ELSEVIER
www.elsevier.com/locate/worlddev
World Development Vol. 34, No. 7, pp. 1182–1200, 2006

0305-750X/$ - see front matter
doi:10.1016/j.worlddev.2005.12.005

The Political Obstacles to Greater Exchange Rate Flexibility in China

STEPHEN B. KAPLAN *
Yale University, New Haven, CT, USA

Summary. — An undervalued currency has arguably helped China pursue an East-Asian style export-led model of development, spurring economic growth and job creation. Recently, however, the undervalued exchange rate has exposed China to a raft of growing major financial and economic vulnerabilities, including an overheating of the domestic economy and renewed financial sector difficulties. Despite these risks, Chinese leaders have refused to significantly revalue the renminbi, suggesting that political objectives are taking precedence over economic optimality. I aim to glean insight into such political explanations by building upon present theories in political economy.

Key words — China, exchange rates, political economy, financial policy, economic development, Asia

1. INTRODUCTION

Growing concerns about the economic and financial risks of an undervalued Chinese renminbi culminated in the Chinese authorities' announcement of a small revaluation of the currency peg last summer. Though arguably, an undervalued exchange rate has helped foster an East-Asian style export-led growth model of development in China, it has also increasingly exposed the domestic economy to economic overexpansion and renewed financial sector difficulties. Additionally, preserving the undervalued currency peg creates considerable hidden economic costs and social welfare distortions. For example, China has been earning a negative dollar return on its foreign reserve investments, while sacrificing tremendous alternative investment opportunities domestically.

In light of these economic costs, it begs the question of why the Chinese authorities have not pursued a larger revaluation. I argue that political objectives have taken precedence over economic optimality. *I hypothesize that Chinese policymakers' ongoing reluctance to pursue greater exchange rate flexibility reflects their concerns about the profitability of the politically important export-oriented manufacturing sector.* This sector has buoyed economic growth and generated large-scale employment, helping the Chinese Communist Party (CCP) achieve its reform objectives. Indeed, the CCP has aimed to enhance employment and preserve socio-political stability through an export-oriented development strategy, while simultaneously reforming inefficient state-owned enterprises.

A larger revaluation could jeopardize job creation in coastal export zones, and therefore exacerbate adjustment problems associated with state sector reform. Hence, a large revaluation could threaten the CCP's reform strategy and, ultimately, its hold on power. Communist Party officials therefore remain reluctant to pursue such measures, despite massive foreign pressures. Domestic pressures from coastal regional governments have further contributed to this phenomenon. Benefiting from the success of coastal export zones, these regional governments have advocated for an extension of preferential exchange rate policies from the central government.

The present political economy literature predominately theorizes about exchange rate

* I would like to thank Professors Susan Rose-Ackerman and Frances Rosenbluth of Yale University's Political Science Department and three anonymous reviewers for many valuable and constructive comments. Final revision accepted: December 8, 2005.

developments from a demand side interest group perspective, neglecting to explore such supply side themes. For example, it focuses on the export-oriented manufacturers that pressured politicians to abandon overvalued fixed exchange rates during the waning years of the ISI period in Latin America (Frieden & Stein, 2001). Basically, the majority of this literature builds upon Frieden's political economy model of exchange rates. It hypothesizes about how and why domestic socioeconomic groups influence government exchange rate decisions (Frieden, 1991).

Employing this model as a base, I offer some theoretical refinements aimed at improving its ability to generalize to other countries and historic time periods. Frieden's model of exchange rates policymaking treats the government as a largely neutral actor, channeling the preferences of interest groups into exchange rate policies. In contrast, I posit that government preferences, such as the CCP's concerns about employment and social stability, are also a crucial element in policy formation.

Frieden's work suggests that a country's manufacturing sector is an important determinant of its government's commitment to a currency peg. He finds that the larger a country's manufacturing sector, the greater its political influence, and thus the *less* likely the government is to maintain a currency peg (Frieden, Stein, & Blomberg, 2004). Interestingly, Frieden employs cases to support his hypothesis that all share a common characteristic: an overvalued currency. However, when we apply Frieden's theory more generally to countries outside of Latin America, we find a high prevalence of cases with *undervalued*, rather than *overvalued* currency pegs. In light of this global and historical variation, I suggest that the probability of maintaining a currency peg is conditioned on the valuation of the exchange rate. For example, in the case of China's undervalued exchange rate, the presence of a large and politically sensitive export-oriented manufacturing sector increases, rather than decreases, the likelihood that the government will maintain its commitment to a fixed exchange rate regime.

In the following pages, I will first illustrate that the renminbi, by definition, is undervalued. I next highlight how such undervaluation is sub-optimal from an aggregate welfare perspective, creating substantial domestic, economic, and financial risks. I then demonstrate how current political economy models of exchange rate formation do not account for key supply side factors or condition for exchange rate valuation, leaving them unable to explain the case of China. Finally, I aim to build upon and refine these theoretical models to better explain developments in current Chinese exchange rate policy.

2. UNDERVALUING EXCHANGE RATES AND ITS DANGERS

(a) *Defining an undervalued exchange rate*

I intend to demonstrate that the renminbi is generally undervalued. That said, I do not suggest that a renminbi revaluation alone will correct global payments imbalances, especially the large US current account deficit. Rather, I am primarily concerned with addressing the domestic vulnerabilities of maintaining an undervalued currency. Moreover, I do not aim to precisely estimate the degree of China's exchange rate undervaluation. Many currency strategists and market economists have already done such calculations, estimating that the Chinese renminbi is about 15–50% undervalued, far more than implied by the 2.1% revaluation in July 2005 [1] (though it should be noted that some actors, such as the IMF, have questioned the robustness of larger market estimates). [2]

Instead, I argue that the renminbi is generally undervalued, or below its equilibrium exchange rate level. Several different approaches for estimating equilibrium exchange rates currently exist. [3] I employ the underlying balance approach that the IMF often uses in its own analysis. This approach defines the equilibrium exchange rate as the rate that produces equilibrium in a country's balance of payments, where normal net capital flows [4] equal the underlying current account, leaving a country's international reserves unchanged (Goldstein, 2004). In China's case, steadily rising current and capital account surpluses over the last several years suggest that the current level of the exchange rate is lower than its equilibrium level. Such an undervaluation implies that a further renminbi appreciation would be needed to generate a deterioration in China's current account and restore balance between current and capital accounts.

A possible critique of this method suggests that current account imbalances reflect a savings-investment problem. Hence, there is no reason to suppose that China's saving