China Should Unpeg the Remninbi Now
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August 2003

China is coming under intense pressure to revalue its currency. At last month's ASEM meeting of Asian and European finance ministers, it was forcefully lobbied by the European participants to move in that direction. ECB President Wim Duisenberg and European Commission President Romano Prodi have added their voices to the chorus. U.S. Treasury Secretary John Snow has said that a more flexible remnimbi is "to be encouraged." No less of a financial sage than Alan Greenspan has weighed in on the question, observing that it is "increasingly evident" that China will have to move to a more flexible currency. More ominously, four U.S. senators have asked the U.S. Treasury to investigate whether China's existing currency practices violate international rules.

Why all this attention is being paid to the value of the remnimbi just now is not hard to fathom. The U.S. current account deficit is continuing to widen with the demand-driven recovery of the American economy, fanning fears that the drop in the dollar could turn into a rout and destabilize financial markets. The jobless nature of the recovery – that employment has not picked up along with production – is widely linked to the current account deficit, the argument being that the U.S. is exporting manufacturing jobs as a result of its $100 billion trade deficit with China. The value of the remnimbi, not an item normally prominent among the concerns of American assembly line workers, was reportedly Topic Number 1 on Secretary Snow's recent bus tour of the U.S. Midwest.

Because China's currency is linked to the dollar and other Asian currencies follow closely along with it, Europe has borne the brunt of the dollar's depreciation. European officials do not question that the dollar had to decline to narrow America's current account deficit, but they would have preferred that the consequences were more evenly shared. As it is, it is mainly the euro that has strengthened against the dollar and mainly the European economy that has suffered a loss of competitiveness. Because the remnimbi is linked to the dollar, it has depreciated against the euro, reinforcing China's already considerable competitive advantage. And if the dollar will have to decline still further to eliminate America's current account deficit, as most observers anticipate, then China's competitive advantage will only be reinforced, heightening Europe's pain.

For Japan, China is a convenient scapegoat for festering economic problems that domestic politicians have been unable to solve. To shift the blame, Japanese officials have sharply criticized China for exporting deflation and "hollowing out" Japanese manufacturing.

Emerging markets similarly feel the pressure of Chinese competition. Currently the single most widely cited economic statistic in Mexico is that more sombreros are now manufactured in China than in Mexico itself. Latin American and East Asian countries are seeing much of the direct foreign investment that they previously received from the U.S. and Europe siphoned off by an insatiable China. Even South Korea, one of Asia's success stories, has complained that its exports are being priced out of international markets as a result of China's artificially cheap currency.

Thus, we have one of those singular conjunctures when everyone – everyone, that is, except Chinese officials themselves – agrees on the urgent need for a remnimbi revaluation. And even Chinese officials, while resisting the idea that now is the time, acknowledge that they will ultimately have to move in this direction.

Until now, pegging the currency has made sense because a stable exchange rate has supported the export growth that has been the engine of China's economic expansion. Pegging has been possible because capital movements in and out of China have been tightly regulated. But neither of these circumstances will prevail indefinitely. China's exports cannot grow five times as fast as domestic demand forever. Eventually, Chinese firms will have to reorient their production toward domestic markets, and an exchange rate that appreciates against foreign currencies will help to provide them with the incentive to do so.

In addition, China's capital account is becoming more porous, making it more difficult to maintain the peg. The errors and omissions line in China's balance of payments accounts ballooned to nearly $8 billion in 2002, reflecting unrecorded capital inflows motivated by expectations of revaluation. As economic and financial liberalization continue, it will become still easier to move money in and out of the country, even if the authorities retain – as they should – a battery of restrictions on international financial transactions. In turn, a more porous capital account will make it more difficult for the authorities to prevent the exchange rate from fluctuating.

A more flexible exchange rate has advantages for a large economy like China. All of the world's other large economies – the United States, Euroland, and Japan – have flexible exchange rates. A flexible exchange rate allows them to adjust their monetary and fiscal policies to more effectively regulate domestic demand. In the long run, there is no reason why China should be different.

