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China's Exchange Rate and Financial Repression: The Conflicted Emergence of the Renminbi as an International Currency

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China's Exchange Rate and Financial Repression

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McKinnon, Ronald / Schnabl, Gunther 2014: China's Exchange Rate and Financial Repression: The Conflicted Emergence of the Renminbi as an International Currency. *China and the World Economy 22, 3, 1-34*.

Schnabl, Gunther / Spantig, Kristina 2014: (De)Stabilizing Exchange Rate Strategies in East Asian Economic and Monetary Integration. *Working Papers on Global Financial Markets 53*.

1. Introduction

An Asymmetric World Monetary System

- International trade and capital flows (outside Europe) are predominantly invoiced in US dollars (informal dollar standard, McKinnon 2013).
- The dollar remains the dominant means of settlement for international payments among banks and the principal intervention currency by governments to smooth exchange rate fluctuations.

The Chinese Exchange Rate Conflict

- Since 2004 the renminbi remains tightly pegged to the dollar.
- China is under pressure to float (let appreciate) the renminbi (Cline and Williamson 2012, Bergsten 2013).
- Demands to make the renminbi more flexible are paired with attempts to liberalize the Chinese capital market including international capital flows to internationalize the renminbi (Ito 2011, Prasad and Ye 2012).

2. The Exchange Rate as a Contested Stabilizer

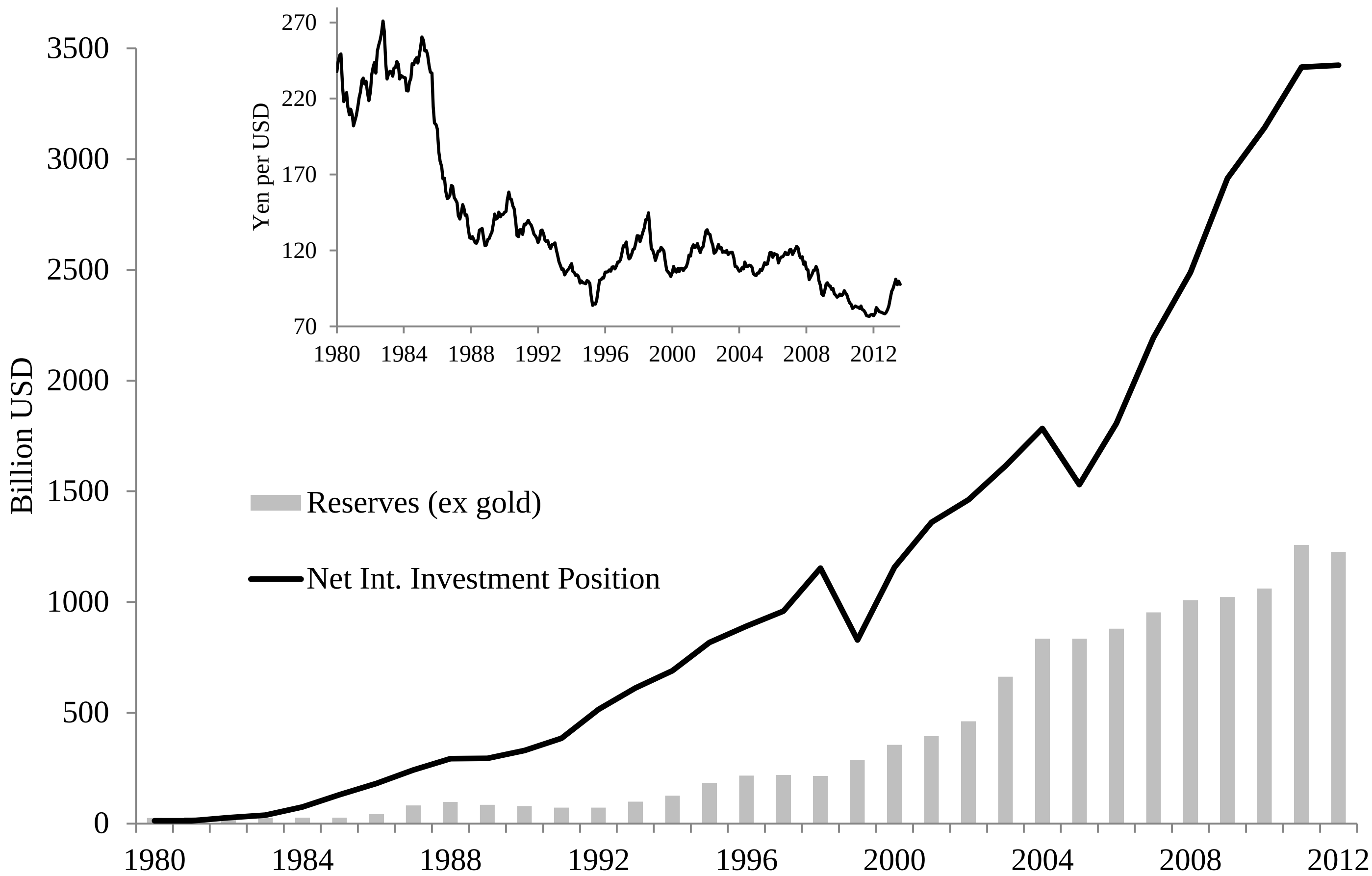
The Stabilizing Effect of the Exchange Rate Peg

