

## CHINA'S DEFENSE OF THE PEG PERPETUATES CENTRAL PLANNING

*David F. DeRosa*

China has maintained a nearly fixed exchange rate of 8.26 renminbi (RMB) to the U.S. dollar since 1994, in spite of the near total collapse of practically every other fixed exchange rate regime over the last decade.

Hong Kong, a special administrative region of China, happens to have the world's other so-far durable fixed exchange rate regime. That is a coincidence, geographically speaking. In Hong Kong's case the stability of its exchange rate derives from the currency board apparatus that was installed before the 1997 reversion to China. The Hong Kong currency board model may be appropriate for smaller developing economies. Large economies are better candidates for floating exchange rates.

If China is going to fulfill the objective of competing on the level of Japan, Europe, or the United States, it would make sense to move to an RMB floating regime (see, e.g., Dorn 2003). This advice coincides with recent pronouncements from the International Monetary Fund, encouraging China to drop or modify the peg.

How did China's fixed exchange rate survive when over the last 15 years fixed exchange rate regimes have self-destructed in such far-flung places as Russia, Mexico, Thailand, the Philippines, Turkey, and Argentina, to name a few?

### Pegged Exchange Rates and Capital Controls

The superficial answer is that China is different because it does not allow full capital account convertibility. This means money can flow into China but it cannot subsequently leave without permission.

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David F. DeRosa is President of DeRosa Research and Trading, Inc.

China allows convertibility for current account transactions but not for capital account items.

Yet economists know capital controls are never absolute and, as Milton Friedman is fond of saying, there is no such thing as a legislative proscription. Circumstantial evidence suggests China's controls are porous. And indeed the controls are leaking. One investment bank estimates that \$70 billion of "hot money" (betting on a revaluation of the RMB) flowed into the PRC in 2003 only to flow back out in May and June 2004 when a change to foreign exchange regime looked less likely. Hot money was defined as the change in foreign exchange reserves less total of the trade surplus and foreign direct investment flows.

What then is the significance of capital controls? Consider Malaysia's much touted experience with capital controls in the late 1990s which was much misunderstood. Malaysia installed capital controls in September 1998, a full 14 months after the onset of the Southeast Asian currency crisis (usually marked from July 1997, the date when Thailand released the baht from its peg). Despite misleading claims, Malaysia did not find a "kinder, gentler way" to deal with its currency crisis by the rather public freezing of foreign exchange trading and capital transfers. Rather, Malaysia merely locked the barn door after the horses had escaped.

Malaysia did, however, reinforce its reputation as having a government that would resort to extreme steps to get its way with the market. And it is important to remember that Malaysia had resorted to capital controls on at least one other occasion in the same decade, though in the earlier case it was to halt the appreciation in the ringgit. The important concept to take from this is that when a government installs capital controls it serves notice to traders or, if you like, speculators that they are playing with fire. It is a statement of willingness on the government's part to undertake heavy-handed measures that are designed to be extremely costly if not ruinous to anyone who has a trading position not favored by the government. That implied threat is the significance of China's capital controls, leaky though they may be in their current form.

What would motivate China to give up the fixed RMB? The system has attracted a lot of commentary over the last 10 years, most of which concerns bogus issues. China got high praise for not devaluing the RMB in the late 1990s, especially in the midst of the Southeast Asian currency crisis (the episodes involving Thailand, Malaysia, the Philippines, and Indonesia). More recently the pendulum has swung to the other extreme. The fixed RMB has been subjected to visceral condemnation. To listen to the public debate one would conclude

China has figured a way to cheat its way to prosperity using the RMB. U.S. politicians (from both parties) as well as some from abroad have accused China of “manipulating” (quoting Sen. Charles Schumer of New York) the RMB to gain some kind of unfair trade advantage against other countries. Exactly how the United States is burdened by the fixed RMB is not clear since, as was mentioned, the RMB has not moved in nearly a decade. To his credit, Treasury Secretary John Snow has tried to rebut China’s currency critics. Nevertheless, in calling for a flexible RMB exchange rate, the Bush Treasury has not made clear whether it wants a full-blown float or merely an adjustment to the current fixed exchange rate.

## The Problem of Overheating

All of this talk in the West about the RMB must be a source of confusion to Beijing where the real problem could be termed a crisis of excessive growth. China’s official statistics show the country grew at 9.7 percent in 2004. A decision has been made to reduce the rate of growth to about 7 percent. Adding to the troubles—according to Beijing—is that certain industries are growing much faster than the rest.

Why should China be growing too fast for its own good? The usual explanations abound: China is growing from a low base; China has cheap labor in abundance; China has embarked on its own version of market-economy reforms, one result being that it has become both an import and export giant. How about examining China’s central bank, the People’s Bank of China?

The PBC has sacrificed monetary stability for the sake of pegging the exchange rate. At the heart of the problem is a hard-wired connection between the “fixed” exchange rate regime and the balance sheet of the central bank. Foreign exchange that comes into China must be turned over to the central bank and, if unsterilized, results in an expansion of money supply. The rate of growth in broad-based monetary aggregates, M1 and M2, accelerated in mid-2002. M2 had been growing at annual rates between 14 and 16 percent from as early as 1999 through nearly the end of 2002. Thereafter, it rose to an annual growth rate of 21 percent at times in 2003.

