The People's Currency
(人民币)

by

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China's Exchange Rate Policy

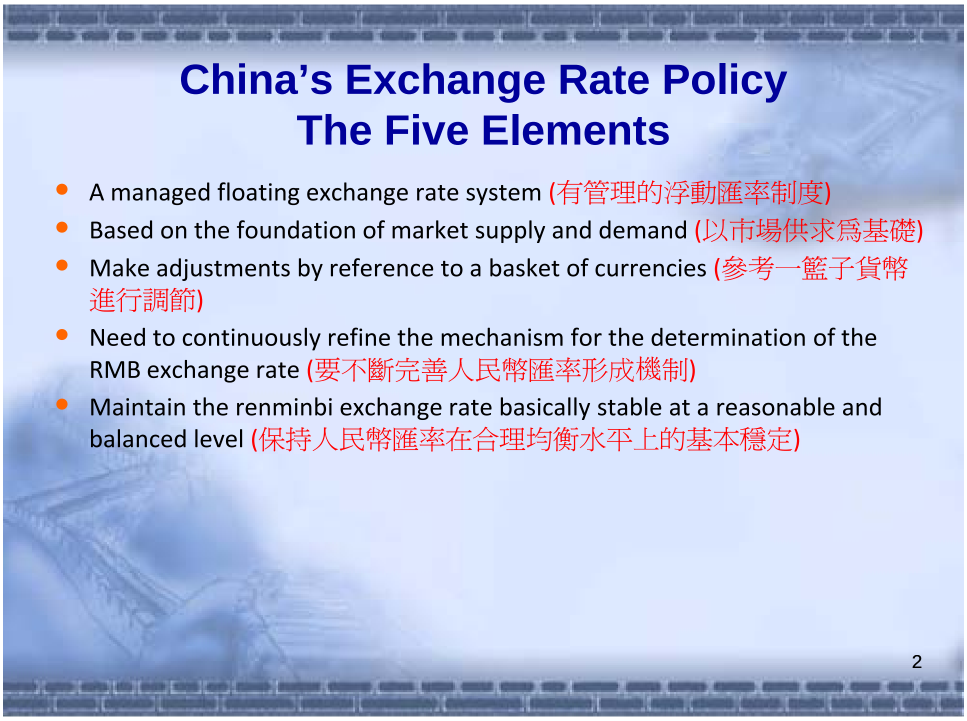
Other than the sovereign debt crisis now raging in the euro zone, the most talked about subject lately in international finance is probably the renminbi (人民币), China's currency, which is literally translated as the people's currency. I am sure you are aware of the sharp international focus on China's exchange rate policy, and the enthusiastic discussion over whether China should quickly allow the renminbi exchange rate to appreciate. It is also a topic that has been highly politicized; and so, regrettably, there has also been a proliferation of rhetoric, characterized by an abundance of rather dogmatic and distorted views, many from respected sources, which I dare say did not address the real issues or pay enough attention to the facts. And so, views on the subject have become rather one-sided, helping to generate quite a lot of one-sided bets in the non-deliverable markets offshore and, among those who have access to the renminbi, a strong preference to hold renminbi over other currencies.

2. Perhaps this is what politics is all about. But politics and central banking do not mix well. A forced mixture often produces painful and possibly debilitating financial chaos. I am confident, however, that the integrity of policy making in money and finance on the

Mainland of China, a matter of grave importance to the sustainability of stable and rapid economic development of China, will be upheld, in this and other episodes of political tension in which such policies feature.

3. Although I currently hold the position of Executive Vice President of the China Society for Finance and Banking, an organization managed by the People's Bank of China, I am not, by any stretch of imagination, a spokesman for financial affairs on the Mainland of China; and I do not have inside information. But I do recognize the facts in front of me and, to the extent that they require interpretation, I think I am qualified to offer my opinion.

The Five Elements



4. As far as I can ascertain, there are five elements in the exchange rate policy of China. Translated into English, they are:

(1) A managed floating exchange rate system (有管理的浮动汇率制度);
(2) Based on the foundation of market supply and demand (以市场供求爲基礎);
(3) Make adjustments by reference to a basket of currencies (參考一篮子貨幣进行調節)
(4) Need to continuously refine the mechanism for the determination of the renminbi exchange rate (要不断完善人民币汇率形成机制); and

(5) Maintain the renminbi exchange rate basically stable at a reasonable and balanced level (保持人民币在合理均衡水平上的基本穩定).

5. One can say that all this is quite a mouthful and that it is not the clearest of policy statements on the exchange rate. As such, one can argue that it could be subject to different interpretations at different times, even, cynically, to suit the political needs prevailing. I must confess having some sympathy with that argument, although it is perhaps understandable that, in the circumstances of the Mainland of China – a large economy in transition – the policy makers would want to keep options somewhat more open and flexible than many outsiders would like to see. I would even go further as to say that there is scope for improvement in policy communication, in terms of enhancing policy transparency, which would only contribute to establishing policy credibility.

6. But these five elements, whatever they mean exactly, have always been there for all to see, and, in response to the recent chorus of political rhetoric, re-emphasized time and again by the authorities, in a manner that does not suggest that the policy will be changed any time soon. Of course, insofar as the more or less fixed exchange rate against the US dollar in the past twenty months is concerned, the explanation, and I think a credible one, is that it is a special policy in response to the financial crisis that originated in the developed markets; in other words, it is a temporary departure from the established policy characterized by the five elements and there will be an exit from the special policy. Thus, when the opportunity presents itself, there will be a return to the "managed floating exchange rate system" that is "based on the foundation of market supply and demand" and "adjustments made by reference to a basket of currencies", and there will continue to be "improvements made to the mechanism for the determination of the renminbi exchange rate", so that it is "kept basically stable at a reasonable and balanced level".