- In countries with underdeveloped goods and capital markets, exchange rate pegs serve as an intermediate target for macroeconomic stabilization (McKinnon 1963).
- The Chinese dollar peg has contributed to the stable and high growth in China, East Asia and the World as a whole (McKinnon and Schnabl 2012).

Lessons Learned from Japan

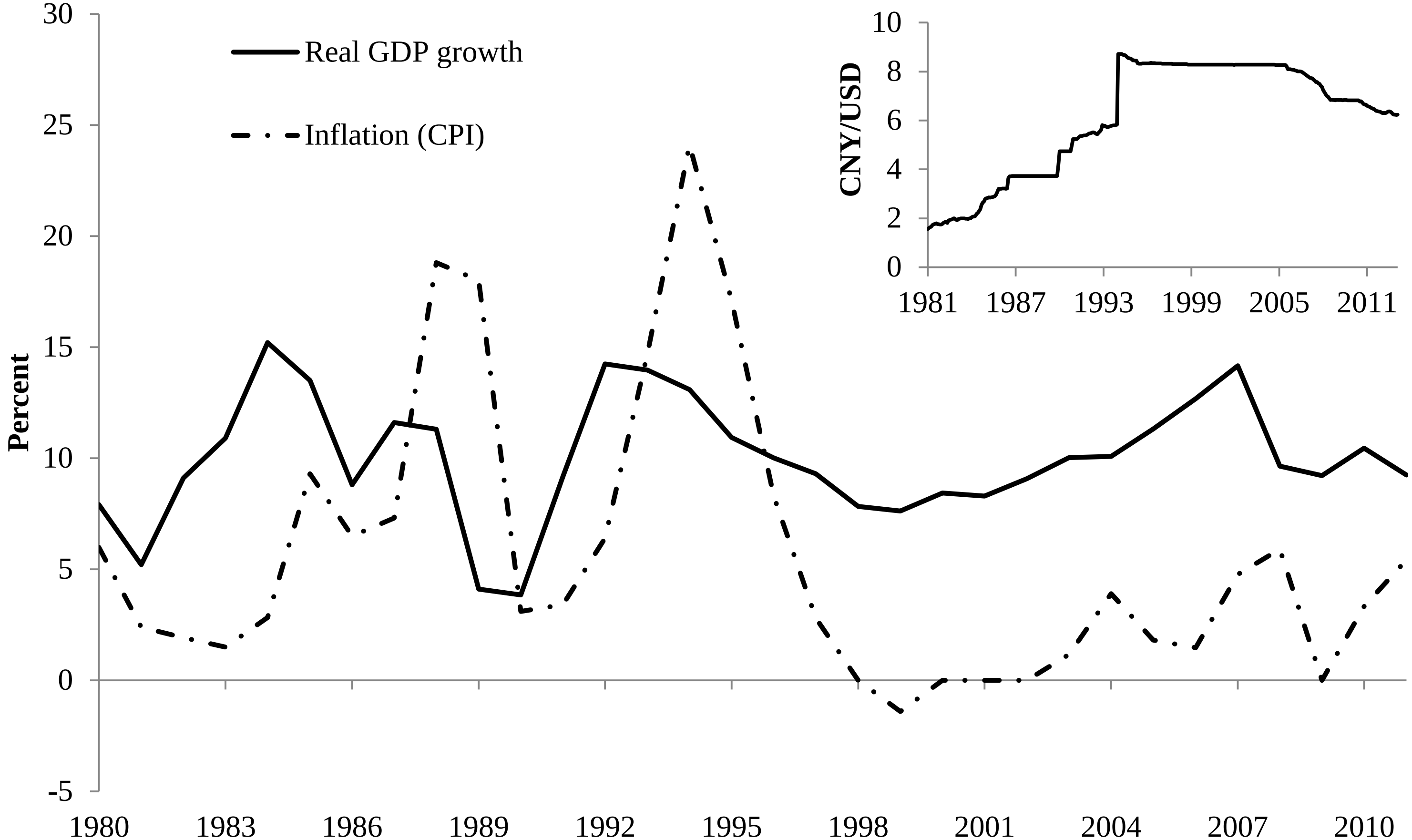
- The freely floating yen has been a source economic instability during the second half of the 1980s due to interest rates were cuts to slow down post-Plaza yen appreciation pressure (bubble economy) (Schnabl and Hoffmann 2008).
- In the 1990s persistent appreciation pressure was a major impediment for the economic recovery (McKinnon and Schnabl 2006).
- Yen fluctuations against the dollar have been a persistent source of instability in East Asia (Schnabl and Spantig 2014).

