

China can Afford a Bit of Inflation

Abstract

China is facing a serious challenge. Its currency is under pressure to appreciate and its economy is overheating. Other East Asian economies are experiencing a similar problem. We make a case for an unconventional strategy to meet the current challenge. Instead of floating their currencies and cooling off their economies by tightening their macroeconomic policy, they should keep their de facto currency pegs to the USD and maintain a robust pace of economic growth by tapping productively the low-cost funds provided generously by currency speculators. They can afford to accommodate a moderate amount of domestic inflation. Real appreciation of their currencies through rising domestic prices and wages and strong import growth would generate offsetting depreciation pressures through the current account channel. By moving the foreign exchange market to a neutral position, this strategy would pave the way for increasing exchange rate flexibility. And that is what East Asian governments should meet and talk about instead of focusing on a formal exchange rate arrangement.

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Introduction

Recently, two issues about the Chinese economy have attracted much attention among economists, policy makers and businessmen. One is whether China should abandon the de facto peg of the Chinese currency, *renminbi* (RMB), to the American dollar (USD), which has been in existence since 1994. The other issue is how hot has the Chinese economy been overheated and how aggressive macroeconomic policy should respond to it. The two issues are, of course, related. What connects the two issues is speculative capital inflows, which have forced China's central bank, the People's Bank of China (PBC), to pile up foreign exchange reserves. By the end of 2003, China's foreign exchange reserves reached \$403 billion. In turn, the swelling of foreign exchange reserves has pumped a lot of liquidity into the financial system, contributing to the overheating of the Chinese economy.

Among western economists and politicians there is a popular view that the time has come for China to abandon the de facto peg of the RMB to the USD and let the RMB to appreciate. The main benefits of an appreciation or revaluation of the RMB are to facilitate reducing America's trade deficit and to enhance the independence of China's monetary policy from external shocks and to be compatible with a liberalization of portfolio capital flows in the long run (Eichengreen, 2004; Roberts and Tyers, 2003; and IMF 2004).

However, China is not yet ready to give up the current exchange rate regime, though it does not dispute the theoretical appropriateness for China of a floating

exchange rate regime in the long run. The critical practical issue is how to complete a smooth transition from “here” to “there”, *i.e.*, from the current exchange regime to a floating rate regime.

It is also important to discuss this issue against the background of East Asia. The pressure for currency appreciation is not just a problem for China; other East Asian economies face the same problem. Even the Japanese government has been intervening extensive to prevent the yen from appreciating. Close economic integration in East Asia through trade and investment requires stability in relative exchange rates in the region. Currently, the USD has served as the *de facto* reference point in maintaining such relative exchange rate stability in the region.

In this paper, I make the following arguments. First, while a more flexible exchange rate is more theoretically compatible with liberalized capital flows that is planned for the future, timing and circumstance are not yet right for the RMB to appreciate now. The basic intuition for this observation is that appreciation under speculative attacks is just as bad as depreciation un speculative attacks. Second, an optimal exchange rate regime is not necessarily a pure peg and a pure float. Managed floating with sufficient flexibility can be appropriate in certain circumstances. Third, relative exchange rate stability is desirable for East Asia to enhance their regional economic integration. However, East Asia is not ready for any formal exchange rate cooperation agreement. Therefore, an informal framework is useful. In particular, East Asian economies’ leaders should meet regularly to discuss cooperation in macroeconomic policy as well as exchange rate policy. Finally, an important current

issue for macroeconomic policy cooperation in East Asia is to accommodate a healthy amount of inflation as an alternative way to bring about a desirable real appreciation of Asian currencies against the USD.

In the rest of the paper, I discuss the current stress in East Asian economies, especially with regard to China first in Section 2. Then in Section 3, I explain why nominal appreciation of the RMB is not a desirable option for China. In Section 4, I present an unconventional case for a moderate inflation with the current exchange rate regime being kept as an alternative to bring about a desirable real appreciation. This is desirable for both China and other East Asian economies. Hence is the desirability for setting up a framework to facilitate an active and regular regional cooperation in macroeconomic policy.

The Stress of the Current Regime

A distinct characteristic of East Asian exchange rate regimes Asia is the tendency of East Asian currencies to peg the USD. Formally, only Hong Kong implements a currency board and all the other economies in the region have floating rates. Even China claims to have a managed floating rate. But in practice, there is a strong desire on the part of East Asian governments to limit the volatility of their exchange rates with interventions in the foreign exchange market. Now in the cases of China and Malaysia, their exchange rates become de facto pegs against the USD.

