China Economic Review 20 (2009) 136–139

Contents lists available at ScienceDirect

China Economic Review

Comments on: "Is the Chinese growth miracle built to last?" and "Will the renminbi become a world currency?"

Ian Sheldon

Department of Agricultural, Environmental, and Development Economics, Ohio State University, United States

1. Introduction

Based on their titles alone, there would seem to be little immediate connection between these two very interesting and useful papers. Closer reading, however, suggests that in fact both are analyzing the same basic problem, albeit from quite different standpoints: the importance of developing an independent monetary policy in China and the concomitant reform of its financial system. In the first paper, the focus is on the costs of China's current growth model as they relate to development of its financial sector, and the extent to which associated policy distortions such as maintenance of a fixed exchange rate may limit China's ability to deal with internal and external shocks to its economy. This is in contrast to recent papers by Lardy (2007), Blanchard and Giavazzi (2006), and Hofman and Kuijs (2007), that have focused more on the rebalancing of and sustainability of China's growth. In the second paper, the author argues that while China's low and stable inflation, and its large and growing share of world trade and output augur well, a major constraint on future internationalization of the renminbi (RMB) is the lack of development of China's financial sector.

2. Paper 1

The starting point of the first paper is a description of key characteristics of China's current growth path: a high rate of investment in the manufacturing sector, relatively slow employment growth, high rates of household and corporate savings, and growth in manufacturing exports. The high rate of investment has been driven partly by the state banks offering low interest rates, as well as there being low prices for complementary factors of production to physical capital such as land and energy, the bias in the capital-labor ratio acting as a constraint on employment growth. At the same time, there have been high levels of precautionary savings by households in China, resulting from a weakening of the social safety net relating to provision of education, health care and retirement (Blanchard & Giavazzi, 2006). Due to the lack of alternative financial instruments, household savings are channeled into bank deposits, resulting in increased liquidity in the banking system. In turn this has allowed the banks to expand credit, especially towards investment in state-owned enterprises (SOEs).

Three features of Chinese economic policy are deemed to be connected to this pattern of growth: exchange rate policy, monetary policy, and management of the capital account. The story here is well-known, and has been analyzed extensively by others including, *inter alia*, Eichengreen (2005a), Goldstein (2007), Goldstein and Lardy (2007), and Frankel and Wei (2007). Starting in 1995 China has managed its exchange rate, first via a peg to the US dollar, and since July 2005 through maintenance of the RMB with respect to a broader basket of currencies. Stability of the RMB with respect to the US dollar following revaluation suggests, however, that the degree of flexibility has been rather minimal, Frankel and Wei (2007) finding the weight placed on the US dollar in the basket was still heavy in both 2005 and 2006. This policy has resulted in accusations of currency "manipulation" from the US Congress as the bilateral trade deficit with China has grown (Eichengreen, 2005a; Frankel & Wei, 2007), as well as considerable analysis of how the amount by which the RMB is under-valued (Goldstein, 2007; Goldstein & Lardy, 2007). The important point is that despite the modest nominal revaluation in 2005, and relaxation of the strict peg to the US dollar, the Chinese authorities have continued to intervene extensively in the foreign exchange market in order to prevent the RMB from appreciating—$20 billion a month in 2006 according to Goldstein (2007). At the same time, there has been a significant increase in

E-mail address: sheldon.1@osu.edu.

doi:10.1016/j.chieco.2008.05.006

China's international reserves, driven by speculative flows prior to the July 2005 revaluation of the RMB, as well as the growing trade surplus.

The net result of China's exchange rate policy has been to increase liquidity in the Chinese banking system, which in turn has had a significant impact on the operation of monetary policy. Essentially, the People's Bank of China (PBOC) has had to sterilize inflows through the sale of short-term bills and three-year bonds, as well as through the use of reserve requirements. As pointed out by the author, while sterilization in emerging economies is typically constrained by the increasing costs of offering higher yields, Chinese state banks have been willing to hold government paper due to the high levels of private saving as well as the lack of capital requirements on them lending to the government.