Special Exchange Rate Policy and Exit

7. There are then the immediate questions of the timing of the exit and whether there will be a large one-off appreciation of the renminbi exchange rate against the US dollar on exit. On the timing of the exit: as an ex-central banker, I think it would be inappropriate for me to make any prediction. But I would draw your attention to what Governor Zhou of the People's Bank of China said in early

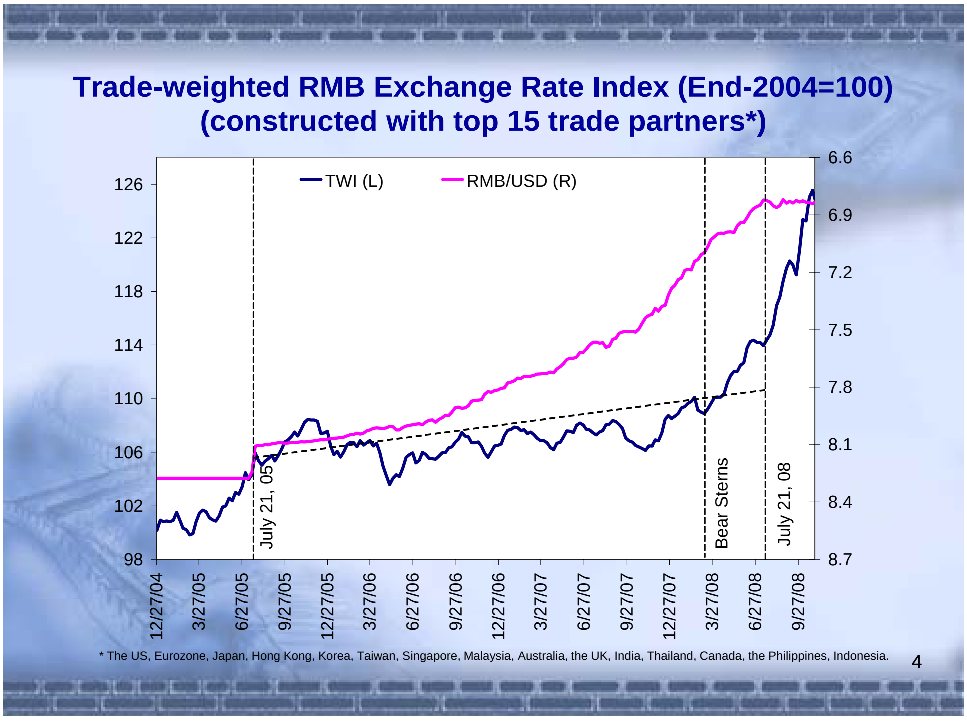
March in response to a press question on China’s exchange rate policy. He said that: “under crisis conditions, the use of special policies, including a special mechanism for the determination of the exchange rate, cannot be ruled out” (在危机的條件下， 排除我们会採用特殊的政策，也包括特殊的汇率形成机制). Indeed, he added that the special policy on the exchange rate is “a component of the package of policies in response to the global financial crisis” (它也是我们应对全球金融危机的一篮子政策中的一个组成部份) and that “for this type of special policy, there will sooner or later be the question of exit” (這樣的政策遲早也有一个退出的問題).

8. While I will leave you to make your own predictions on the timing of exit, my advice to you is that, in doing so, you should focus more on the normalization of domestic economic conditions, which are obviously tied in with economic conditions in the developed markets, rather than allow political events to exert undue influence on you. I think, as far as the leadership in Beijing is concerned, six months before the mid-term election in the United States or the publication, or the delay in the publication, of some report on currency manipulation, or the holding of meetings of the Sino-US strategic dialogue, or presidential visits overseas are not particularly relevant. Linking exit from the special policy to any of these events is counter-productive. But then this is someone with an allergy to politics speaking. I have to add, nevertheless, that while the domestic economic conditions of China in isolation probably make an exit imminent, the economic conditions in the developed markets continue to cause considerable concern in China, so much that I think there is a need for great caution. Furthermore, there is sadly the rather more frequent