Japan's Net International Investment Position



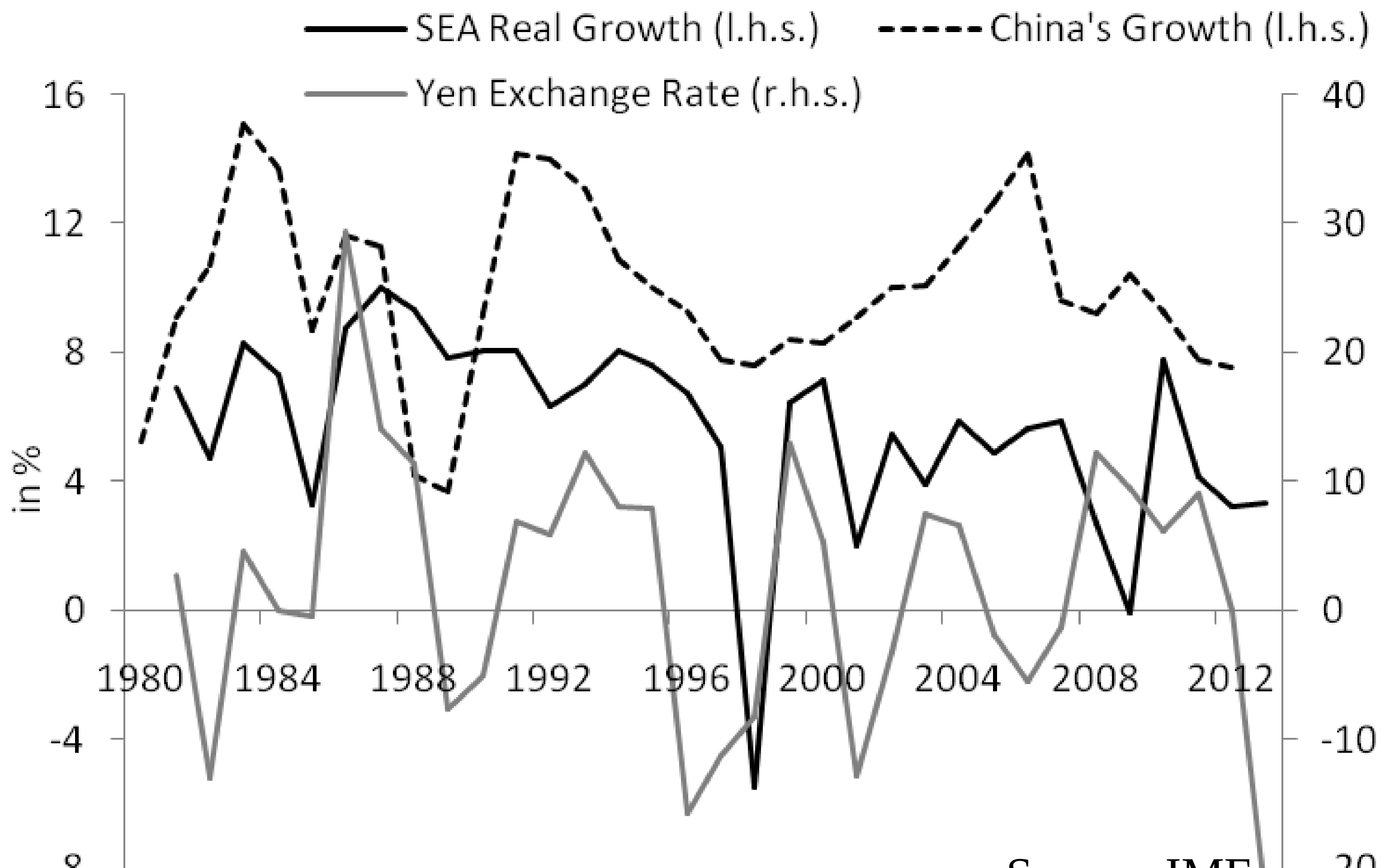
Source: IMF.

The Stabilizing Chinese Dollar Peg



Source: IMF.

Synchronized Business Cycles in East Asia



Source: IMF.