Even though the PBOC has been quite successful up to now in its sterilization operations, the author of the first paper argues very convincingly that anchoring inflation rate expectations to the exchange rate will ultimately make it more difficult for China to achieve balanced and sustainable long-run economic growth. Macroeconomic stability in China will require independent monetary policy, which is not consistent with maintaining the exchange rate, especially as China's capital account gets more porous. It should be noted, though that this author, as in a previous paper (Prasad, Rumbaugh, & Wang, 2005), while pushing for greater flexibility in the Chinese exchange rate is not arguing for a rapid opening up of China's capital account in the short-run—an argument also espoused by Eichengreen (2005a). Nonetheless, it is certainly the case that as China becomes more integrated into the global capital market, it will be more and more subject to what Obstfeld (1998) has termed the "open-economy trilemma". Specifically, in the presence of an increasingly open capital account, if the Chinese authorities want to pursue a monetary policy targeted towards domestic goals such as low inflation, a fixed exchange rate regime is simply unsustainable.

In addition to macroeconomic stability, the author of this paper also argues very importantly, as they have done elsewhere (Prasad, 2005), that independent monetary policy is a necessary condition for effective reform of the Chinese financial sector, which in turn will ensure a more efficient allocation of resources through better intermediation of China's pool of savings. Specifically, proper use of the interest rate by the PBC as opposed to financial repression will help "…foster the commercial orientation of the banking sector…" Indeed, the author emphasizes that incremental banking reform will simply not succeed if the PBOC continues to be constrained by the exchange rate regime.

If not the exchange rate, what would be an alternative nominal anchor for China? Here the author of this paper offers what I think is their most important contribution to discussion of Chinese macroeconomic policy: they propose that China adopt an informal inflation targeting regime, i.e., public announcement of a medium to long-term range for the rate of inflation, as well as institutional commitment to low inflation as the priority of monetary policy. Interestingly, this is one of the policy reforms proposed by the author of the second paper, as well as an argument put forward earlier by Eichengreen (2005a), and laid out in detail in a recent jointly-authored paper by the current author (Goodfriend & Prasad, 2007).

While inflation targeting has been discussed in considerable detail in the macroeconomics literature, it is worth raising a few points here in terms of its application to emerging economies, and China in particular. The definition of a fully-fledged informal inflation targeting regime has been laid out in papers by *inter alia*, Bernanke and Mishkin (1997), and Mishkin (2000), however, the common characteristic of both formal and informal regimes has been the focus on an explicit inflation objective both in terms of a targeted range for the rate of inflation, and institutional acknowledgement that the key focus of monetary policy is inflation. Among emerging economies that have adopted inflation targeting, examples of both fully-fledged (Brazil) and informal (Chile and Peru) inflation targeting regimes can be found. In the case of China, there appears to be agreement that China should adopt an informal inflation targeting regime (Eichengreen, 2005a; Goodfreind & Prasad, 2007). The PBOC would then continue its current approach in terms of monitoring monetary growth and credit, but its key target would switch from the exchange rate to the targeted inflation rate. However, as Eichengreen (2005a) notes, the other trappings of formal inflation targeting such as issuance of an inflation report and a transparent policy-making process would not have to be adopted immediately for the regime to work.

The principal expected benefits of inflation targeting are well-known: price stability, employment stability, compatibility with productivity growth, and the tying down of inflation expectations. As Goodfriend and Prasad (2007) note, the success of an inflation targeting regime is very dependent on the credibility of the central bank, requiring significant institutional support to maintain that credibility. Emerging economies, however, are typically very vulnerable to inflation and currency crises due to weak fiscal, financial and monetary institutions (Mishkin, 2004). Consequently, the monetary authorities in emerging economies face not only the challenge of building credibility and reducing the rate of inflation, but also the issues of fiscal and financial "dominance" (Fraga, Goldfajn, & Minella, 2003).

For inflation targeting to work, there has to be fiscal stability. If instead a government runs large fiscal deficits, they either have to be monetized or eroded by a currency devaluation resulting in monetary growth and inflation. Ultimately, an inflation targeting regime will break down if monetary policy becomes subservient to fiscal policy, i.e., fiscal dominance. It is also necessary to have a sound financial system in place, especially the banking sector. If the latter is weak, the central bank will be constrained in its ability to raise interest rates to target inflation for fear of provoking a collapse of the financial system, i.e., financial dominance. Finally, not only does there need to be an institutional commitment to inflation targeting, there also has to be a commitment to instrument independence of the central bank, i.e., prohibition of underwriting fiscal deficits, independence and insulation from government interference and the political process. At the same time, inflation targeting should be characterized by what Bernanke and Mishkin (1997) have termed "constrained discretion"—in other words the central bank should have flexibility in stabilizing say employment subject to being accountable for meeting the inflation objective.