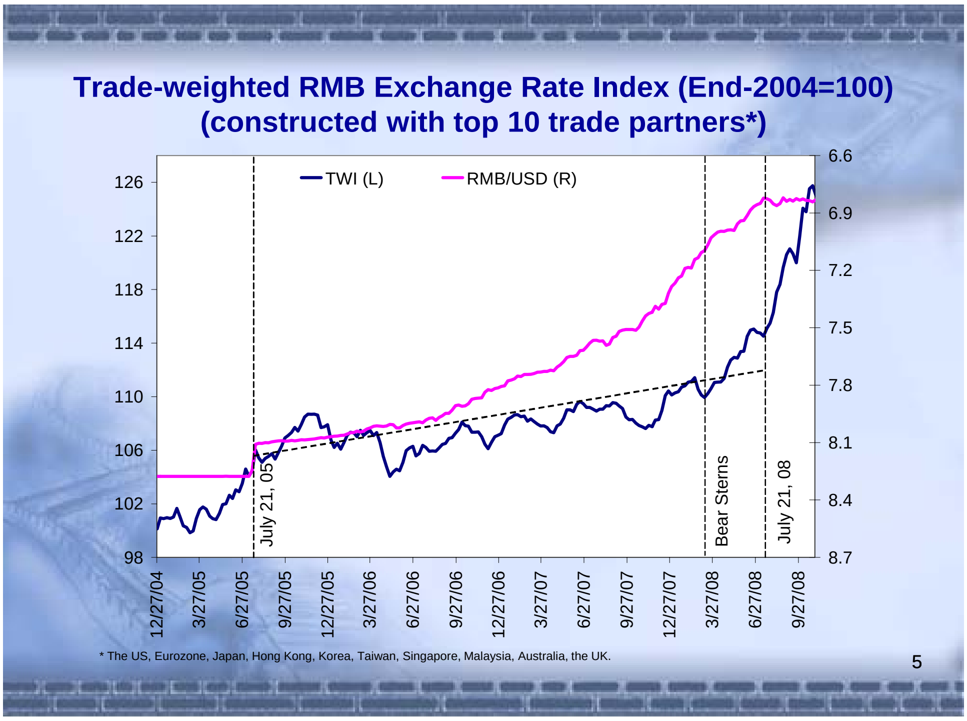
occurrence of natural disasters of late, presenting downside risks to the robustness of the economic recovery and adding greater complexity to macroeconomic management in China.

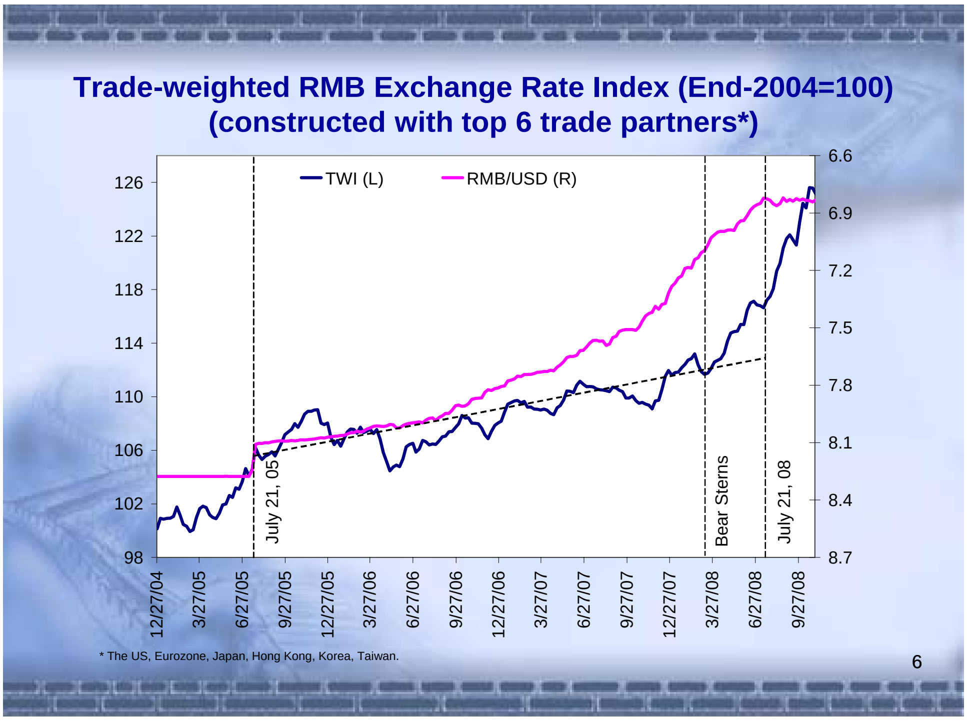
Is There a Need for a One-Off Appreciation on Exit?

9. Let me turn to the question of whether there will be a large one-off appreciation of the renminbi exchange rate against the US dollar on exit from the special policy. To answer that question, one should first try and decipher the encryption in the five elements of the established policy. Here, an examination of



the empirical evidence helps. The policy was in operation over the three-year period from July 2005 to July 2008, but I would separate this period into two parts using the collapse of Bear Sterns in March 2008 as the divider. The first part is the 32-month period from July 2005 in which the five-element policy was functioning reasonably smoothly and the second part, when the crisis broke and intensified, and the US dollar appreciated sharply, is the 4-month period in which all was not well, thus necessitating the introduction of the special policy in July 2008.