3. China as an Immature Creditor Country

Current Account Surplus and Financial Intermediation

- A current account (saving) surplus necessitates a respective capital outflow.
- In a mature creditor economy (such as Germany) this outflow is in domestic currency, what eliminates foreign exchange risk for the private financial sector.
- In China, private financial institutions can not lend to foreigners in domestic currency.
- The US dollar is the dominant international money and China's financial markets are restricted by interest rate and capital controls.

Public Intermediation

- China finances the current account surplus by the acquisition of liquid dollar claims (foreign reserves)
- or via illiquid foreign direct investments associated with government-sponsored aid to countries with large raw material resources.

Financial Market-Based Fear of Floating

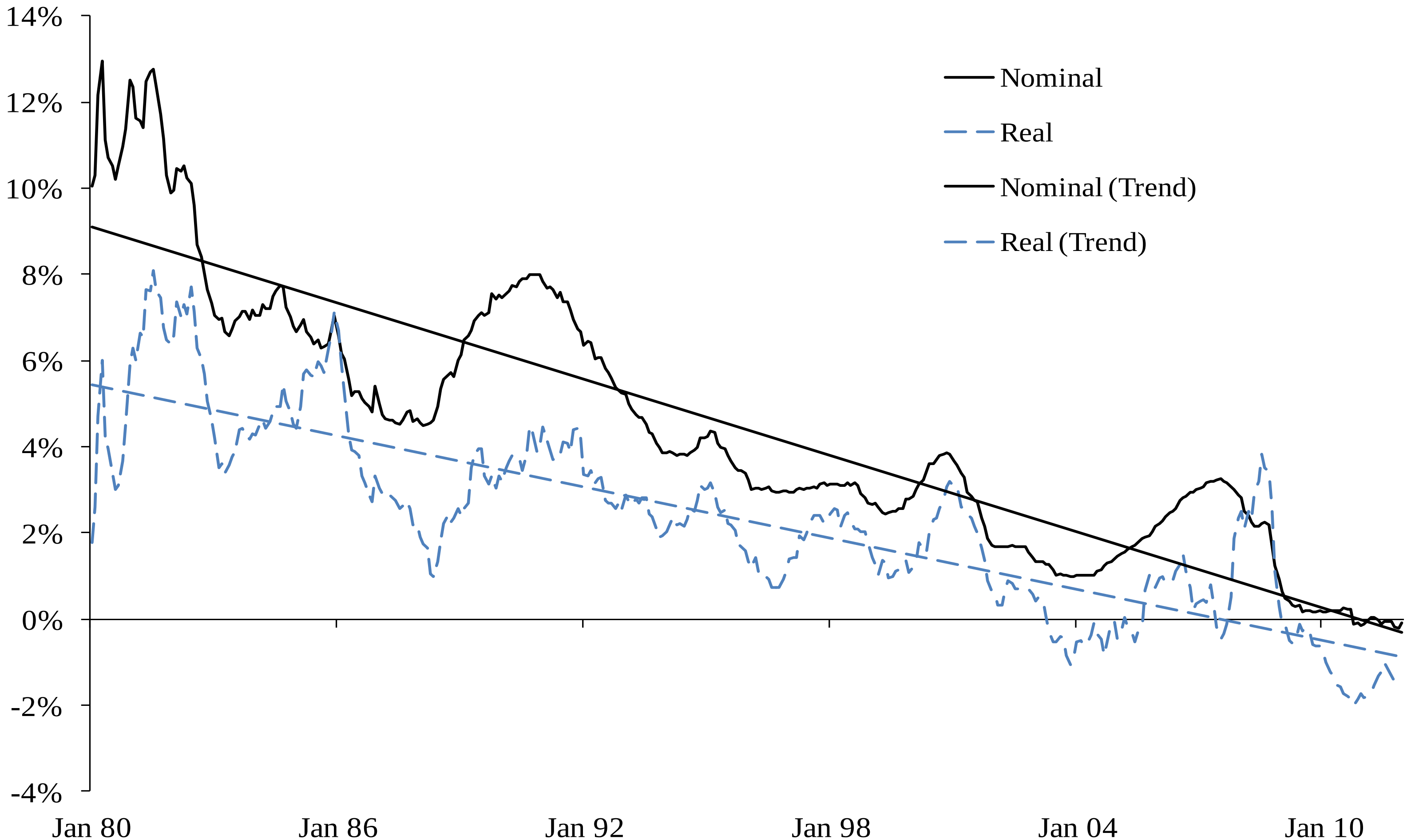
The Floating Dilemma

- If the Chinese government would withdraw from the foreign exchange market,
- Chinese banks could (would) not finance the current account (saving) surplus.
- Given yuan (dollar) appreciation (depreciation) expectations, in net terms Chinese banks can not lend abroad in renminbi.
- The higher the stock of net international assets, the higher is the currency mismatch in the national banking sector (Japan).

