

Applying the Concept: China's Fixed Exchange Rate

In the spring of 2005, people in business and government, including the U.S. Treasury Secretary, were calling for China to move away from its fixed-exchange rate regime. For a decade, China's central bank, the People's Bank of China, has pegged the value of the Chinese currency at 8.28 yuan to the U.S. dollar. (At this writing, that's still where it is.) By the end of 2004, this was far below anyone's estimate of purchasing power parity (PPP) tells us it should be. According to the *Economist's* Big Mac index (see Chapter 10, page 241), the yuan is undervalued by nearly 60 percent. A Big Mac that costs \$3.00 in the U.S could be had for 13.25 yuan in Beijing. That means that it should take at most 3.5 yuan to buy a dollar!

Exchange-rate stability has been one of the essential ingredients in a phenomenal economic boom. Over the 10 years of the fixed-exchange rate regime, China's economy more than doubled in size, with growth averaging in excess of 8 percent per year. But recently, the costs of keeping exchange rates fixed may be exceeding the benefits.

Maintaining a fixed exchange rate is a straightforward exercise for any country: The central bank stands ready to buy and sell the currency at a fixed rate. In the Chinese case, since the dollar price of the yuan is too low, everyone wants to buy. Since the Central Bank of China has a monopoly on printing yuan, they will never run out.* And over the years, this is exactly what the Chinese have done. Chinese central bankers have used yuan to purchase foreign assets. In the past five years, they have bought \$450 billion worth of securities, primarily in the form of U.S. Treasury bonds. The mechanics are the same as the example on pages 495-497 of Chapter 19: When the People's Bank of China purchases U.S. Treasury bonds, it increases the size of Chinese commercial bank reserves.

The Chinese fixed-exchange rate policy has started to create both economic and political problem. On the economic side, the result has been a combination of rising inflation and a growing current account surplus. By fixing its exchange rate, a country loses control of domestic monetary policy. This means that by keeping the yuan-dollar exchange rate constant, China

* In the opposite case, where a central bank tries to peg its currency's value too high, everyone wants to sell. Even with substantial foreign exchange reserves, the result will eventually be a speculative attack that forces depreciation. See the discussion on page 502 of Chapter 19.

imported American monetary policy. And during the first few years of the 21st century, that meant adopting a very low interest rate policy. But unlike the U.S., which was experiencing a combination of low growth and low inflation, China was booming. The result of importing accommodative U.S. monetary policy has been inflation. By early 2005, Chinese inflation was estimated to be over 5 percent and rising.

If inflation in China were to stay high enough for long enough, it would eventually fix the undervaluation problem, restoring purchasing power parity. But that would mean Big Macs in Beijing would have to nearly double in price to 24.75 yuan – not a solution most people would suggest.

Beyond the problem for rising inflation, the undervalued yuan meant exports were cheap and imports expensive. As a result, China has regularly had a current account surplus that is between 2 and 3 percent of GDP – in 2004, that amounted to \$46 billion. That is, they export more than they import. And to do it, the Chinese are making loans to the rest of the world. And those loans have been in the form of U.S. Treasury bonds – in effect, China is lending to the U.S. government. Should a developing country that is in need of capital investment be making loans to the biggest and one of the richest countries in the world? Probably not.

Finally, there are the political problems caused by the fact that the yuan is so dramatically undervalued. Manufacturers outside of China have a tough time competing with what amounts to a big production subsidy. If the value of the yuan were closer to PPP, the dollar price of Chinese exports would be significantly higher.

Action by the Chinese to allow the yuan to appreciate would help solve all of these problems. Authorities would gain control of domestic monetary policy and could move to control domestic inflation; they could reduce the size of their current account surplus and stop lending tens of billions of dollars a year to developed countries; and political pressure would fall. All in all, it sounds like a good thing to do. By the time you read this, Chinese policymakers may have already done it. Take a look at a website like <http://finance.yahoo.com/currency> and see if it still takes 8.28 yuan to purchase one dollar.