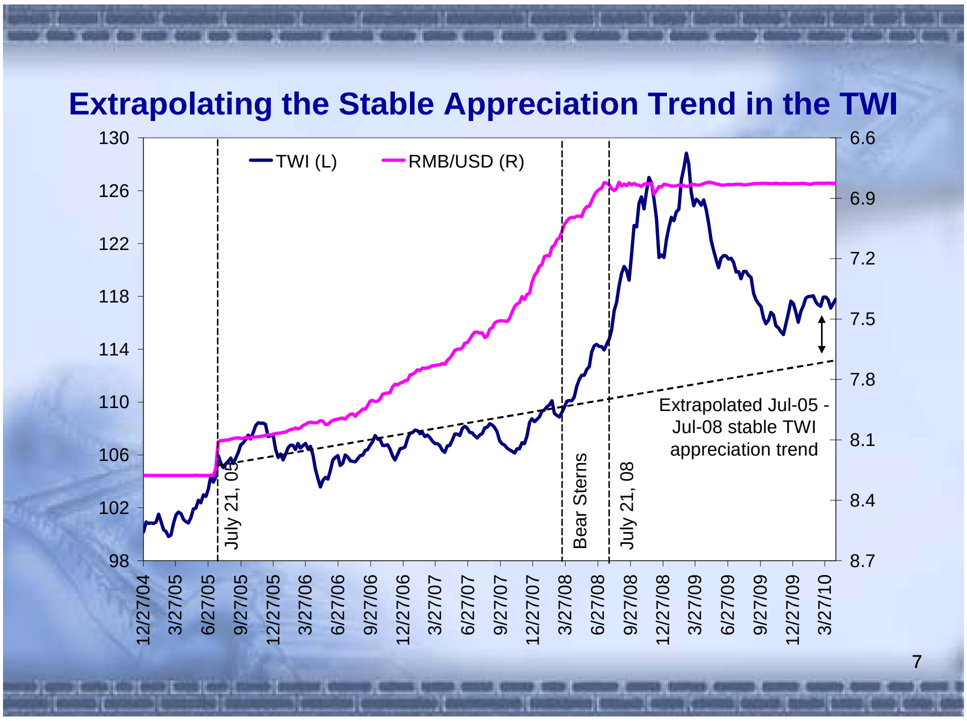




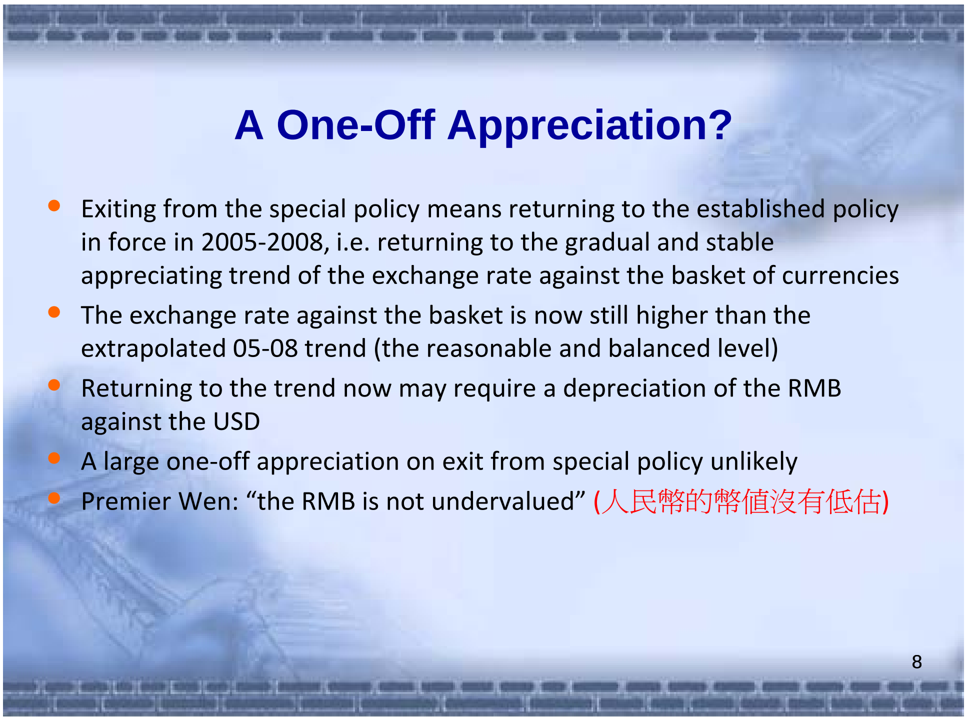
10. One observation from the empirical evidence in the 32-month period readily presents itself. Using different trade-weighted exchange rate indexes as proxies for the undisclosed basket of currencies that policy makers make reference to, there was a stable appreciating trend of about 2% to 3% per annum during that period. This trend was probably established as a matter of policy and achieved operationally through the hard work of the People's Bank of China in determining, on a day by day basis, a bilateral exchange

rate of the renminbi against the US dollar and standing ready, at a small margin around that daily determined exchange rate, to absorb the net flow in and out of the renminbi into foreign reserves. Thus, "a managed floating exchange rate system" (the first element of the established exchange rate policy) is a suitable description of the system. And it is arguably "based on the foundation of market supply and demand" (second element), recognizing of course that the People's Bank of China is part of the market, and the largest market participant by far. Indeed, "adjustments to the renminbi exchange rate (against the US dollar) are made by reference to a basket of currencies" (third element), as the behavior of the trade-weighted exchange rate indexes over the 32-month period shows. There were, nevertheless, fluctuations around the trend, which are at times quite significant, suggesting that there is a "need continuously to refine the mechanism for the determination of the renminbi exchange rate" (fourth element). But, by and large, "keeping the renminbi exchange rate basically stable at a reasonable and balanced level" (fifth element) was achieved, if this is interpreted as maintaining a stable and gradual appreciating trend for the exchange rate index against the undisclosed basket.

11. Thus, if my attempt to decipher the encryption is not way off the mark, the exchange rate policy of China, as it was practised from July 2005 to March 2008, is, in more simple language, to maintain a stable and gradual appreciating trend in the exchange rate index of the renminbi against a basket of currencies. However, in March 2008 Bear Sterns collapsed, the crisis erupted and intensified, and the US dollar appreciated sharply against other foreign currencies. I believe the policy makers then faced a difficult task in the second quarter of 2008. Continuing to keep the exchange rate index against the basket of currencies on the gradual appreciating trend would have required fairly significant **depreciation** of the renminbi against the US dollar. Continuing to allow the renminbi exchange rate to respond to market supply and demand would have meant continued appreciation against the US dollar, which was already strong, thus pushing the exchange rate index of the renminbi against the basket of currencies to way above the "reasonable and balanced" trend. Both were obviously not desirable under crisis conditions. Hence, the special exchange rate policy of fixing the renminbi exchange rate against the US dollar was implemented on 21 July 2008, as "a component of the package of policies in response to the global financial crisis". Even then, the exchange rate index of the renminbi against the basket of currencies continued to appreciate sharply. It was not until March 2009 when the US dollar peaked that the index fell back.



