2015.06.19 (No.29, 2015)

Occasional Paper

Institute for International Monetary Affairs

SEMINAR
on

China's Exchange Rate and Financial Repression

－The Conflicted Emergence of the Renminbi as an International Currency－

Luoxi Dao, Research Assistant

luoxi_dao@iima.or.jp

Economic Research Dept. and Emerging Economy Research Dept.

Institute for International Monetary Affairs (IIMA)

This report serves as documentary of a seminar hosted by the Institute for International Monetary Affairs (IIMA) on June 16, 2015. The seminar titled "China's Exchange Rate and Financial Repression: The Conflicted Emergence of the *Renminbi* as an International Currency" was given by Prof. Dr. Gunther Schnabl from the Institute for Economic Policy, Leipzig University, Germany.

Welcome Remarks

Mr. Muneo Kurauchi, Managing Director of Institute for International Monetary Affairs

This year is the 20th anniversary of the Institute for International Monetary Affairs (IIMA). On behalf of IIMA, Mr. Muneo Kurauchi welcomed the guest speaker and the attendees and gave thanks for all the continuing support for IIMA.

Mr. Kurauchi commented that China has been at the centre of the stage of regional and world economics in the past few years. China's recent moves, such as the creation of the Asian Infrastructure Investment Bank (AIIB) and the "One Belt, One Road" strategy, have attracted global attention. Simultaneously, the rapid internationalization of China's currency, the *renminbi* (or yuan), has become a hot topic in global financial circles due to the implications of the stability of regional financial markets. He closed his remarks by referring to the institute's willingness of the further research on these topics.

Seminar

Prof. Dr. Gunther Schnabl, Institute for Economic Policy, Faculty of Economics and Business Administration, Leipzig University

Mr. Schnabl first thanked IIMA for the invitation and introduction. He started with a short introduction to his paper[1], in which he claimed that the current dollar-dominant international monetary system creates the specific context for China's internationalization of *renminbi*. China is making tremendous efforts to expand the international use of its currency. According to Mr. Schnabl, these efforts are, to some extent, a reaction to the unprecedented quantitative easing of the United States Federal Reserve.

An Asymmetric World Monetary System

The basic assumption of the paper is that the dollar is the core of the international monetary system. Under such an "informal dollar standard", international trade and capital flows are invoiced in US dollars, a state of affairs with considerable significance for private agents who facilitate financial transactions as well as for public agents, such as central banks, who smooth exchange rate fluctuation by intervening only in dollars. Mr. Schnabl compared European countries with East Asian countries and concluded that the European monetary integration process is based on contracts, treaties, and rules. In East Asia, the intraregional exchange rate stability was created because most countries followed the similar "dollar peg".

[1] McKinnon, Ronald / Schnabl, Gunther (2014): *China's Exchange Rate and Financial Repression: The Conflicted Emergence of the Renminbi as an International Currency*, CESifo Working Paper No.4649

Mr. Schnabl also pointed out the importance of the use of the dollar as a reserve currency. Central banks in East Asia, particularly China, carry a large amount of dollar-denominated assets on their balance sheets, which exposes central banks to exchange risk. Since 1994, China has mostly remained pegged to the dollar, which contributed to stabilizing and stimulating the Chinese economic growth.

"Japan Bashing" vs. "China Bashing"

Mr. Schnabl summarized the effect of China's exchange rate peg as a "contested stabilizer". Given its undeveloped capital market and lack of maturity as an international creditor, continuing controls on capital inflows and interest rates controls are better monetary policies for China for the time being.