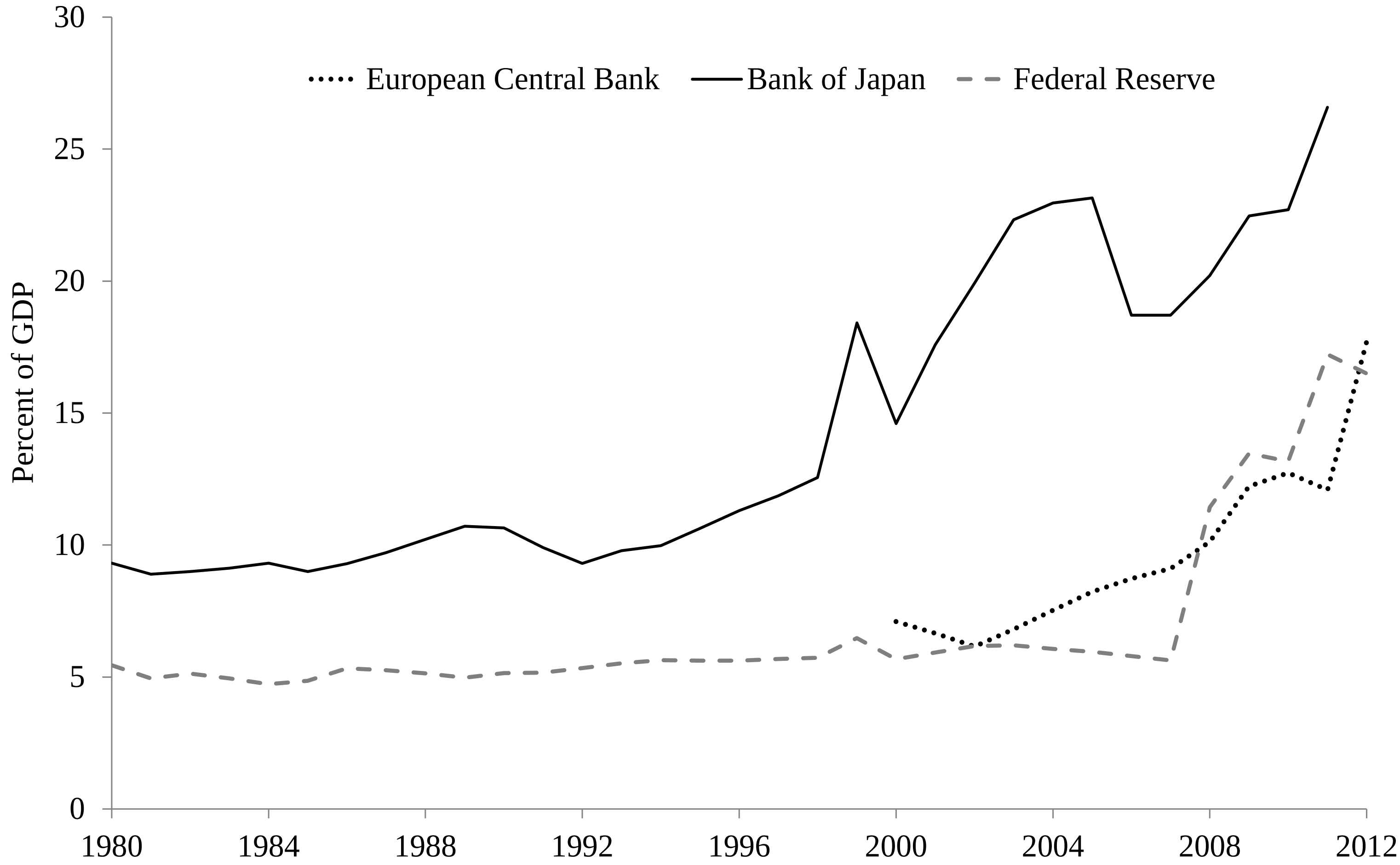
The Persistence of Exchange Rate Stabilization

- The Peoples Bank of China has to step in and stabilize the exchange rate on a daily basis.
- If the PBC would leave the market, the exchange rate would spiral upwards in an uncontrolled fashion (post-Plaza yen appreciation).