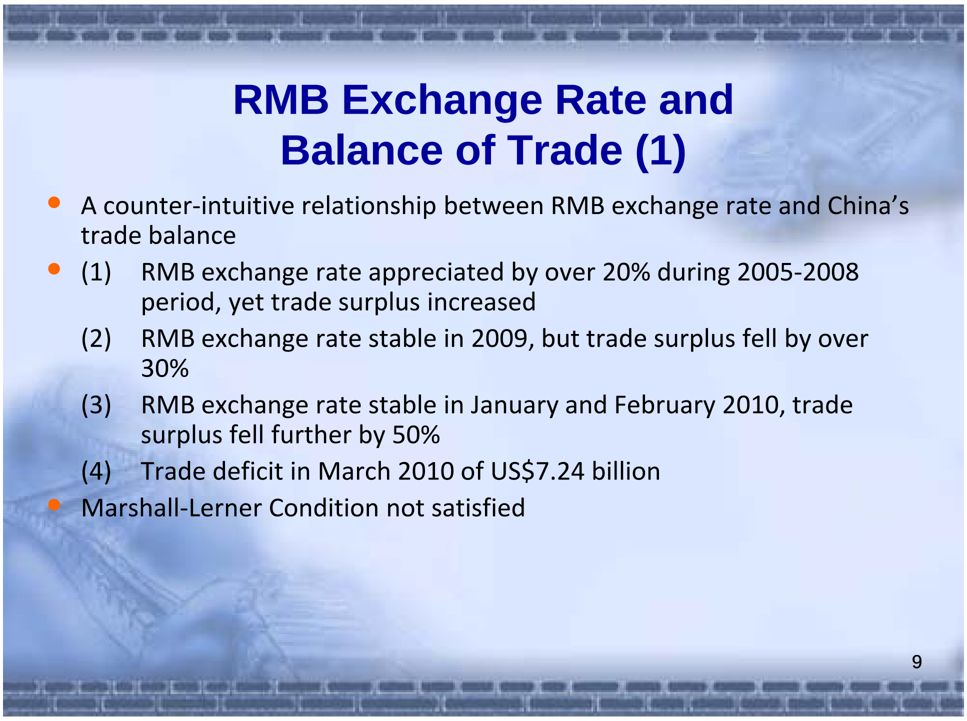
12. Let me draw your attention to another observation. With the recent strengthening of the US dollar against the euro and the yen, the exchange rate index of the renminbi against the basket of currencies is now significantly above the trend of 2005-2008, if it is extrapolated to the present, and moving away from it. Thus,



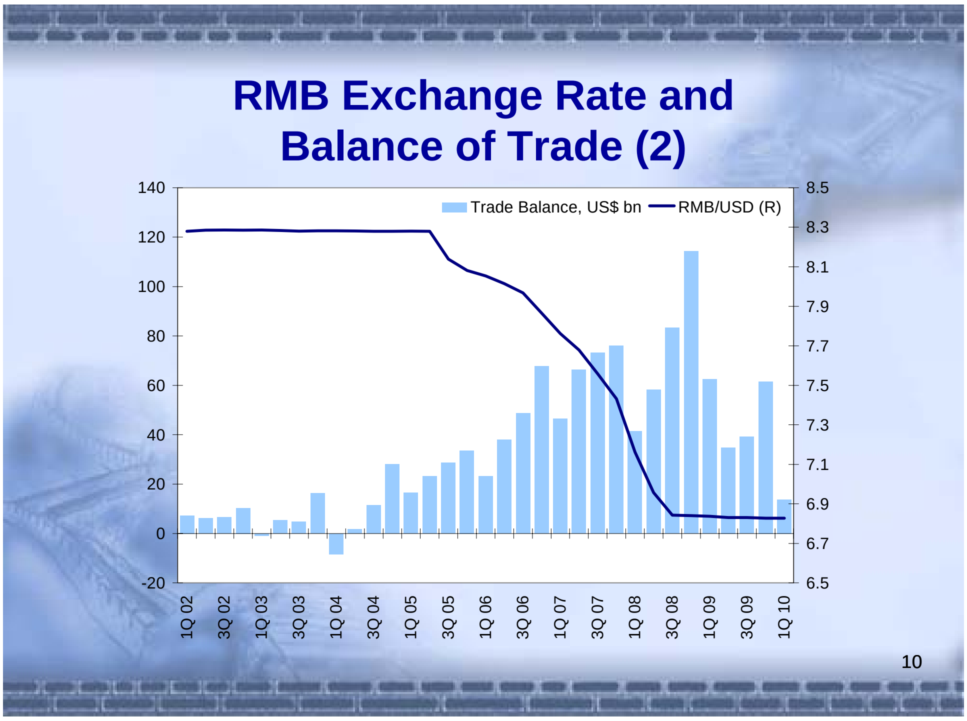
an exit from the special exchange rate policy of the past 20 months and a return to the established exchange rate policy in practice in 2005-2008, if that means returning to the stable and gradual appreciating trend of the exchange rate index against the basket of currencies established in that period, would require a significant **depreciation** of the exchange rate of the renminbi against the US dollar on exit. So, contrary to market expectation, I think there is unlikely to be a large one-off appreciation of the exchange rate of the renminbi against the US dollar on exit from the special policy when exchange rate flexibility is re-introduced. Consequently, I hope, like me, you can appreciate why Premier Wen in March this year said that "the renminbi is not undervalued" (人民币的币值没有低估).