Ever since the 1997 East Asian currency and financial crisis there has been extensive diagnosis and prognosis of the structural weaknesses in East Asian. One of the

often cited structural weaknesses is the de facto peg of many Asian currencies to the USD. The basic argument is as follows. Exchange rate pegs short of a robust currency board are inherently vulnerable. This has much to do with the phenomenon of “original sin”, *i.e.*, most developing economies cannot borrow or lend in their own currency in international financial markets. Therefore, they have to bear the exchange rate risk. The de facto currency peg maintained by a government creates a false illusion of permanence of the existing peg. That results in a moral hazard problem on the part of companies, financial institutions and investors in the private sector. When domestic interest rates and returns are higher than overseas, it induces large capital inflows, and often such capital inflows are not hedged against the depreciation risk in the forward market, which is, of course, not necessarily if the peg is expected to last. However, the open un-hedged position in foreign debts exposes an economy to speculative attacks. To a large extent, this is exactly what happened to many East Asian economies prior to the 1997 currency crisis. Importantly, the same analysis applies to the opposite case of an economy that lends to the rest of the world like Japan and China right now. The open un-hedged assets in foreign currencies equally invite speculative attacks, but in this case, the pressure is for a currency to appreciate. Based on the above reasoning, a major policy recommendation for East Asian economies by many prominent economists and the International Monetary Fund (IMF) is to increase exchange rate flexibility.

East Asian economies have recovered largely from the currency and financial crisis in 1997, very painfully in some economies. In recent years, their growth have resumed vigorously. In the case of China, there is obvious sign of overheating.

McKinnon and Schrabl (2003) have argued that many East Asian economies have reverted back to the practice of pegging their currencies to the USD, against the policy recommendation for more exchange rate flexibility. Furthermore, there is also ample evidence that the current exchange rate regime in East Asia is again under duress. But this time, the pressure comes from the opposite direction. East Asian currencies are pressed to appreciate. A sure sign for the stress is that many Asian economies have to pile up huge sums of foreign exchange reserves. Table 1 shows the level and change of foreign exchange reserves in select East Asian economies. The case of China is most eye-catching. In 2003, foreign exchange reserves (exclusive of gold) reached \$403 billion, increasing by a whopping increase of \$117 billion. In terms of size, Japan had the biggest foreign exchange reserves at \$653 billion, increasing by \$201 billion in 2003. Together, the foreign exchange reserves of those East Asian economies in Table 1 reached \$1,826 billion, an increase of \$565 billion in 2003.

It is important to relate the pressure on the East Asian exchange rate regime to a proper international context. The most relevant factor in the rest of the world is that America's widening trade deficit. In 2003, it widened to \$582 billion¹, 5.3% of America's GDP. As indicated by Table 1, the increase in the foreign exchange reserves of those Asian economies financed 2/3 of that trade deficit.

American trade deficit can be accounted by two main factors. The first one is that America led the rest of developed economies in recovering out of the last recession that

¹ Trade deficit on the custom basis, IFS online database.

began in 2001. Therefore, its imports grew faster than its exports. But this factor can explain only a minor part of American trade deficit. The other factor is much more important. It is the massive stimulation from America's monetary and fiscal policies that has boosted domestic absorption well beyond production. The federal funds rate has been kept at the historical low of 1%. On the front of fiscal policy, government budget deficit reached \$395 billion in 2003. The phenomenon of twin deficits re-emerged in America.

American external imbalance is straining the international system. International financial markets have been concerned with the sustainability of the huge American external imbalance and accordingly expect a corresponding adjustment in exchange rates. As a result, the American dollar started to depreciate, so far mostly against the euro. In terms of the annual period-average rate, the USD depreciated against the euro 5.17% in 2002 and 16.48% in 2003². Also in terms of the annual period average rate, the USD appreciated against the Japanese yen by 3.18% in 2002 and depreciated only by 7.54% in 2003. In terms of the nominal effective exchange rate, the USD depreciated only by 1.04% in 2002 and 11.62% in 2003.

The movements of exchange rates reflect the pattern of international capital flows. Prior to 2000, American trade deficit was largely financed by private capital inflows in America. Such private capital inflows were lured by the illusory capital gains in American financial markets, especially the stock market. However, the bursting of the high-tech bubble in 2000 discouraged significantly private capital flows into America,

² The numbers are computed, using the data from the IFS online database.

especially from Europe. The European central bank operates in an inflation targeting regime and does not have a particular target for the exchange rate. Hence the depreciation of the USD against the euro. In contrast, Asian economies have been resisting the appreciation of their currencies against the USD with the accumulation of foreign exchange reserves.

Another sign for the stress of the current exchange rate regime in East Asia is that the Chinese economy appears to have overheated. Weighed down by the Asian financial crisis and later on by the world recession that started in 2001, the Chinese economy slowed down significantly in 1998-2001 in comparison with its past growth track. Private demand was weak. Deflation pressure was present in many sectors. To stimulate the economy, the Chinese government timely made an aggressive use of expansionary monetary and fiscal policies. Interest rates were lowered aggressively. One-year term deposit rate was reduced to 2.25% in 1999-2001 and 1.98% in 2002³. The government borrowed by issuing bonds to fund an ambitious investment program of infrastructure projects. Fiscal deficit rose to 249 billion yuan in 2000 (2.8% of GDP), 252 billion yuan in 2001 (2.6% of GDP), 315 billion yuan (3.1% of GDP) in 2002⁴.