Masson, Savastano, and Sharma (1998) argue that fiscal and financial reforms are prerequisites for attempting inflation targeting in emerging economies. So does implementation of such a regime face any specific problems in China? On the one hand, there seems to be no problem of fiscal dominance (Eichengreen, 2005a), the Chinese fiscal deficit and government debt being quite low. Although, as the current author notes, this may be somewhat deceptive as there are, for example, large unfunded liabilities in the state banking system. On the other hand, despite some progress in improving the commercial orientation of the Chinese banking sector, as well as its regulation and supervision, further reform of the sector is still required (Goodfriend & Prasad, 2007). However, as noted earlier, this author, and others such as Mishkin (2004) believe that independent monetary policy, and hence inflation targeting, can aid reform of the financial sector, because it will not work without government support for the necessary reforms.

3. Paper 2

The second paper is motivated by a very intriguing question: what is the possibility that China's currency will eventually become one of the world's major currencies? At first this might seem a somewhat premature question, the author noting the RMB currently has none of the characteristics of an international currency—it is neither used much for invoicing exports and imports, nor does it circulate outside of China. In addition, foreign governments do not hold RMB-denominated assets in their foreign exchange reserves, and foreign firms neither borrow in Chinese capital markets nor do they repatriate their profits. However, in examining the key factors that contribute to international use of a currency, the author does raise a legitimate question about the future of the RMB, particularly its potential as a regional currency.

Citing Tavlas (1991), the author notes three factors are important for international use of a currency: low and stable inflation; a country's share of global trade and output; and open, deep and broad financial markets. In an empirical analysis, Chinn and Frankel (2005) find that a currency's share in world foreign exchange reserves is positively correlated with a country's share of global GDP, and negatively correlated with its inflation rate relative to the global average. China meets the first two of these criteria—inflation has been generally kept under control over the past decade, and its share of global GDP in 2006 was 5.5% at market exchange rates/ 9.7% measured in terms of purchasing power parity (PPP), placing it among the top-five largest economies. Likewise China accounts for a significant portion of international trade, it being forecast to become the world's second-largest trading nation in 2008. However, as the author points out, the lack of use of the RMB as an international currency stems both from the restrictions placed on its use by the Chinese authorities, and the under-development of China's financial markets, issues also raised by Eichengreen (2005b).

In this context, a key focus of this paper is on the current status and impact of China's capital-account controls, its financial system and the exchange rate regime. Like the first paper, the author of the second paper argues that China's current exchange rate regime, in combination with the restrictions on its capital account, has a major impact on how it conducts monetary policy, and contributes, therefore, to the under-development of its financial system. For example, the author highlights the connection between China's previous focus on a “growth at any cost” objective, reflected in its very high rates of manufacturing investment and the performance of its financial system. As noted in Dollar and Wei (2007), and Lardy (2007), much of this investment has been inefficient, resulting in excess capacity in sectors such as steel and ferroalloys. However, the ability of the PBOC to use interest rates to affect the allocation of capital has been constrained by the exchange rate regime, and administered interest rates have not only been ineffective in slowing investment, but they are also an obstacle to reforming the Chinese banking system—essentially the same story as the first paper. The proposals for policy reform are also very similar: a move towards a more flexible exchange rate regime, with some relaxation of capital controls; increased independence of the PBOC with monetary policy focused on inflation targeting; and further reform of the financial sector.

The key conclusion of the paper is that an inflation targeting regime, along with less restrictive capital controls would probably encourage some use of the RMB as an international currency. Having said that, the author also notes that international use of the RMB is not a stated objective of the Chinese authorities, and therefore, they are likely to continue with their cautious, incremental reforms. In addition, the empirical evidence suggests that international use of a currency changes pretty slowly over time (Chinn & Frankel, 2005). To quote Eichengreen (2005b), “…While the renminbi is everyone's favorite candidate for the new reserve currency champion four or five decades from now, such hopes are, in my opinion, still highly premature…” (p. 22).

4. Summary

Both of these papers make a useful contribution to our understanding of key macroeconomic issues relating to the Chinese economy. Their common focus is China's lack of an independent monetary policy and the continuing under-development of its financial sector. While moving to a flexible exchange rate regime is part of the discussion in both papers, unlike some other current papers, the focus is less on undervaluation of the exchange rate *per se*, but more on the connections between different reforms. In other words, moving away from a pegged exchange rate requires both, consideration of an alternative anchor for inflation expectations, especially if restrictions on the capital account are either eased or it becomes more porous, as well as further reform of the financial system. Even though China is less susceptible to the types of problem facing many emerging economies, the current lack of policy flexibility is likely to make it increasingly difficult for the authorities to deal with growing inflationary pressures, the continued decline in the US dollar, and a slowdown in external demand. Irrespective of whether or not the RMB becomes an international currency, deeper reforms of the Chinese economy will not only promote sustainable and balanced economic growth, it should also help in dealing with current global economic imbalances.