Exchange Rate and the Balance of Payments

13. I am sure some would draw a totally different conclusion than that of Premier Wen, by pointing to the large current account surplus or the overall trade surplus of China, or even the bilateral trade surplus China runs with the United States. Indeed, based on this perspective, there are now many estimates of how undervalued the renminbi is. But I think we all need to be reminded of the fact that the inverse relationship between the exchange rate and the balance of trade is not something that we can always take for granted. There is of course attraction, for



political convenience, to look for example narrowly at imports and say that the exchange rate of the jurisdiction from where the imports come is undervalued, unfairly eroding the competitiveness of the corresponding domestic industry and leading to the loss of many jobs (and importantly votes). Many therefore attributed the global imbalance to the renminbi being undervalued and pushed vehemently for appreciation. But the actual experience since flexibility was introduced to the renminbi exchange rate in July 2005 gave us counter-intuitive evidence. The trade surplus increased sharply over the period 2005-2008 when the renminbi appreciated against the US dollar by over 20%. When the renminbi was held stable against the US dollar in response to the financial crisis, the trade surplus actually fell by over 30% in 2009. In the first two months of 2010, when the renminbi exchange rate continued to be held stable, the trade surplus fell further by 50%. And there was a trade deficit in March amounting to US$7.24 billion and only a very small surplus in April.



14. This counter-intuitive relationship between the exchange rate and the balance of trade of China suggests that, using academic jargon, the price elasticity of imports and exports from the supply and demand sides may be such that the Marshall-Lerner Condition – something that I understand is now taught in high schools – may not be satisfied in the Mainland of China. But other things have of course not been equal. There have been sharp shifts in economic performance in major markets that could have made much bigger differences to international trade flows than that caused by exchange rate movements, or the lack of them. Under the circumstances, I think it would not be advisable to rush into making changes to the exchange rate policy, whether it is the much anticipated exit from the

special policy or, after exit, the possible move onto a significantly different trend for the exchange rate index of the renminbi against the undisclosed basket of currencies.

The Longer Term Issue

15. Whether or not the exchange value of the renminbi, measured against a basket of currencies, should be allowed to appreciate more quickly on exit from the

special policy is a longer term issue. It is a matter I think that should be considered in the context of the longer term economic development of China. As China continues on the path of reform and liberalization, enthusiastically embracing globalization, the real effective exchange rate of the renminbi will have to appreciate, as the general price level in China, which is still relatively low now, converges with that in the rest of the world, in particular, that in China's major trading partners. This convergence can only take the form of either a relatively high rate of domestic inflation or an appreciation of the nominal exchange rate, or some combination of both. In the case of China, where the authorities should position the optimal point on the spectrum of policy choices between the two is I am sure quite clear to them.

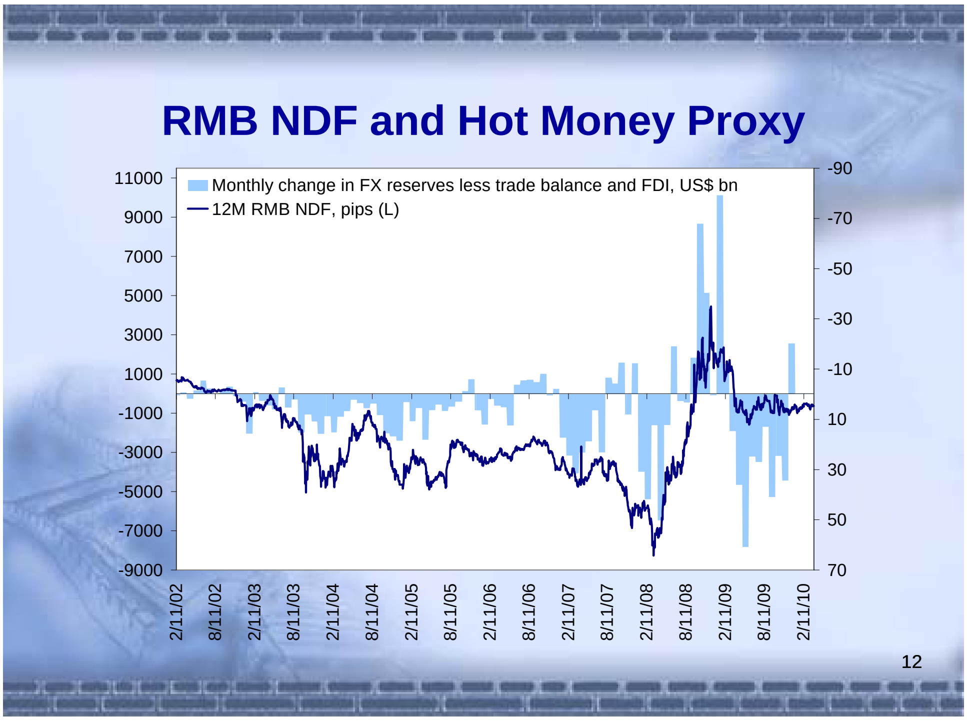
16. There is of course the substantial current account surplus that we have been seeing, which has been the subject of political controversy and, more importantly, presenting

challenges to monetary management, and there is a need to address it. If in the case of China the balance of payments position is insensitive to the exchange rate, or even possibly bears a counter-intuitive relationship with it, then the solution lies in the further liberalization of the capital account. This would encourage outward portfolio investment by the private sector, thus obviating the need for continued large accumulation of foreign reserves by the government and lighten the task of monetary management. This would also enable national savings to achieve a higher and more stable risk-adjusted rate of return. Together with enhanced social security arrangements, this should in time bring down the very high savings rate as the people find that there is less of a need to self-insure. At the same time, domestic consumption and therefore imports would be encouraged, thus correcting the current account surplus.