Drawing on Japan's experience of floating the yen against the dollar, Mr. Schnabl believed that Japan benefited very little from the flexibility (or perhaps volatility) in its exchange rate, which provids great lessons for China. The Plaza Agreement in 1985 triggered a strong yen appreciation, and a "one-way bet" in international foreign markets on yen appreciation emerged, a situation also recently seen in Switzerland. The attempts of the Bank of Japan to soften the appreciation pressure on the yen by interest rate cuts created the breeding ground for speculation in the stock and real estate markets which eventually led to the burst of an economy bubble and a lasting recession, the effects of which are still being felt. The launch of "Abenomics", which include a massive monetary and fiscal expansion, aims to devalue the yen and stimulate the Japanese economy. In addition, Mr. Schnabl pointed out that Japan's floating currency policy increased macroeconomic uncertainties among neighboring countries, such as Korea, which share similarities with Japan in domestic industry and international trade.

Similar to Japan in the past, China is under growing criticism for unfair trade practices and a huge current account surplus and faces strong external pressure to appreciate the *renminbi*. Compared to Japan, China's capital market is much less developed. However, Mr. Schnabl mentioned that contrary to the fluctuating yen, China's fixed exchange rate has been stabilizing factor for the East Asian business circle simply because other smaller economies, such as those of Southeast Asian, could align their dollar peg with China's peg.

Problems and Policy Recommendations for China

Mr. Schnabl emphasized the importance of social and economic stability in China. By comparing the floating exchange rate and the "dollar peg", he believed the Chinese government should continue its interventions to stabilize the exchange rate against the dollar and thereby the domestic economy. Furthermore, the near-zero interest rate trap of advanced economies, such as the United States, the European Union and Japan, provides external constraints on China's ability to achieve full financial liberalization.

An important incentive behind the government intervention can be explained by China's substantial current account surplus, which necessitates respective capital outflows. However, without achieving interest rate liberalization and capital account convertibility and without developing a broad, deep and sophisticated domestic financial market, China is far from being in a favorable position to lend internationally in domestic currency.

Therefore, Mr. Schnabl mentioned two ways for China to finance the current account surplus: (1) through acquiring liquid dollar claims, which is nonetheless associated with foreign exchange risks and (2) through making illiquid foreign direct investment. In this regard, AIIB is believed to be an alternative to transforming foreign reserves into real assets and generating capital outflows.

In general, China's financial repression is inevitable under the dollar standard and impedes both the internationalization of the *renminbi* and the liberalization of China's capital market. Despite several important steps towards the *renminbi* internationalization, such as the development of an offshore market and the Shanghai Pilot Free Trade Zone, Mr. Schnabl suggested that there is still volatility and uncertainty. For China, he argued that it is necessary to keep financial transactions in *renminbi* "offshore" to avoid speculative inflows of "hot money". In the end, he also mentioned the possibility of increasing wage levels as a policy instrument to invigorate domestic demand and offset the negative effects of the continuous build-up of foreign-currency denominated assets.

Question & Answer Session

<Questions from Attendee 1>

Does China have a clear intent to internationalize the *renminbi*? If that is the case, what would be the drivers to incentivize China to liberalize its capital market and pursue the goal of the internationalization of *renminbi*?

<Response from Mr. Schnabl>

It is difficult to incentivize China to do so. The motivation is clear only because they are trapped in the way. China is accumulating the foreign currencies that they don't wish to. The main problem is there are no alternatives for China to get away from the low returns in its foreign reserves once the *renminbi* is appreciated.

The incentives to fully liberalize the market are very limited because it would be accompanied by a surge of capital inflows and result in the inflation, which the Chinese government would oppose since the higher prices of food and energy could hit the domestic poor, which goes against the Communist Party's ruling purpose.

<Comments from Attendee 1>

Governor Zhou of People's Bank of China (PBoC) said China is planning to liberalize the interest rate in the near future, which can be seen as a step forward. However, your guess is that China has not seen the right moment to claim its intention to pursue the goal of market liberalization.

<Comments from Mr. Schnabl>

The full liberalization of interest rates incorporates (a) stopping the sterilization, (b) fully liberalizing interest rates of loans and deposits and (c) privatizing the banking sector. With such regard, China still has a long way to go.