Private demand turned around sharply in 2002 in China. The growth of domestic fixed investment increased from 13.1% in 2001 to 16.1% in 2002 and 27.6% in 2003. Different from the period 1998-2001 when government-financed infrastructure

³ IFS online database.

⁴ Statistical Bureau of China.

investment provided the main support, the pickup in fixed investment in 2002-03 was mainly due to the business sector. Industrial fixed investment growth jumped to 39.3% in 2003, an increase of 17.1 percentage points over the previous year. A big part of industrial fixed investment was undertaken in response to the existing or perceived shortage in automobiles, residential housing, urban development, and power generation. At the same time, the growth of exports increased from 6.8% in 2001 to 22.4% in 2002 and 34.5% in 2003. In contrast to the pickup in these two sources of aggregate demand, the demand for consumer goods remained steady. The growth rate of the retail sale of consumer goods was 10.1% in 2001, 11.8% in 2002 and 9.1% in 2003. Nevertheless, the stimulative effect of the strong demand for fixed investment and exports overwhelmed. Production started to accelerate. The growth rate of GDP in comparable prices was 7.3% in 2001, 8.0% in 2002 and 9.1% in 2003. A more reliable statistic for production is the growth of the secondary sector (mostly industry) production in comparable prices. That was 8.7% in 2001, 9.9% in 2002 and 12.5% in 2003.

There is an important connection between what happened to China's foreign exchange reserves and the overheating of the Chinese economy. The piling up of foreign exchange reserves resulted in a significant unintended monetary expansion. Table 2 shows how changes in foreign exchange reserves have been impacting money and credit supplies in China. The PBC has been trying very hard to sterilize the effect of the increase in foreign exchange reserves on money supply. This can be seen from the fact that reserve money growth rate was less than that of foreign exchange reserves. The growth rate of foreign exchange reserves was 28.1% in 2001, 35% in 2002 and 40.8% in

2003. In comparison, the growth rate of reserve money was 10% in 2001, 12.5% in 2002 and 17.6% in 2003. The fact that the growth rate of reserve money was accelerating in 2001-2003 indicates that the PBC was losing monetary control.

It is important to observe that while the increase in foreign exchange reserves did make it difficult for the PBC to restrain the expansion of reserve money, the PBC was able to contain it with sterilizations through open market operations. The sudden pick-up in 2002-03 in fixed investment and credit supply has important domestic causes. In 2002, domestic credit expanded at the rate of 29.3%, while M2 grew only by 19.4%. The large differential between these growth rates indicates a weak spot in the current monetary regime. The link between money supply and credit supply can be quite elastic. That may render monetary targeting ineffective as a tool to influence aggregate demand.

So far, the strong domestic fixed investment in China has occurred mainly in select sectors. In some cases such as residential housing and automobile, consumer demand is expected to grow strongly. In other cases such as coal, electricity, steel and transport, there exists large shortage in production capacity. In turn, strong fixed investment in general has generated strong demand for raw materials that have also triggered a sharp price rise in world markets. Though the current expansion round of investment expansion is barely two years old, there is already ample sign of over-expansion and emerging excess capacity in some sectors such as residential housing, steel, cement and electrolyzed aluminum. Furthermore, more worrying is the re-emergence of inefficient small-scaled production facilities that would result in new excess production capacity.

To recapture the above discussion, the large American trade deficit has generated heavy pressures for exchange rate adjustments. While the euro appreciated the most against the USD, the appreciation of Asian currencies has been limited by unprecedented piling up of foreign exchange reserves. To a significant extent, the pressure in the foreign exchange market has been accentuated by large speculative capital inflows, especially in China. In turn, the swelling of foreign exchange reserves has constrained the capacity of Asian central banks to contain the expansion of domestic money and credit. In the case of China, there is clear sign of overheating. However, there are also important domestic factors contributing to the overheating in China.

The Fallacy of RMB Appreciation

In view of the stress as described above, is now the right moment for China to follow the frequently proffered advice to appreciate the RMB and adopt a floating rate regime? Let us examine the main arguments from China to increase exchange rate flexibility

As analyzed above, the pressure for Asian currencies, especially the RMB to appreciate comes mainly from the perceived need to correct American trade deficit. Therefore, the validity for this argument depends on whether under-valuation of Asian currencies is the main cause for American trade deficit. Obviously, the answer is no. It is a plain fact that American trade deficit results from expansionary American monetary and fiscal policies. It mirrors a dismal domestic saving rate. American fiscal position turned abruptly from a surplus of 1.6% of GDP in 2000 to a deficit of 4.9% of GDP in 2003.

American domestic saving fell from 18% of GDP in 2000 to 13% of GDP in 2003⁵. No amount of exchange rate adjustment would correct American current-account deficit by itself unless American fiscal policy is restored to some level of sanity and the private sector starts to save more. Unless American government and individuals restrain their profligacy, there is no way to correct American trade deficit through exchange rate adjustments alone.