17. But this is not the shorter term issue at hand at this point of time. Inflation is stable and inflation expectation is reasonably well anchored. And, with the uncertainty surrounding what hopefully is the end game of the financial crisis in the United States and Europe, and the need domestically to deflate an asset bubble while sustaining the nascent economic recovery, the scenario confronting policy makers in Beijing now is already, as Premier Wen put it, extremely complex (极为复杂). Why make it even more complex with a hasty exit from the special exchange rate policy and a one-off significant appreciation on exit that is economically unjustifiable?

Market Dynamics

18. But I have to confess again: this is a retired central banker with an allergy to politics speaking. Meanwhile, with the abundance of global liquidity searching for return, the timing and the extent of possible renminbi exchange rate appreciation, specifically against the US dollar, have provided fertile grounds for making large bets. These take the form of non-deliverable forwards (NDF) and options (NDO) that involve amounts probably many times more than that justified by the need for hedging exchange rate risks outside of the Mainland of China. I am not familiar with the market dynamics of these innovative, non-deliverable derivatives, in particular whether or not they could impact upon the domestic money and foreign



exchange markets of the renminbi. I am sure, however, that the authorities are on top of this. Their track record in the maintenance of monetary and financial stability over the past two decades of excesses and turmoil in global finance has been better than most. I just hope those making big bets through the use of these derivative products realize the risks that they are taking and are in a position to manage them, unlike some of those in the past who found themselves caught badly punting in the so-called accumulators.

19. These large NDF and NDO bets, regrettably, may translate themselves into an intensification of political pressure on the renminbi exchange rate policy, particularly when these bets have, according to market sources, been piling up along with the political rhetoric and as maturity of the contracts approach. That would be unfortunate. I have little sympathy for those losing bets of this nature. I have the experience of making this happen and I can tell you: it felt good. But, seriously, it would be bad to see, along the way, a further move towards the slippery slope of protectionism, just as it was bad to have to engage in controversial market intervention. This is yet another example of the dark side of financial innovation, creating distorted incentives in the financial system that put the private interests of some above the public interest of pursuing a free and open international system for trade and finance. But that is another subject for another day.

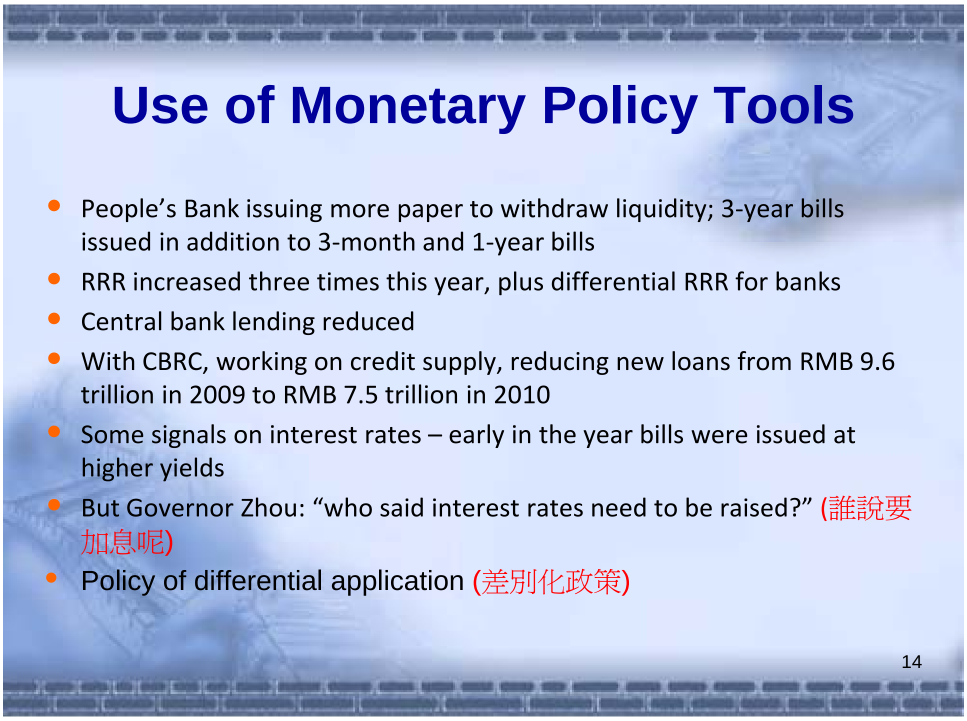
Monetary Policy

20. On the subject of today, let me widen it and talk briefly on monetary policy on the Mainland of China, noting that it is an increasingly important matter for the rest of the world, in particular this region. Indeed, I was told that the fastest growing population in the world is now the population of People's Bank watchers, as global exposure to China builds up quickly, taking advantage of the much higher economic growth potential there and being captured in the increasing variety of financial instruments open to foreign investors and made available in Hong Kong.

