Comments on
Inflation, Appreciation, or Reform

A Structural and Institutional Perspective on RMB and China’s External Imbalance”
By Geng XIAO

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November 13, 2007
More to Agree than to Disagree

- The author correctly points out that:

1. The reduction in transaction cost (together with rising productivity) is an important factor contributing to the improvement in the competitiveness of Chinese products.

2. In the long run, the government can at best control the nominal exchange rate, but not the real exchange rate. There is a tradeoff relation between price adjustment and exchange rate adjustment.

3. The Balassa-Samuelson hypothesis suggests that a fast growing country should see its exchange rate appreciating in real terms, but this had not been observed in China until recently because of the existence of an immense amount of surplus labor in the rural areas. However, the Balassa-Samuelson effect is becoming more apparent as China approaches full employment (Lewis turning point).


- I have some reservations, however, regarding the author’s denial of the possible role that exchange rate policy can play in redressing BOP imbalances.
A Policy-mix Approach

- Tinbergen's rule: Achieving a multiple number of independent policy targets requires an equal number of policy instruments.
- Mundell's rule: Each policy instrument should be assigned to a policy target on which it has the greatest relative effect.
- Exchange-rate policy cannot solve China’s structural problems (state-owned enterprises, banks, agriculture). It should be assigned to reduce China’s external imbalance.

Note: Increase in foreign exchange reserves = current account balance + capital account balance + errors and omissions.
Source: State Administration of Foreign Exchange http://www.safe.gov.cn/
The Mechanism behind the Rise in Foreign Exchange Reserves

- Stronger dollar, weaker yuan
- Weaker dollar, stronger yuan

$\text{Yuan/dollar}$

- Current rate
- Equilibrium rate

Amount of increase in foreign exchange reserves as a result of dollar buying intervention

Dollar supply

Dollar demand

$\$
Liquidity Expansion - Mechanism, Effects and Policy Responses

Balance-of-payments surplus

Interventions → Open market operations (Sterilization narrowly defined)

Foreign exchange reserves, Monetary base

Credit multiplier → Deposit-reserve ratio

Money supply

Liquidity effect → Interest rates

Consumer prices, assets prices

Policies aiming at reducing BOP surplus

RMB revaluation
Import promotion/export restraint
Liberalization of capital outflow

Monetary tightening (Sterilization broadly defined)
Is Exchange Rate Stability More Desirable than Price Stability?

- Japan’s experience in the late 1980s
  - McKinnon’s hypothesis of “ever higher-yen syndrome” is irrelevant for China, because China’s major concern now is expansion of an asset bubble rather than deflation.
  - It was not a strong yen per se, but attempts by the monetary authorities to suppress the yen’s appreciation through intervention in the foreign exchange market and monetary easing (by keeping interest rates low) that led to the bubble economy in the late 1980s.

- Hong Kong’s experience following the Asian Crisis (1997-98)
  - Hong Kong suffered negative GDP growth and negative inflation as a result of the Asian Crisis
  - Overvalued HK dollar (relative to other Asian currencies which had depreciated sharply), together with the need to maintain high interest rates in line with the United States, delayed Hong Kong’s recovery.
The "Impossible Trinity" in International Finance

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Japan's Financial Situation at the Time of Transition to a Floating Exchange-rate System