The next line of the argument is that even if a depreciation of the USD is not enough to correct American trade deficit, it would help substantially to reduce it. In the case of China's exports to America, many American politicians have made the argument that American jobs have been lost to China through out-sourcing because of the low value of the RMB. This is a false argument in flagrant violation of the basic economic principle of comparative advantage. By and large, Chinese workers and American workers do not compete in the same industries. Outsourcing is dictated by technological advance and American comparative advantage. Appreciation of Asian currencies in general, and the RMB in particular, would merely serve to divert import supplies away from China to other low-wage economies. It would not save much in terms of American jobs replaced by outsourcing.

If appreciation of the RMB would not help much to correct American trade deficit, would it be in the self interest of China to appreciate? A recent academic advocate is Roberts and Tyers (2003). They basically make two arguments for China to appreciate

⁵ IFS online database.

the RMB. First, East Asia is now much better prepared for any subsequent turbulence in terms of exchange rate volatility that may result from the floating of the RMB. In 1998, China stood firm against the depreciation pressure. One of the key considerations is regional financial and exchange rate stability to prevent another round of competitive depreciations. Roberts and Tyers argue that most East Asian have recovered from that currency and financial crisis. However, the fact Asian economies have become more robust against exchange rate turbulence does not lead to the conclusion that they need to appreciate their currencies against the USD.

The other argument comes from the conventional wisdom on unholy trinity: it is impossible to have the three goodies of an independent monetary policy, a fixed exchange rate and free capital mobility at the same time. For a large economy such as China, independence of monetary policy from external shocks is generally regarded essential. That leaves a choice between the other two: a fixed exchange rate and free capital movement. At present China opts for exchange rate stability by keeping capital-account restrictions. However, in the next round of financial reform, China is committed to relaxing restrictions on portfolio investment and opening up the domestic financial sector to foreign competition, even though China did not make such explicit commitments for the accession in 2001 into the World Trade Organization (WTO). Another key component of the next round of financial reform is interest rate liberalization. As capital movement becomes freer and interest rates are liberalized, it is necessary for China to increase exchange rate flexibility. Eichengreen (2004) would even argue that with current ineffective capital flow controls, China is already ready to adopt a floating

exchange rate. This theoretical argument is widely shared, and may well apply to China, but only in the long run. However, this argument does not answer the question of why China should let the RMB float right now, especially under heavy speculative attacks.

In a recent paper, McKinnon and Schnabl (2003) have brought up two relevant considerations that may help us to understand better why Asian economies prefer to maintain a de facto peg of their currencies to the USD. While it appears puzzling that a peg to the USD is not really optimal to Asian economies from the standpoint of an optimal currency area because their trade shares with America are not predominant. In the case of China, its trade share with America is similar to that with Japan, and the latter actually surpassed the former recently. Therefore, a peg to a basket that consists of the USD, the euro and the Japanese yen would appear to make more sense in terms of real exchange rate stability. However, what matters to traders and investors is not the actual trade share, but the share of the USD in invoicing and financial transactions. In this case, the share of the USD is predominant for Asian economies. For instance, more than 80% of international trade of South Korea was invoiced in the USD (Table 4), though the share of the USD declined steadily over the past two decades.

The second consideration is, more importantly, what they call conflicted virtue. It is related to the impact of exchange rate volatility on the balance sheets of an economy. Most developing economies suffer from the weakness of “original sin”, *i.e.*, the inability to borrow or lend in their own currency. Their foreign debts and assets are generally denominated in foreign currencies. Therefore, domestic residents have to bear the exchange rate risk. Theoretically, domestic residents can hedge away the exchange rate

risk, but only if there exists a well developed forward market. However, here is the catch-
22. Forward markets cannot develop without a period of orderly free floating. However, floating tends not to be orderly in the absence of well developed forward markets.

In theoretical discussion, a floating exchange rate is generally regarded as an absorber of external shocks. That is why exchange rate flexibility is desirable. But this is only true from the standpoint of international trade. However, from the standpoint of balance sheet worth, exchange rate changes will always cause capital losses on the part of domestic residents of a developing economy, as long as they have open un-hedged positions. With the presence of a substantial amount of un-hedged exchange risks, a country with persistent current-account deficits is prone to the depreciation risk. If speculators are successful in attacking the vulnerable currency, a large depreciation will increase substantially the real burden of foreign debt, as Asian economies painfully experienced in 1997-98. The same logic works the other way as well. An economy with persistent current-account surpluses is prone to the appreciation risk. If speculators are successful in attacking the currency and force it to appreciate, that economy would suffer capital losses from the foreign assets it owns. This is exactly what is happening now to China and other East Asian economies. While there is no reliable estimate of speculative capital inflow in the case of China, we can size it up from the balance of payments account. In 2003, China had a current-account surplus of \$29.5 billion, and at the same time it also had a capital-account surplus of \$90.5 billion. \$54.7 billion of the capital-account surplus was due to the inflow of direct investment, so there was a residual of \$35.8 billion, possibly speculative capital inflow. As a result, foreign exchange reserves

had to increase by \$120 billion (Eichengreen, 2004, Table 1). By the end of 2003, China's foreign exchange reserves reached \$403 billion. A 20% appreciation of the RMB, a figure widely anticipated by currency speculators, would cause a capital loss of more than \$80 billion from the stock of official foreign exchange reserves alone. Adding the loss from the foreign assets held by the private sector, the magnitude of the balance sheet effect of RMB appreciation is definitely not negligible. It is evident that the fear for the balance sheet losses from exchange rate volatility is a legitimate justification for maintaining exchange rate stability.

