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China's exchange rate policy

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Abstract

Should or will the yuan depreciate? This is an important question widely speculated in world financial markets and intensively debated in China in the wake of the East Asian financial crisis in 1997. The present paper examines in detail the fundamentals that determine the exchange rate in China and concludes with two important findings. One is that the past two decades of economic reform has made domestic prices in China sufficiently market-determined and linked to world prices so that the exchange rate can serve as an effective nominal anchor. Exchange rate stability leads to domestic price stability. The other result is that because of the flexibility of domestic prices, a change in the exchange rate has only a modest and ephemeral effect on the terms of trade and trade flows. Therefore, exchange rate flexibility is not essential to keep the current account in balance. Such evidence suggests that China should continue the policy to maintain exchange rate stability, as it has done since 1994.

JEL classification: E61; F31; O53

Keywords: China; Nominal anchor; Inflation; Exchange rate; Monetary policy

1. Introduction

Will or should the yuan depreciate? This is a question widely speculated in world financial markets and intensively debated in China. There has been keen interest in the exchange rate policy in China in the wake of the Asian financial crisis in 1997. The yuan–dollar exchange rate has been stabilized at 8.30 since 1994. Has that been a sensible exchange rate policy?

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Should China make the exchange rate more flexible and possibly let the yuan to depreciate to counter the aftermath of the Asia financial crisis?

In the debate about the need for the yuan to depreciate, most of the attention has been focused on the fact that export growth has been slowing down in China. Therefore, a depreciation of the yuan is needed to make Chinese exports more competitive. The present paper argues that now in China, the exchange rate is actually more useful as a nominal anchor than as an expenditure-switching tool. Exchange rate stability provides a firm anchor for domestic price stability that is conducive to sustained long-run economic growth. As the Chinese economy becomes more integrated with world markets and domestic prices more firmly linked with world prices, trade flows have become less responsive to the variation in the exchange rate. Therefore, it is a sensible policy to maintain exchange rate stability as long as short-term speculative capital flows remain restricted.

The paper is organized as follows. Section 2 reviews the post-1978 developments in the foreign exchange market. Then, I analyze how the exchange rate was related to the domestic price level in Section 3 and investigate how the exchange rate affected the flows in the balance of payments in Section 4. Finally, Section 5 presents the case for targeting the exchange rate as a nominal anchor, especially in the light of the Asian financial crisis.

2. The profile of the exchange rate

Let us begin with a brief look at the behavior of the exchange rate during the reform period (1978–1997). Fig. 1 plots two measures of the yuan–dollar rate. One is the exchange rate published by the Chinese statistical agency.[1] Before 1993, this was the official exchange rate, but after 1994, it became a market exchange rate. Because there were multiple exchange rates before 1994, the official exchange rate did not reflect the average exchange rate used in all foreign exchanges transactions. Therefore, Fig. 1 also plots PWT 5.6, the exchange rate provided by the Penn-World Table (Summers & Heston, 1991), which is a weighted average of the official rate and a parallel rate as explained below.

When China was a planned economy before 1979, the official exchange rate played no significant role in foreign trade, because with state monopoly in foreign trade, losses in exports resulting from an overvalued exchange rate were offset by profits from imports. Profit motive did not guide significantly foreign trade. However, the role of the exchange rate changed, after economic reform began in 1978. As foreign trade became decentralized, the overvalued official exchange rate hurt the export incentive. Therefore, an internal settlement rate closer to the average cost of earning a US dollar in exports (2.80 yuan per dollar) was used for trade transactions in place of the official exchange rate in 1978–1984. Meanwhile, the official rate depreciated steadily towards the internal settlement rate until 1985 when it was merged with the latter.

In 1985–1993, multiple exchange rates reappeared in another form. Because of the existing foreign exchange controls, foreign-funded enterprises were required to balance their

[1] The Chinese data used in the present study mostly come from the *Statistical Yearbook of China (1999)*.