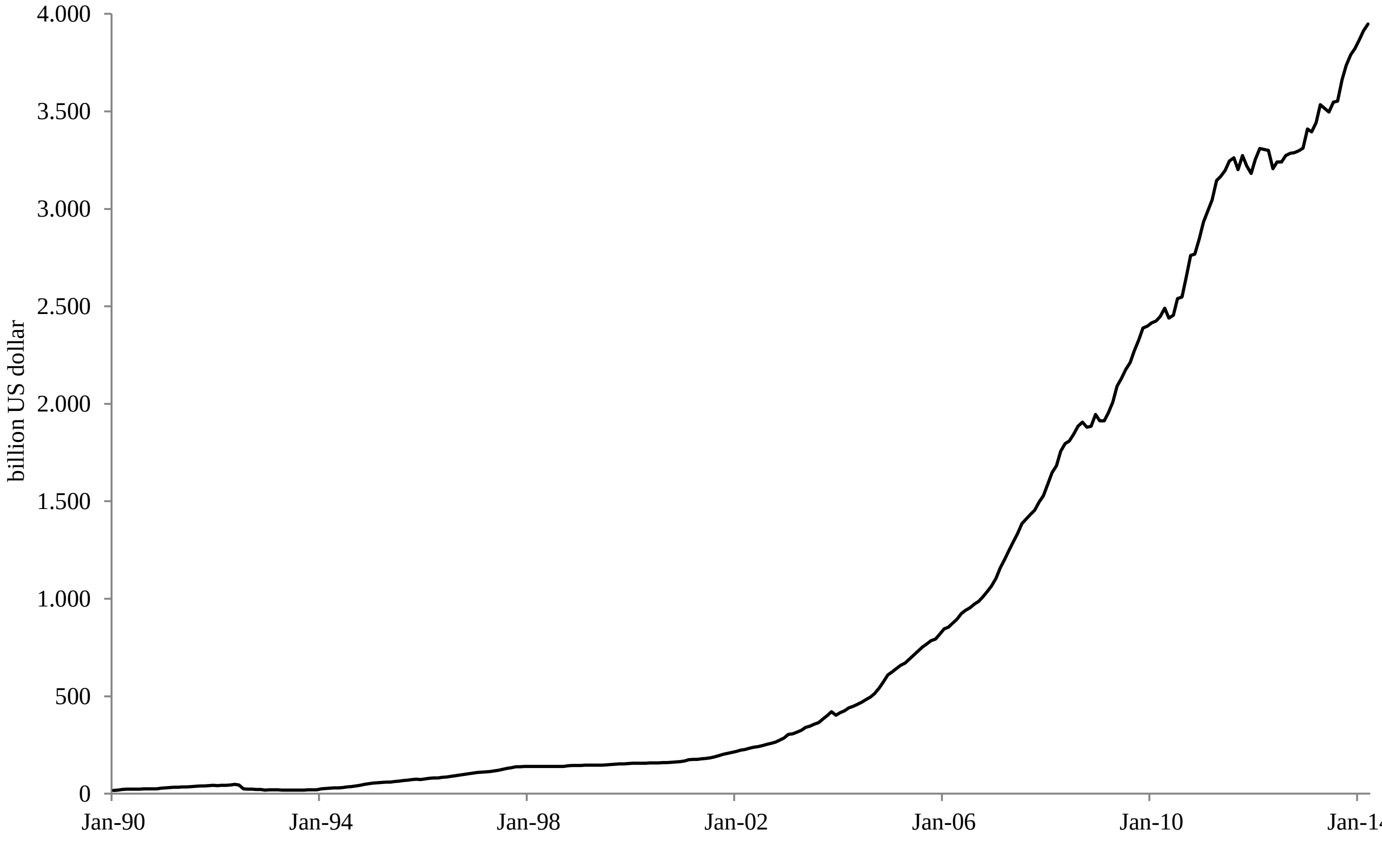
The Structural Decline of G3 Interest Rates



G3 Central Banks’ Monetary Base as Percent of GDP



China’s Foreign Reserve Accumulation



Source: IMF.

4. Financial Repression and Internationalization Constraint

Prerequisites for Renminbi Internationalization

- International anchor currencies are backed by highly developed and free capital markets,
- which provide investors a large variety of low-cost investment opportunities (diversification).
- To challenge the dollar as an international currency, China has to liberalize its capital market and abolish capital controls.

First Steps towards Renminbi Internationalization

- Offshore trading in Hong Kong, Singapore, London, Frankfurt, etc. is legalized.
- Issuance of Dim Sum bonds in Hong Kong.
- Swap agreements with other large central banks to reduce the risk for renminbi denominated trade obligations.
- Shanghai Pilot Free Trade Zone.
- Renmibi-based markets remain small. The pilot zone is subject to a tight fire wall, what is likely to increase volatility and uncertainty (Chartelier's Principle).