In the case of East Asia, another legitimate consideration for having de facto currency pegs against the USD is that such exchange rate regimes provide an effective mechanism to bring about relative exchange rate stability, which is important for increasing economic integration and division of labor among East Asian economies. It is widely observed that East Asia became increasingly integrated over the past two decades through trade and direct investment. Table 4 shows the share of intra-regional trade. Including both China and Japan, the share of East Asia intra-regional trade rose from 32% in 1980 through 39.6% in 1990 to 46.5% in 2001. Pegging to the USD is not really the first best arrangement. There has been active discussion for East Asia to move towards something like the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS). However, at present, there is a lack of strong political will, especially between China and Japan, for a formal framework of economic and financial integration in East Asia. Therefore, the current regime may serve as a second-best solution.

With regard to China, there is one more argument in favor of the current peg of the RMB against the USD. That is to use the exchange rate as a nominal anchor. As a monetary regime, exchange rate targeting can be equally as effective as inflation targeting to bring about price stability. It is true that China is a large economy. The nominal anchor argument is sometimes regarded to be more applicable to small economies than to large economies. Therefore, it is often discounted with regard to China (Roberts 2003). However, in fact, the RMB peg to the USD did serve China well as a nominal anchor to bring down inflation and keep price stability. In 1993-94, China also experienced a serious inflation. In 1994, the inflation rate in terms of consumer price index rose to 24.1%. China implemented a package of reforms that installed and strengthened macroeconomic institutions. A key component of that package is to unify multiple exchange rates by forming a national foreign exchange market. In the following years, exchange rate stability in the form of a de facto peg to the USD worked to bring down the inflation rate, which fell gradually to 2.8% in 1997. Figure 1 plots the RMB-USD rate against retail consumer goods price index. Both series are scaled as ratios to sample mean. It is evident that the two series did move together closely enough to validate the nominal anchor argument. What is needed for exchange rate targeting as a monetary regime to work is high trade dependence without much pricing power and a flexible labor market absent of union rigidity. Both are true in the case of China.

In sum, the case for increasing exchange rate flexibility in East Asia is not clear-cut. While there is a well-argued theoretical case for better compatibility between free capital movement and a floating exchange rate, chiefly to secure an independent

monetary policy, there are also legitimate considerations for East Asian economies to prefer exchange rate stability, or de facto pegs to the USD. In particular, it is important to observe that exchange rate adjustments alone cannot correct American external imbalance. With under-developed forward markets, exchange rate volatility entails substantial capital losses for East Asian economies. At the current juncture, speculators have already taken large positions against the RMB and other East Asian currencies. Therefore, it would be very unwisely to reward them by abandoning the existing pegs to the USD.

Inflation as an Alternative Strategy

In the above two sections, we have made two observations. First, the Chinese economy is now overheating and the RMB is under pressure to appreciate. Second, letting the RMB appreciate freely at this juncture and circumstance would benefit currency speculators and it is not a desirable option. Then, is there a better policy option for China, and to a certain extent, for other East Asian economies as well? I argue that maintaining strong growth with a relaxed tolerance for moderate inflation is a viable and better alternative strategy. What does this strategy entail in terms of major macroeconomic indicators? In its Monetary Policy Implementation Report: 2004Q1, PBC stated that the official targets for monetary policy continued to be 7% for real GDP growth and 3% for consumer price index (CPI). However, the year-over-year growth rate of real GDP reached 9.1% in the first quarter of 2004 and that of CPI to 3.8% by April (2.6% for RPI). By these two measures, the Chinese economy is already overheated well

beyond the control limits. Conventional wisdom would call for a radical tightening in terms of macroeconomic policies. In my view, the official targets should be jettisoned and new upper limits could be relaxed to 10% for real GDP growth and 4% for RPI.

Specifically, the current approach of the government is in the right track. The main elements of the current tightening package are as follows. First, use all means available to dry up excess liquidity in the banking system, especially by raising required reserve ratios. By April 2004, required reserve ratios were raised twice by a cumulative amount of 1.5 percentage points and further, differential reserve ratios have been introduced to link required reserves to lending quality and capital adequacy. Second, avoid a nationwide across-the-board braking through a freeze on bank lending with a view to achieve another soft landing. Third, rely on administrative window guidance to tighten lending in certain sectors where excessive speculation (residential housing in some cities) and inefficient small-scaled duplicative investment projects (steel and power generation) become acute. The basic idea is to keep the current growth momentum but make exceptional use of more aggressive window guidance to check excessive investment in certain sectors.