Measured inflation in consumer prices started to rise, right on cue. The annual rise in the CPI had been in its own corridor of 0 to 2 percent. By the end of 2003 it was rising at 2.8 percent and by mid-2004 it was increasing at about 5 percent. In this environment it is not surprising to see a boom in industrial output.

## Beijing's Choke Therapy

Beijing's solution is to institute what some observers appropriately enough have started to call "choke therapy"—that is, the use of a set of government directives to suppress economic expansion in selected industries, among them steel, cement, and real estate. In particular, banks have been ordered to rein in credit to these industries. This was affirmed in August 2004 by Premier Wen Jiabo when he told banks not to lift the industry-specific lending freeze. The order was to curb loans for steel, cement, and real estate. The *China Daily* reported that new bank loans in the first six months fell by \$42 billion from a year earlier. According to the PBC's Web site, the decline in new loan creation in June 2004 was nearly \$29 billion. Someday Beijing may have to address the question of whether choke therapy can be reversed.

At the same time some industries have been told to slow down their growth, other industries have been told to speed up their growth. The *Securities Times* recently quoted central bank deputy governor Guo Shuqing as giving the green light for expansion of certain industries, including energy, transportation, education, and tourism. That this edict came from a central banker highlights how strange China's policies are.

Moreover, ask how Beijing goes about selecting which industries should grow and which should be throttled? The answer would please Procrustes—the fabled robber of Attica who made his victims "fit" his bed. Too short, he stretched you out; too long, he chopped off your legs. In China, some industries grow too fast so they have to be stopped. Others are not growing fast enough so they must be given a push. On a more subtle note, one has to wonder if Procrustian choke therapy can accommodate policy adjustments when unexpected economic events take place, such as oil price shocks.

In a word, China has chosen macroeconomic adjustment by the "old fashioned way," namely, central planning. In doing so, Beijing has lost the efficiency that would result in having the adjustment process done by macroeconomic prices (the exchange rate and the interest rate).<sup>1</sup> This judgment, of course, rests on what one believes is the role of exchange rates. Here the economics profession has taken virtually every possible position over time.

<sup>1</sup>The PBC did raise the benchmark rate on one-year yuan loans by 0.27 percentage points, from 5.31 percent to 5.58 percent, in October 2004. The last rate increase was in July 1995.

## Economists' Debate over Exchange Rates

Some economists have considered exchange rate fluctuations, even exchange rates themselves, to be nothing more than a nuisance, an unnecessary drag on the world economy. Others have condemned the foreign exchange market as a platform for excessive and unnecessary "overtrading"—hence the policy recommendation to introduce the so-called Tobin tax on currency trading. Another view is that exchange rates fluctuate too much, as though there were some universal set of standards by which economists can pontificate on how wide price swings should be. And then there is the perennial ultimate suggestion that all countries should give up their currencies to adopt a single world currency. That would have the result of ending foreign exchange trading once and for all.

### *The First Axiom*

The fundamental problem with these views is that they fail to recognize that exchange rates are prices, something that ought to be identified as an axiom of economics. As with any price the function of exchange rates is to cause adjustments to supply and demand so as to achieve market clearing conditions. Whether they move a little or a lot, or whether they are the subject of thin trading or massive trading is irrelevant. The essential point is that freely floating exchange rates clear foreign exchange markets without central planning.<sup>2</sup>

This analysis leads one to wonder what will be the less obvious consequences of China's freezing its exchange rate. Restrictions on degrees of freedom for monetary policy are obvious but others are harder to detect or outright invisible. To the extent the pegged exchange rate differs significantly from what would prevail without the peg, the mixture of industrial output is artificially determined. The tough part is that to answer the question one has to imagine what would have otherwise been the state of the economy absent the pegged exchange rate whereas in practice one can only observe what it is like today.

### *The Second Axiom*

There are other implications subtle to the mechanics of the workings of the economy. Macroeconomic forces strive to achieve a state of market clearing for goods, money, the foreign sector, and the asset markets, which requires adjustments in macroeconomic prices.

<sup>2</sup>For a detailed defense of floating exchange rates and free capital markets, see DeRosa (2001).

Imbedded in this process is the choice of which macroeconomic prices to adjust and by how much, which brings us to the second axiom: the market correctly chooses which prices to assign to do the heavy lifting. Moreover, all other arrangements, meaning ones wherein a government constrains which prices can be put to the work, so to speak, are inferior to what a free market system would do of its own accord. A more cynical statement is that the free market's macroeconomic solution may not be perfect, but at least it is better than any alternative that policymakers can invent.

## Conclusion

The rulers of China have probably never considered the above-mentioned two axioms, as their behavior demonstrates. China is not the first country to become stubbornly attached to a pegged exchange rate regime. China, however, is extraordinary in regard to the lengths Beijing has gone to reorganize the economy as a consequence of keeping the exchange rate fixed within a narrow band. Worse still, the defense of the RMB peg has contributed to China's reversion to heavy-handed central planning.

## References

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