21. There are five monetary policy tools in the toolbox of the People's Bank of China. As the People's Bank watchers are aware, the characteristics of the five tools are transparently described in the website of the People's Bank of China. They are:

(1) Open market operations (公开市场业务);
(2) Reserve requirement (存款准备金);
(3) Central bank lending (中央银行貸款);
(4) Interest rate policy (利率政策); and
(5) Exchange rate policy (汇率政策).

22. With the continued accumulation of foreign reserves and there being no longer the need for quantitative easing, open market operations have lately been



focusing on sterilization and the reduction of excess reserves in the system. There have been more bills issued by the People's Bank and also the re-introduction of three-year bills. For the same purpose, the reserve requirement ratio (RRR) has also been raised three times this year to 17%. There may also have been some further contraction in central bank lending, following on from a trend that had been established before the crisis, but this may be more a reflection of reduced dependence of the commercial banks on central bank funding. Some in the market interpreted these moves, involving the use of the first three tools in the toolbox, collectively as monetary tightening. I choose to see them as attempts to normalize monetary conditions or the removal of excess liquidity in the system so that monetary conditions become less stimulating to credit expansion. But the overall monetary policy stance is still "to continue to implement suitably accommodative monetary policy" (继续实施适度宽松的貨幣政策).

Interest Rates

23. There were, nevertheless interesting signals given at the beginning of the year when the yields of the three-month and one-year bills at issue were raised slightly, perhaps for the purpose of alerting the market to the possibility of higher interest rates. But, since

then, there have not been any further upward adjustments in yields and so far no follow through on the interest rate front, notwithstanding an intensification of market expectation that interest rates will soon be raised. Interestingly, when confronted by reporters a few weeks ago on the effect of higher interest rates on the economy and on asset prices, Governor Zhou of the People's Bank of China responded by asking reporters on "who says interest rates need to be raised" (谁说要加息呢).

24. I draw your attention to all this in order to bring out what I think is the stance of the authorities on interest rate policy, the fourth tool in the toolbox. Because we are all too familiar with the use of interest rates as the main monetary policy tool, we may have neglected the possibility of working on the supply of credit rather than the price of credit in restraining credit expansion. In People's Bank watching or indeed in understanding policy making in China we need to be open minded and appreciate that the use of administrative means can be a lot more effective in terms of achieving the desired results, although I hasten to add that they do not score the same high marks in terms of the efficiency in the allocation of scarce resources. This is one important characteristic of a socialist, market economy – the efficiency of the policy transmission mechanism – that we should perhaps try better to understand.

25. The supply of new bank credit for 2010 has been targeted at RMB7.5 trillion, compared with the actual of RMB9.6 trillion in 2009. Furthermore, the pacing in the disbursement of new loans is to be targeted at somewhere between the patterns of 4:3:2:1 and 3:3:2:2 in each of the four quarters of the year. By the look of the latest relevant developments, these efforts on the supply of credit are producing desirable results, to the extent that, I think, the authorities may wish to adopt a wait and see attitude on whether or not to work also on the price of credit, in other words, to use the interest rate policy tool. This is understandable, given that higher interest rates may encourage more inflow of capital and speculative position taking on the renminbi exchange rate.

26. Some of you may have also noticed the targeted approach adopted by the authorities in the use of some of the monetary policy tools, for example, different reserve requirement ratios for different banks and different policies on the supply of credit for different activities. This is now described as the policy of differential application (差别化政策), which is proving to be quite effective in China in, for example, drying up credit for property speculation and doing so in a timely manner. There are of course pros and cons to this type of involvement of the authorities in the market. This is perhaps something that the free marketers are rather skeptical to, preferring, for example, the allocation of credit in accordance with the credit worthiness of the borrower, as perceived by the lender, rather than

in accordance with administrative guidance by the government. But then we also have markets elsewhere, which were left to operate rather more freely, as the free marketers would like it, producing sub-prime mortgage assets, leading eventually to massive market failure that require an even greater and more controversial degree of involvement of the authorities.

Conclusion

27. Let me conclude this lengthy speech, for which I offer my apologies. The record speaks itself. In macroeconomic management generally and in monetary including exchange rate policy specifically, China is doing the right things and coping well, notwithstanding the very complex scenario the country faces. The approach adopted may not be to the liking of some, particularly those, dare I say, who have been conditioned by established paradigms and who are unfamiliar with how a socialist, market economy functions. International politics, in an increasingly globalized environment, makes it worse and often the hard facts are ignored. But I believe that China will get it right and contribute to the stabilization and recovery of the global economy. An exit from the special exchange rate policy of the last 20 months will come, sooner or later, as reality of China's economic development dictates but not as a solution to problems associated with the current financial crisis of the developed markets. On timing, I would look for clear signs of normalization in the economic and financial conditions in China as well as in the major developed markets, and not for political events.

28. On matters of currency and exchange, it is important that China proceeds with great caution. The potency of international finance is to be respected and harnessed. Whatever moves taken, there are likely to be important implications for the future of the international monetary system. With the right moves, I believe that the renminbi – the people's currency – is destined to play a much more important role in what now appears to be a system that is inherently unstable. China, in the fullness of time, will achieve an economic scale matching that of the United States and the euro area. With confidence in the renminbi supported by a long track record of sound macroeconomic management, the renminbi is a promising candidate to be the third, stabilizing leg of the international monetary system.

Joseph Yam
19 May 2010