On top of those measures that have been taken by the Chinese government to slow down the overheating economy, it is also advisable to boost wage growth. However, as discussed above, the Chinese labor market is actually very competitive. Chinese enterprises tend to be small in scale, so they do not possess significant pricing power in general. Furthermore, labor is not effectively unionized and there is no aggressive collective bargaining as it is in most developed economies. That is why the nominal

anchor argument can also apply to China even though it is a large economy. Therefore, it is not a simple matter to boost wages in China. However, there is something the government can do to influence wage growth in the business sector. For instance, the government can raise minimum wage to lift up the wage floor for all enterprises. As well, the government can deliberately boost wage growth in the public sector, influencing indirectly the wage growth in the business sector. In this way, real appreciation of the RMB can be integrated with a pro-poor social policy. This can not only enhance social cohesion in China, but also win approval from social activists in developed economies. Would wage growth be too excessive to erode China's competitiveness as a platform for labor-intensive production? It is not likely to happen. Given the vast size of the Chinese economy and the tremendous progress China has made in attracting foreign investment with a competitive physical and social infrastructure, it is not an easy matter to find a ready substitute for China. To a large extent, production in China defines the price floor for most labor-intensive tradable goods.

This is not an advocacy for irresponsible macroeconomic policy. On the contrary, the objective is to facilitate the natural working of the price and income adjustment mechanism for a fixed exchange rate regime. Raising domestic prices and costs is just another way to realize a desirable real appreciation of the RMB. Further, strong economic growth driven by domestic absorption would reduce trade balance. Both developments would generate pressures for the exchange rate to depreciate.

Compared to the alternative of a nominal appreciation of the RMB, this strategy has the following benefits. First, it denies profits to currency speculators. It is inevitable

that a de facto peg is rigid and speculators would attempt to test the robustness of the peg for profits time and again. In times of crisis, it is never a good idea to yield to speculators. As discussed above with regard to conflicted virtue, forced appreciation is just as bad as forced depreciation. If China could successful maintain the current peg, speculators would be unable to profit from their long positions in the RMB, though they would not necessarily lose much either. In effect, they are lending to China willingly at low interest rates without getting a hefty risk premium usually demanded of an average developing economy, especially some Latin American economies. In a sense, China is currently blessed with a golden opportunity of a plentiful supply of foreign funds at rock bottom interest rates. In the rest of the world, only America can command such an exceptional privilege. If China could put such funds to good and wise use, the payoff would be substantial. Unfortunately, at the moment that China has to re-cycle such funds back to America, perhaps even at an interest rate penalty in increases in official foreign exchange reserves.

Second, a real appreciation through rising domestic prices and wages is likely to enable China to enjoy a gain in the terms of trade. It is a plain fact that the wage level in China is very low in comparison with that in developed economies, America in particular. Of course, that makes China a competitive place for production of many labor-intensive goods. And that is also a major contributing factor for out sourcing. However, most of the gain from out sourcing and export processing is kept by producers and consumers in developed economies. Given the fact that China has developed the essential infrastructure and established itself as a highly competitive production base for labor-intensive

operations, it is time to demand some pricing power and a fair share of the value added in export processing. An appropriate amount of wage increase may bring it about.

Third, the central bank can afford to maintain a supportive monetary policy by leaving deposit interest rates at current levels or not raising them substantially. Low interest rates would discourage inflow of speculative capital on the one hand, and stimulate domestic absorption on the other hand. Now in China, economic growth has entered a new era in which consumer-finance based spending such as car purchases and housing construction is playing an increasing role as a growth engine. It is true that the Chinese economy has already exhibited signs of overheating. In 2003, real GDP growth surged to 9.1%. Many commodity prices such as energy, steel and cement have been rising in anticipation of a fast growing Chinese economy. In some sectors, production expanded by more than 40%. Yet, there remains ample room to keep the Chinese economy hot for a while. Given the existing huge pool of idle labor and low level of urbanization, there is still plenty of room for further economic expansion.

Fourth, faster economic growth would lead to more import demand. In this way, China and other developing Asia could play a bigger role as a growth engine for the rest of the world. Given that import demand tends to grow faster than production, trade surplus in China and elsewhere in Asia would fall. Together with rising labor costs, a reduction in trade surplus would generate pressures for depreciation of their currencies, instead of appreciation, opposite to the expectations of currency speculators. In this way, China could extract itself from the current no-win corner successfully.

Finally, there is another very important side benefit. Inflation can reduce the real cost of absorbing nonperforming loans. It has been widely documented and extensively analyzed that Chinese financial institutions have been saddled with large amounts of nonperforming loans, though recent reforms have improved the situation somewhat. There is no shortage of recommendations to clean up existing nonperforming loans. But in the end, the government would always balk at the enormous cost of any resolute solution. A bit of inflation may significantly alleviate significantly the cost of cleaning up nonperforming loans, and the government may be tempted to accept some more resolute solution.