Externally Imposed Financial Repression

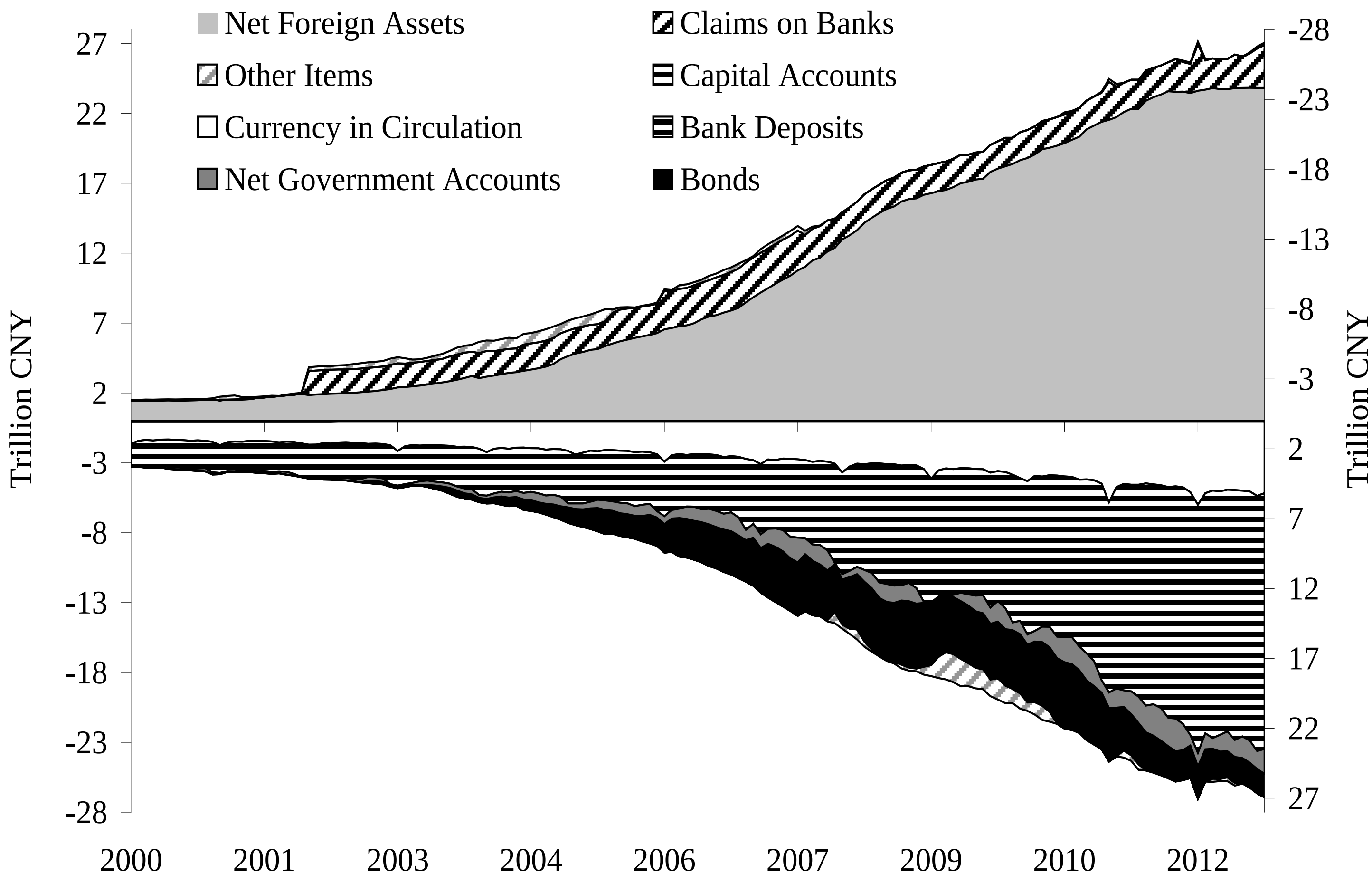
Market-Based Sterilization

- Liquidity absorption by central bank bond sales is costly and drives the interest rate level up.
- New speculative capital inflows are attracted.