<Questions and comments from Attendee 2>

How would you assess the most recent economic situation in China? As shown in the slide, China's foreign reserve accumulation has recently declined. The amount of capital account surplus slightly decrease and the pace of capital flows pouring into China is decelerating. Some argue that the Chinese central bank is intervening to prevent the rate of *renminbi* against the US Dollar from falling. This may indicate a structural change in the Chinese economy. Therefore, I believe it is time that the Chinese authorities should lean towards a more comprehensive package of market-based exchange rate rather than just keep the capital controls.

One more point. You mentioned different instruments to internationalize the use of *renminbi* in the offshore and onshore market. But it seems to me a bit patchy. How do you think of the need of more market-based capital control reforms?

<Response from Mr. Schnabl>

There are some observations and arguments on the small decline in foreign reserve amount of China. The U.S. will soon start to raise the interest rate. And once it starts, it will cause instability in emerging markets, potentially including China.

Some argue that China wants to devalue its currency to deter the speculators before they are forced to. Others explain the People's Bank of China puts it in AIIB. Anyway the recent situation reveals the uncertainty with respect to China's future economic development.

However, from the time perspective, we have to understand that there has been always the stylized fact that the U.S. has been issuing additional amount of dollars, which were absorbed by other countries and caused problems there. Japan's experience of bubble and burst in 1980s and 1990s is one of those cases. This pattern is unlikely to change in the near future.

<Questions from Attendee 3>

The real estate bubble in China is a big issue. Do you think the Chinese government would and should worry about the bubble in the overheating Shanghai stock market?

<Response from Mr. Schnabl>

Unless you have a fundamental answer to convince the U.S. to stop this type of too accommodative monetary policy, it is very difficult to escape such situation. Since the pressure comes from outside in a form of speculative capital inflows, it would be difficult for the periphery economies to deal with the issues. China is dealing it with tight capital controls, which is good. But once you control it on one side, other problems will crop up, for instance the risks in the shadow banking sector. If you depress the real estate market, the problem of stock market will become more serious. I believe the bubble in China has gone very far and created already many problems which prevent China's real economy from growing at a high speed as before.

<Questions from Attendee 4>

As you mentioned, wage increase will be a good way to boost the domestic consumption and raise the real exchange rate of the *renminbi* as wage increase will induce the inflation at some point. I support your recommendation because it seems a market-based solution. But regarding the foreign exchange regime, why you stick to the dollar peg rather than letting market decide?

<Response from Mr. Schnabl>

To adjust the current macroeconomic imbalance between China and the rest of the world, it is necessary to adjust the real exchange rate of the *renminbi*. One way of the adjustment is to let the *renminbi* float. But that is sure to cause a huge speculative in-and-outflow of capital in China that creates other macroeconomic problems. The alternative way is to increase the domestic wages of China. To increase the wages can be easier to implement than to float the exchange rate and could achieve the same purpose: appreciation of the real exchange rate. Inflation may cause social uncertainty but it can be mitigated if the wage hike is higher than inflation.

If we look at the case of Switzerland, the outcomes of their announcement of appreciation were amazing with the flood of cheap liquidity as speculators were waiting for a one-way bets.

<Questions from Attendee 5>

China should internationalize its currency since it is the second largest economy in the world. The domestic financial reform and a friendly external environment have to be achieved for the *renminbi* internationalization. I have been thinking about the monetary policy coordination among major economies. It may sound unrealistic today but should be considered seriously in the long term. The continuing Quantitative Easing (QE) of advanced economies will undoubtedly be detrimental to the world economy. At the G-20 meeting, the central bank governors agreed to equalize the effects of QE. China is, to my sense, likely to have more incentives than others on such moves. What do you think regarding this point?

<Response from Mr. Schnabl>

I would welcome currency coordination but I am skeptical that the direction of currency coordination is towards monetary tightening. Every country attempts to pursue their national interests. Compared to the main players in the core international monetary system such as the U.S., euro area and Japan, it will be difficult for China, from a financial market perspective, to be an active player in the game due to very nature of its underdeveloped capital market.

Address: 3-2, Nihombashi Hongokucho 1-Chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3245-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp　URL: http://www.iima.or.jp