Of course, this is not a risk-free strategy. In fact, it is highly risky. It is not easy to steer a fast-speeding economy away from many dangerous potholes. The most serious risk may be asset price bubbles and wasteful investments, which have appeared already in China. In fact, it is precisely the loss of control over a booming economy fueled by speculative capital inflows in 1995-96 that threw Thailand into a collapse of financial institutions in 1996 and a currency crisis in 1997. There is a possibility that history may repeat itself in China. However, there is no risk-free optimal solution to real world problems. In contrast to 1997, China has the advantage of learning from past errors in its neighbors. In fact, China has taken effective measures to curb excessive speculation in real estate market and relied extensively window guidance to discourage lending to inefficient small-scaled investment projects in some industries such as steel. Restructuring of financial institutions is being carried out. Therefore, there is ample

reason to believe that this strategy of real appreciation through inflation may actually work.

Coming back to the issue of how to get from “here” to “there”, we have made two observations. On the one hand, it is true that in the long run, China should increase exchange rate flexibility as it gradually lifts up exchange controls on portfolio investment. On the other hand, now it is not a good time and a right circumstance to let the RMB float freely because it would benefit mainly international speculators. So there is a question of when is the right moment to let loose the exchange rate. I believe that the right moment is when the foreign exchange market is in a neutral position, not subject to massive speculative attacks for either depreciation or appreciation. The inflation strategy advocated here can pave the way for that right moment to come sometime down the road. Real appreciation through rising domestic prices and wages and strong import growth would generate pressures through the current account for the RMB to move in the other direction. Soon or later, a crossing point would be reached. And there the right moment would present itself.

So far, our attention has been focused on China. But the challenge confronted by China is present in other East Asian economies as well. Increasing economic integration in East Asia through trade and investment requires relative exchange rate stability. And most East Asia economies loathe exchange rate volatility. Therefore, they all share a common ground with China. The inflation alternative can be equally applicable to them. Therefore, there is a need for East Asian governments to seek cooperation and coordination in macroeconomic policy. In the aftermath of the 1997 currency and

financial crisis in East Asia, there has been strong interest in enhancing cooperation among East Asian governments in exchange rate and financial policies. Some would even advocate moving towards some formal ERM like EMS. However, such grand vision of a formal exchange rate agreement is not very likely in the near future because there lacks a strong political will for giving up national sovereignty among East Asian governments, especially between China and Japan. There has been some real progress in creating a formal framework in the form of the Chiang Mai Initiative under which the central banks have signed swap agreements to provide mutual aid in times of crisis. However, such a formal arrangement is woefully inadequate for prevent another region-wide currency crisis. So what more can be done to strengthen the robustness of East Asian economies to another currency crisis? Informal arrangement of cooperation seems to be the preferred *modus operandi* in East Asia. Now it would be valuable for East Asian governments to meet to discuss more about macroeconomic policy cooperation than exchange rate cooperation.

Conclusion

In this paper we present a case for an unconventional option to meet the current challenge confronted by China and other East Asian economies. Their currencies are under pressure to appreciate and their economies are heating up. The conventional recipe would be to let Asian currencies appreciate through freer floating and raising interest rates to cool off hot economies. However, this solution would benefit mainly speculators, constrain economic growth, and may result in potentially destructive turbulence from

exchange rate volatility and financial instability. In contrast, a better alternative to keep the current pegs to the USD and let their economies to speed along with a moderate bit of inflation, tapping productively the low-cost funds provided generously by currency speculators. Of course, it is essential to ensure good quality investments and sound financial institutions.

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Tables and Figures

Table 1: Foreign Exchange Reserves in East Asia

Millions of USD

	1997	1998	1999	2000	2001	2002	2003
China	139,890	144,959	154,675	165,574	212,165	286,407	403,251
Hong Kong	92,804	89,606	96,236	107,542	111,155	111,896	118,359
South Korea	19,710	51,963	73,700	95,855	102,487	120,811	154,509
Japan	207,866	203,215	277,708	347,212	387,727	451,458	652,790
Singapore	70,883	74,418	76,304	79,685	74,851	81,367	94,975
Malaysia	20,013	24,728	29,670	28,625	29,585	33,280	43,466
Thailand	25,697	28,434	33,805	31,933	32,350	38,042	40,965
Total	576,864	617,322	742,098	856,427	950,319	1,123,261	1,508,315
Increment		40,459	124,776	114,328	93,893	172,942	385,054

Source: IFS Online database.

Table 2, Money and Credit

	1997	1998	1999	2000	2001	2002	2003
Foreign exchange reserves, \$ million	139,890	144,959	154,675	165,574	212,165	286,407	403,251
Annual growth rate of foreign exchange reserves, %	33.2	3.6	6.7	7.0	28.1	35.0	40.8
Reserve money, billion yuan	3,145	3,234	3,479	3,791	4,171	4,692	5,517
Annual growth rate of reserve money, %	17.0	2.8	7.6	9.0	10.0	12.5	17.6
M2, billion yuan	9,187	10,556	12,104	13,596	15,641	18,679	22,355
Annual growth rate of M2, %	20.7	14.9	14.7	12.3	15.0	19.4	19.7
Domestic credit, billion yuan	7,954	9,547	10,701	11,873	13,488	17,441	20,861
Annual growth rate of domestic credit, %	19.8	20.0	12.1	11.0	13.6	29.3	19.6
Fixed investment, billion yuan	2,494	2,8401	2,986	3,292	3,721	4,320	5,512
Annual growth rate of fixed investment, %	8.8	13.9	5.1	10.3	13.1	16.1	27.6

Source: IFS online database and the Statistical Bureau of China.

