD from the market, there would be more pressure on domestic money supply. But, is the current policy sustainable?

Probably not.

First, under the current under-limit and lower limit control, the rise or fall of the RMB against the USD cannot exceed 1 percent of the middle rate. When supply exceeds demand on the foreign exchange market, as it happened in Q4 2012, and the PBOC did not soak up all the USD supply, the RMB to USD exchange rate would hit an upper-limit and the trading on the market freeze consequently. This happened more often recently, and if this becomes the new normal, it will damper the development of foreign exchange market.

Second, taking into consideration that in the future, there is still room for RMB to appreciate, it makes sense for the private sector to prefer holding RMB assets rather than USD assets. How could the PBOC encourage the private sector to hold more USD assets? Well, one way to do this is through more strict administrative measures, for example, the regulatory agency can urge companies to pay back their foreign debts, so that companies has to get more USD from the market. But this means the private sector has to bear more burdens. It looks more like a sort of penalty.

My colleague Zhang Bin and I recently made a new proposal for RMB exchange rate reform¹. It's simple: keep the one percent daily band if you like, but make a clear announcement that unless the RMB exchange rate (with the USD, and/or with a currency basket) moves up or down more than 7.5 percent annually, the PBOC will not intervene the market.

It means that the PBOC will play the role as a firefighter and only response to emergencies. Let's think about two extreme cases.

Scenario one. If the RMB exchange rate goes up dramatically, by more than 7.5 percent, then the PBOC should step in and calm down the market, and for good reasons. If RMB appreciated too fast, Chinese government would worry about massive bankruptcy of export factories and rampant unemployment of migrant workers in these factories. It is not only an economic crushing blow, but also a threat to social stability.

Scenario two. If the RMB exchange rate goes down dramatically, by more than 7.5 percent, then the PBOC also need to do something to back it up. If this scenario happens, it indicates that RMB is overpriced, and China will go back to a de facto

¹ Zhang Bin and He Fan, "Next step for RMB exchange rate reform", Caijing, Feb 16, 2013. Beijing.

peg-to-the-USD regime. It is much better than doing nothing, watching a plummeting of RMB, and the sequel of capital flight and financial crisis.

But why do we choose the mysterious number 7.5? It's just a happy coincidence with this year's growth target, which is also 7.5 percent, and a back-on-the-envelope calculation. You may want to pick up another number if you like. How about 8, which is the lucky number in China? The point is, whatever number you choose, it should be large enough to convince the investors, but not too large to scare the market.

The purpose of this new proposal is to send a clear signal to the market, and create a larger room for the reform of RMB exchange rate regime.

Under this new regime, RMB may appreciate further, and there is going to be more fluctuation of the RMB exchange rate. Will this hurt China's export, employment and macroeconomic stability?

China has a diversified group of trade partners. What really matters is not the bilateral exchange rate, or the nominal exchange rate. If you want to see the impacts of exchange rate on trade performance, better looking at the Real Effective Exchange Rate (REER), which is the weighted average of a country's currency relative to a basket of the currencies of its major trade partners, and adjusted for the effects of inflation. We checked the data on the REER movement of RMB, USD, EURO, Singapore dollar, Korea Won, India Rupee, and Mexican Peso in the period of 1994 to 2012. This is the period when China moved from fixed exchange rate regime to the new managed floating regime. We found that the Singapore dollar, which is under a kind of BBC (Basket, Band and Crawling) regime, was the most stable currency. The implication is that, constant market intervention does not guarantee exchange rate stability. A larger band for fluctuation, with more clear rules, probably suits China better.

There is already a large body of literature discussing the exchange rate target zone². The basic message is, given the assumption that central bank can make a credible announcement, the movement of exchange rate will be rather smooth and stable within the band. China has enormous foreign exchange reserve and the economic growth is quite robust. China still has large room for maneuver for its fiscal

² Paul Krugman, "Target Zones and Exchange Rate Dynamics", *The Quarterly Journal of Economics*, Vol. 106, No. 3 (Aug., 1991), pp. 669-682.

and monetary policies. It's the right time to speed up the reform of RMB exchange rate policy.

We do not buy the argument that RMB appreciation can help the U.S. a lot on reducing its current account deficit. A study by our colleagues at the Institute of World Economics and Politics (IWEP) shows that the income elasticity of China's exports are much larger than the price elasticity, meaning that China's exports depend more on how deep are American's pocket, not on how cheap the price on the tag of "Made-in-China" goods³. But we do believe that RMB exchange rate reform should be one of the major components of any policy packages to balance Chinese economy. Exchange rate is not only the relative price of two currencies, but also the relative price of tradable and non-tradable products. China's manufacturing sector is very competitive, even by international standard. But its service sector, which is mainly the non-tradable sector, is lagging behind. Getting the price right, then resource reallocation will follow. It helps to facilitate the long-wanted structural changes.

We also believe a faster RMB exchange rate reform can pave the way for other reforms like RMB internationalization and capital account liberalization. But sequence matters⁴. Some argues for a more rapid RMB internationalization and capital account liberalization right now, and the PBOC has started to working out a roadmap and time table. We cannot see why we should do it in such a rush. RMB internationalization will have a very profound impact on global financial system. Capital account liberalization is a prerequisite for RMB internationalization. But these are long-term goals. It's a long march for China's financial reform. First things first. What we need to do is pushing forward the reform of exchange rate and interest rate. Cleaning the house, then open the door and welcome the guests. Even if we want to utilize the opening up policy to create new momentums for domestic reform, as China did successfully in early 2000s with its entry into the WTO, why not opening up the financial sector directly? You just cannot put the cart before the horse⁵.

³ Qingyi Su, Zhizhong Yao and Feng Tian, "Income and Price Elasticities of China's Exports," *China & World Economy*, Vol. 21, No. 1, pp. 91, 106, 2013.

⁴ Yu Yongding, Temptation for China's Capital Account, Project Syndicate, March 27, 2013.

⁵ Eswar Prasad, Thomas Rumbaugh, and Qing Wang, "Putting the Cart Before the Horse? Capital Account Liberalization and Exchange Rate Flexibility in China", IMF policy discussion paper 05/01, 2005.

We are living in an age of uncertainty. International financial markets are in turmoil, and domestic financial sector is fragile. Advanced countries pumped money to their economies through quantitative easing policy, and released a huge flood of liquidity to the international financial market. One day they decide to exit and increase the interest rate, a sudden stop of capital inflow, or even a panic of capital flight will trail, and cause serious risks for emerging markets. So, why make a frantic dash now?

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