References

Bernanke, Ben S., & Mishkin, Frederic S. (1997). Inflation targeting: A new framework for monetary policy? *Journal of Economic Perspectives*, *11*(2), 97–116.
Blanchard, Olivier, & Giavazzi, Francesco (2006). Rebalancing growth in China: A three-handed approach. *China & World Economy*, *14*(4), 1–20.

Chinn, Menzie, & Frankel, Jeffrey A. (2005). Will the euro eventually surpass the dollar as leading international reserve currency? *Working Paper 11510* Cambridge, MA: National Bureau of Economic Research.

Dollar, David, & Wei, Shang-Jin (2007). Das (Wasted) Kapital: Firm ownership and investment efficiency in China. *Working Paper 13103* Cambridge, MA: National Bureau of Economic Research.

Eichengreen, Barry (2005). Is a change in the renminbi exchange rate in China's interest? *Asian Economic Papers*, *4*(1), 40−75.

Eichengreen (2005). Sterling's past, dollar's future: Historical perspectives on reserve currency competition. *Working Paper 11336* Cambridge, MA: National Bureau of Economic Research.

Fraga, Arminio, Goldfajn, Ilan, & Minella, André (2003). Inflation targeting in emerging market economies. *Working Paper 10019* Cambridge, MA: National Bureau of Economic Research.

Frankel, Jeffrey A., & Wei, Shang-Jin (2007). Assessing China's exchange rate regime. *Economic Policy*, *51*(July), 577−627.

Goldstein, Morris (2007). A (lack of) progress report on China's exchange rate policies. *Working Paper 07-5* Washington DC: Peterson Institute for International Economics.

Goldstein, Morris, & Lardy, Nicholas (2007). China's exchange rate policy: An overview of some key issues. *Paper presented at Conference on China's Exchange Rate Policy, October 19, 2007* Washington DC: Peterson Institute for International Economics Available at: http://www.petersoninstitute.org/events/event_detail.cfm?EventID=47

Goodfriend, Marvin, & Prasad, Eswar (2007). A framework for independent monetary policy in China. *CESifo Economic Studies*, *53*(1), 2−41.

Hofman, Bert, & Kuijs, Louis (2007). Rebalancing China's growth. *Paper presented at Conference on China's Exchange Rate Policy, October 19, 2007* Washington DC: Peterson Institute for International Economics Available at: http://www.petersoninstitute.org/events/event_detail.cfm?EventID=47

Lardy, Nicholas (2007). China: Rebalancing economic growth. *Paper presented at Conference on The China Balance Sheet in 2007 and Beyond, May 2, 2007* Washington DC: Peterson Institute for International Economics Available at: http://www.petersoninstitute.org/events/event_detail.cfm?EventID=21

Masson, Paul R., Savastano, Miguel A., & Sharma, Sunil (1998). Can inflation targeting be a framework for monetary policy in developing countries? *Finance and Development*, *Vol. 35(1)*. (pp.)Washington DC: International Monetary Fund.

Mishkin, Frederic S. (2000). Inflation targeting in emerging-market countries. *American Economic Review*, *90*(2), 105−109.

Mishkin, Frederic S. (2004). Can inflation targeting work in emerging market countries? *Working Paper 10646* Cambridge, MA: National Bureau of Economic Research.

Obstfeld, Maurice (1998). The global capital market: Benefactor or menace? *Journal of Economic Perspectives*, *12*(4), 9−30.

Prasad, Eswar S. (2005). Next steps for China. *Finance and Development*, *Vol. 42(3)*. (pp.)Washington DC: International Monetary Fund Available at: http://www.imf.org/external/pubs/ft/fandd/2005/09/prasad.htm

Prasad, Eswar, Rumbaugh, Thomas, & Wang, Qing (2005). Putting the cart before the horse? Capital account liberalization and exchange rate flexibility. *China and the World Economy*, *13*(4), 3−20.

Tavlas, George S. (1991). On international use of currencies: The case of the Deutsche mark. *Working Paper No. 90/3* Washington DC: International Monetary Fund.