Table 3: Invoice Currencies in Korean Trade as Percent of Overall Trade, 1980-2000

	Exports (receipts)					Imports (payments)				
	\$	¥	DM	£	other	\$	¥	DM	£	other
1980	96.1	1.2	2.0	0.4	0.3	93.2	3.7	1.7	0.5	0.9
1985	94.7	3.7	0.6	0.3	0.7	82.4	12.3	2.0	0.5	2.8
1990	88.0	7.8	2.1	0.5	1.7	79.1	12.7	4.1	0.9	3.4
1995	88.1	6.5	2.4	0.8	2.2	79.4	12.7	3.8	0.7	3.4
2000	84.8	5.4	1.8	0.7	7.3	80.4	12.4	1.9	0.8	4.4

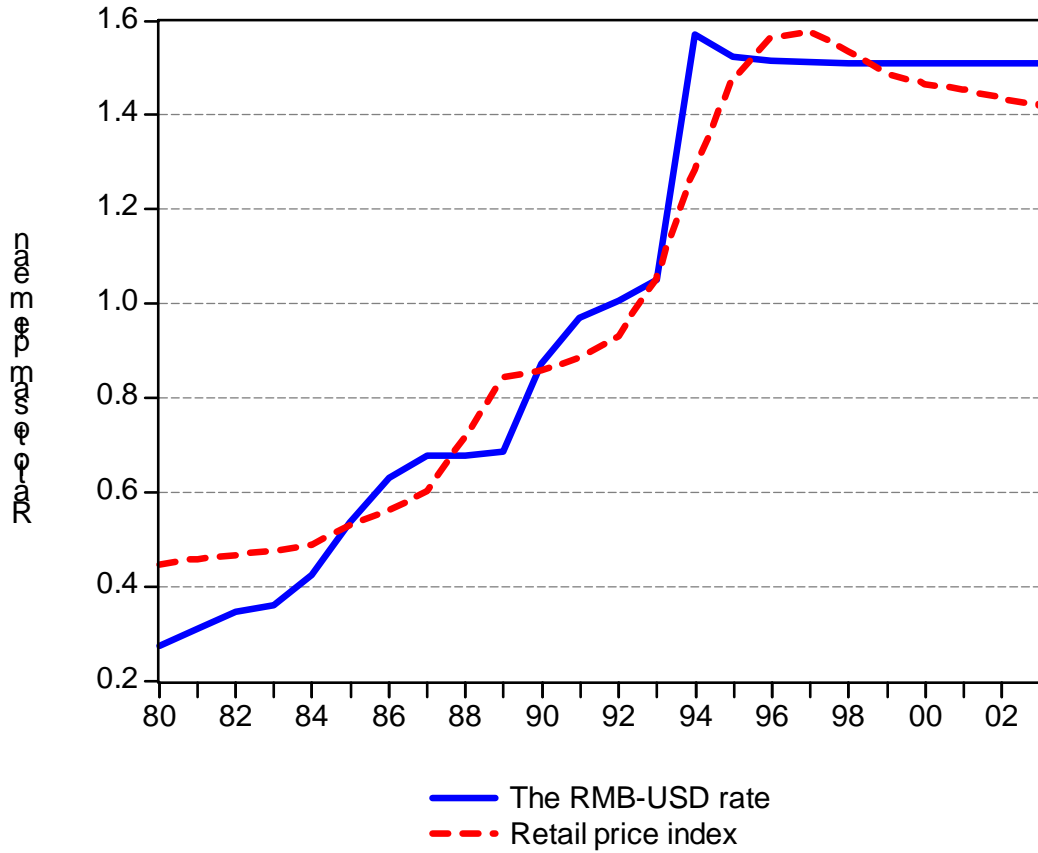
Source: Bank of Korea: Monthly Statistical Bulletin. Trade in services is not included. Quoted from McKinnon and Shnabl 2003.

Table 4: Intra-Asian Trade as Percent of Overall Trade, 1980-2001

	Exports			Imports		
	EA ₃	EA ₂	EA ₁	EA ₃	EA ₂	EA ₁
EA ₁						
1980			18.9			15.3
1990			22.2			19.6
2001			26.0			25.3
EA ₂						
1980		21.7			18.2	
1990		32.0			30.1	
2001		36.9			41.5	
EA ₃						
1980	32.0			31.8		
1990	39.6			42.9		
2001	46.5			53.1		

Source: IMF: Direction of Trade Statistics. EA1 = Hong Kong, Indone-sia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, EA2 = EA1 + China, EA3 = EA2 + Japan. Quoted from McKinnon (2003, Table 1).

Figure 1: Exchange Rate and Domestic Price: China



Source: Statistical Bureau of China.