But is now the time to abandon the long-standing peg to the dollar? Critics of revaluation offer three arguments why shifting now to a more flexible exchange rate would be premature.

First, China's banking system is a mess. Weak banks may be unable to handle the additional balance-sheet stress caused by currency fluctuations. Hence, allowing the exchange rate to move will raise the already considerable risk of a banking crisis. The implication is that the country should complete the process of recapitalizing and commercializing its banking system before allowing more flexible currency.

To be sure, problems in the Chinese banking system are serious, and the authorities should waste no time in solving them. But will a more flexible exchange rate really aggravate them significantly? China's banks have not funded themselves by borrowing offshore in dollars, the practice that got Thai and Korean banks into such trouble in 1997. To a large extent they are prevented from doing so by capital account restrictions. And it is important to remember what is being urged on the Chinese authorities. They are being asked to allow the exchange rate to fluctuate more freely, not to deregulate the capital account or turn a blind eye to bank borrowing abroad. To the contrary, what China needs is more rigorous bank regulation, including regulations designed to limit currency mismatches on bank balance sheets. Already commercial banks have been required to increase their foreign exchange holdings, which is a step in the direction of protecting them against exchange rate risk. Strengthening bank regulation should be a priority whether the remnimbi peg is abandoned or not. But one not incidental benefit of better bank regulation will be to limit the domestic financial repercussions of a more flexible exchange rate.

A second objection is that Chinese firms lack the hedging instruments needed to protect themselves against exchange rate fluctuations. Unpegging the remnimbi, it is said, could lead to the collapse of the entire state-enterprise sector. To be sure, China's state enterprises, like its banks, have deep problems urgently requiring attention. The prospect of a more flexible exchange rate adds yet one more reason for the authorities to either privatize those state enterprises or close them down. In practice, of course, doing so will take time. But it is important to recognize that the rapid growth of private enterprise has already reduced the state sector to a small share of the Chinese economy. As a result, the old state-owned dinosaurs have a much reduced capacity to destabilize the Chinese economy.

Moreover, enterprises seeking hedging instruments will be able to find them in Hong Kong. China's own financial system may be undeveloped, but it has, right next door, one of the world's most sophisticated financial markets, complete with benchmark bonds and a well-defined yield curve on which to base forwards, futures and other hedging instruments.

Finally, it is argued that because Chinese financial markets lack depth and liquidity, a floating remnimbi will be unstable. But this assumes that the value of the currency will be left entirely to market forces. In fact, no Asian country allows this; in practice, they all intervene heavily in the foreign exchange market. When it unpegs the remnembi, China will certainly do the same, limiting the currency's day-to-day fluctuations. Last April the People's Bank launched regular open market offerings of central bank bills, creating an ideal instrument with which to conduct such intervention.

Currently the betting is that China will adopt explicit fluctuation bands similar to those of the ERM, perhaps sometime early next year. The risk with this strategy is that fluctuation bands can quickly become a target for currency speculators. A better option would be for the government to keep its target range for the exchange rate and intervention strategy to itself, as countries like Singapore have done.

There is never an ideal time to abandon a currency peg. If the exchange rate is weakening under pressure from speculators, abandoning the peg tends to be seen as an embarrassing admission of policy failure by the government. On the other hand, if the currency is strong, as in China today, there is always a temptation to ask "What's the hurry? Why tamper with success?" While the Chinese economy continued to surge ahead at an 8.2 per cent annual rate in the first half of 2003, it still has to soak up millions of additional workers. This encourages the natural tendency to leave the exchange rate problem for another day.

But no currency remains strong forever. Sooner or later some event – say, a bank failure or a corporate scandal – will cause capital flows to reverse direction. If, when this happens, China has already moved to a more flexible exchange rate, the result will simply be a smooth depreciation of the remnembi. But if it sticks with the peg, the result instead could be a speculative attack and a currency crisis, with highly disruptive consequences. Think, in other words, of Argentina.

By moving to a more flexible exchange rate now, the Chinese authorities would receive accolades from other governments. More importantly, they would buy themselves insurance against the risk of a speculative attack down the road.

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