Non-Market-Based Sterilization

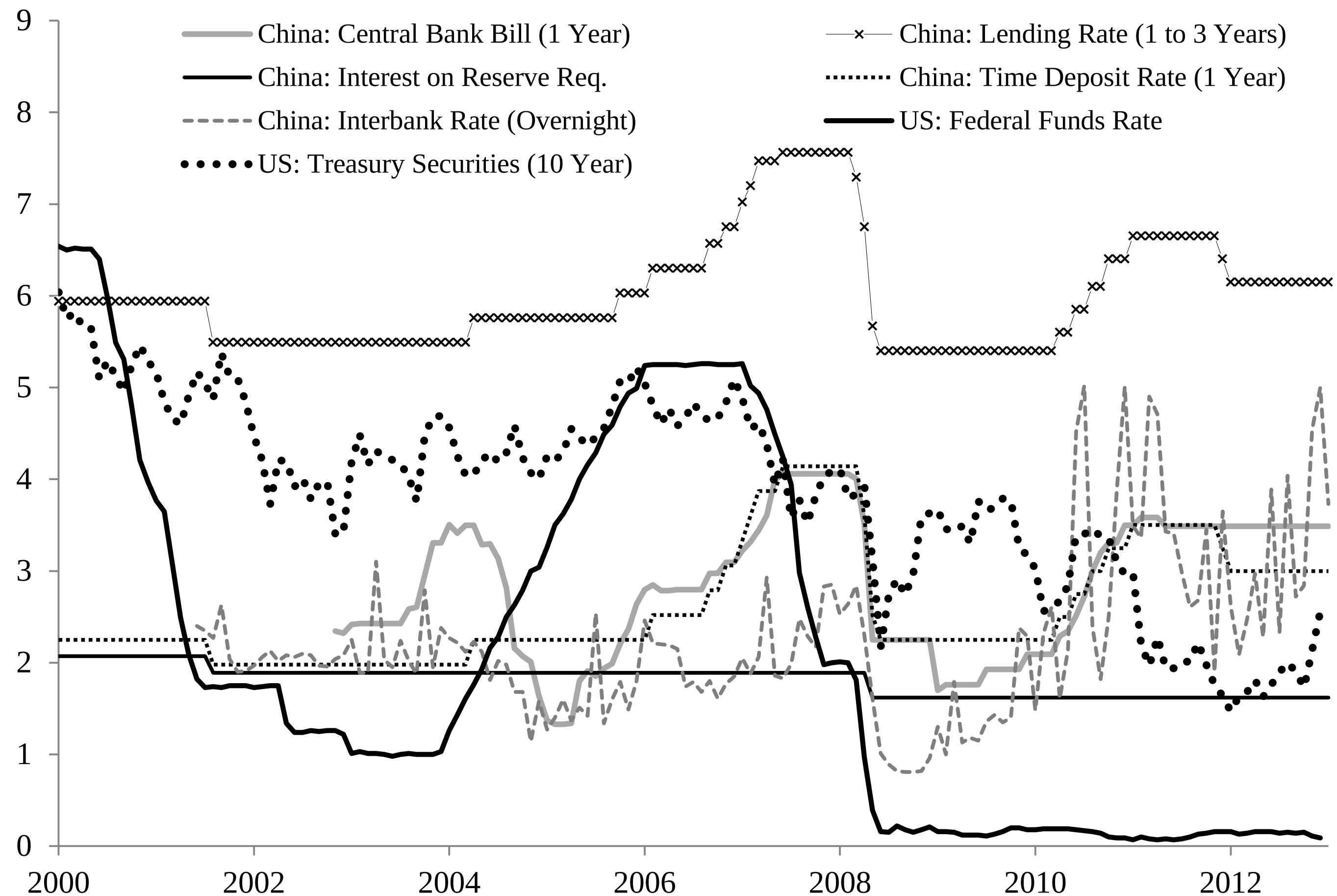
- The Peoples Bank of China absorbs the liquidity emerging from foreign reserve accumulation by central bank increasing reserve requirements.
- Because the reserve requirement rate is kept low, the sterilization costs are shifted to the commercial banks.
- The commercial banks shift the sterilization costs to depositors via lower deposit rates, what encourages shadow banking.
- Upper limits on lending rates contribute to a surplus demand for credit, which allows preferential credit allocation via the state controlled banking sector (*window guidance*).
- Nominal exchange rate stabilization cum non-market-based sterilization is equivalent to real exchange rate stabilization (McKinnon and Schnabl 2012).

Peoples Bank of China Balance Sheet



Source: IMF

Fragemented Interest Rate Structure in China



Source: IMF

5. Zero Interest Rate Constraint on Internationalization

- Quantitative easing in all major industrialized countries continues.
- The announced exit from quantitative easing in the US has caused instability in emerging markets.
- Japan can be seen as a role model for the future monetary policy path in the large industrialized countries (Schnabl 2014).
- To transform the renminbi into an international currency, Chinese capital markets have to be liberalized and capital controls have to be dismantled.
- A dismantling of capital controls would drive down the Chinese short-term interest rates towards zero, pushing up inflation and asset (real estate) prices.
- The liberalization of Chinese domestic capital markets would require the end of the sterilization policies (including window guidance).
- China remains trapped in exchange rate stabilization against the dollar.
- Real appreciation could be achieved via wage increases.

Thank you very much for your attention!