



Exchange Rate Arrangement: Flexible and Fixed Exchange Rate Debate Revisited

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China as an Optimal Currency Area

China is a large country with tremendous differences across its land. The diversities between eastern and western regions, to some extent, exceed those of the euro zone. For instance, in the eastern part of China (such as the Pearl River Delta), the per capita income is about five times that of the western part (such as the Guizhou Province and Qinghai Province), whereas inside the euro zone, Germany's per capita income is only about 1.5 times that of Greece. However, even with these diversities, China is still better positioned as an optimal currency area than the euro zone and can issue a common currency, for China satisfies several key elements that are required by an optimal currency area.

The first one concerns fiscal setting. China, as a sovereign country, possesses a centralized fiscal transfer payment system that enables the transfer of funds from the relatively rich regions in the coastal area to the poor regions in its less-developed middle and western regions every year. Second, China also has a highly mobile labor market. Many people from the low-income regions seek better job opportunities in high-income regions; consequently, at least 160 million rural workers are now working in China's cities. Third, China has a very unified domestic market sharing an integrated system of trading and transportation. Domestic markets, such as the commodity market and the product market, are all homogeneous. Fourth,

China's macroeconomic policies are very effective and coordinated. Those are part of the reasons why China can be viewed as an optimal currency area, even though the regional differences between the rich ones and the poor ones, in terms of per capita income, are still very large. As long as fiscal transfer and macroeconomic policies work well, and the labor market remains highly mobile, China as an optimal currency area will operate smoothly and stay sustainable, albeit the diversities remain.

The other reason I'd like to refer to is the ability of the Chinese government to address financial systemic risks. One example was when I was involved in the tackling of financial crises as a key representative from the People's Bank of China. Local financial crises were breaking out in provinces or regions, including the ones in Guangdong Province and then in Hunan Province in the late 1990s, as well as the problems in Xinjiang Uygur Autonomous Region and Ningxia Hui Autonomous Region.

Guangdong is a developed area with many people who are very rich. But in the late 1990s, Guangdong experienced major fiscal insolvency and financial institution problems. Other regions, such as Ningxia and Xinjiang, although less developed, also underwent financial difficulties. When addressing these kinds of problems, we usually have to decide first whether the central bank should intervene by providing liquidity as the lender of last resort. We also need to figure out how to handle local government debt and deal with the relationship between local governments and the central government. We have to design a framework that not only can prevent moral hazard but also can calm down the crisis situation. In this way, the capabilities of the People's Bank of China and other financial supervisors to identify problems and address potential systemic risks have been tested and

proven, and they solidified the ground on which the common currency is established.

China's Policy Choices over Exchange Rate Regimes

There is continuous theoretical debate in the history of exchange rate regimes since the beginning of the 1970s, when the Bretton Woods system collapsed and exchange rate regimes of many countries kept evolving. In reality, exchange rate arrangements are not the simple dichotomy of fixed or floating exchange rates.

According to the IMF, there are eight categories of exchange rate arrangements, and the IMF's view regarding exchange rate arrangements also evolved over time. During the Bretton Woods era, the IMF was of the opinion that fixed exchange rate arrangements were better. Before the Argentine crisis, it argued for the bipolar view (either fixed or floating), while after the crisis it called for floating exchange rates. After 2009, the IMF took the view that exchange rate arrangements all had merits and shortcomings.

The floating exchange rate arrangement has several merits. First, using a floating exchange rate makes it easy to adjust to economic shocks, and the arrangement itself is less vulnerable to speculative attacks. It also helps to avoid the resource misallocation caused by exchange rate distortions. But a floating exchange rate also has its problems. For example, it may cause uncertainty or excess fluctuation or overshooting, and it leads to a larger exchange rate risk. Fixed exchange rate arrangements are favorable because they give rise to lower inflation (for developing countries) and facilitate more investment and trade. However, they also result in exchange rate distortions and are vulnerable to currency crisis and speculative capital flows.

Here I will briefly discuss China's progress in exchange rate regime reforms. In 1994, China unified the dual-track exchange rate regime, which used to offer two different foreign exchange prices of the renminbi. Since then, China has been implementing a managed floating exchange rate regime, and reforms were pursued in a "mini bang" approach rather than a "big bang," which perfectly suited China's specific circumstances. From 1994 through 2002, the real effective exchange rate (REER) of the renminbi, which is regularly compiled by the Bank of International Settlements, increased very rapidly together with the U.S. dollar, to which the renminbi was pegged. Between 2002 and 2005, when the U.S. dollar weakened in value, the renminbi started to depreciate along with the dollar, which caused some problems and disputes.

In 2005, the preconditions for foreign exchange mechanism reform were broadly in place. For example, the financial reforms were well under way, and major state-owned banks were overhauled and listed (or were to be listed). The foreign exchange market was developed to a better level, and China's capital account was gradually opened. Most important, China was experiencing stable growth and low inflation, which provided a relatively favorable background for reform. Therefore, as the opportune time arrived, China decided to de-peg the renminbi against the U.S. dollar, and hence came the more flexible renminbi exchange rates afterward. Since the 2005 reform to the end of February 2013, the renminbi nominal exchange rate to the U.S. dollar has appreciated about 32 percent, and the REER of the renminbi appreciated by more than 36 percent. The trend of the renminbi exchange rate has changed from unilateral appreciation to two-way floating and the price now falls into a broad equilibrium range.

However, the reform process was interrupted by the global financial crisis, when we had to narrow the daily floating band of renminbi according to the situation in the post-Lehman Brothers period. That said, the renminbi did not depreciate as much as currencies of other emerging market economies did. But the reform never ceased for long. On June 19, 2010, China decided to further promote the market-based exchange rate mechanism reform with reference to a currency basket, emphasizing the fundamental role of market supply and demand and the flexibility of the renminbi. On April 16, 2012, China widened the renminbi daily floating band to ± 1 percent from ± 0.5 percent. Also since 2012, the People's Bank of China has significantly reduced market intervention. Up until now, market forces are already playing a dominant role in the formation of the renminbi exchange rate. China's exchange rate regime, without doubt, is becoming more and more market oriented.

Nevertheless, a floating exchange rate regime does not rule out foreign exchange market intervention. In some circumstances, intervention is still well justified. For example, when the exchange rate exceeds the predetermined band, or when the capital account experiences large imbalances and there are excessive trades in the foreign exchange market, or the financial market falls into crisis-scale turmoil, market intervention can be restarted to the extent that the intervention is in a two-way manner, with the intent of preventing or correcting a large, short-term fluctuation of the exchange rate.

As a result of more flexible exchange rates— in both nominal and real terms, China's current account surplus as a percentage of GDP experienced significant downward adjustment. In 2007 and 2008, China's current account surplus-to-GDP ratio peaked, but declined rapidly thereafter. In

2011, the current account surplus to GDP ratio had already declined to 1.9 percent, and in 2012 the ratio was 2.3 percent.

The direction of renminbi exchange rate reform is irreversible. China will continue to enhance exchange rate flexibility, and in the near future, China is going to increase the floating band of the renminbi even further, letting market supply and demand play the fundamental role in exchange rate formation. China will also reduce central bank intervention, enhance the self-rebalancing capability of foreign exchange market, and improve the self-pricing and risk management capabilities of the financial institutions.

Exchange Rate and Real Economy Adjustments

The exchange rate and the real economy are interlinked naturally. When exchange rate adjusts, the real economy will be influenced by the exchange rate and reflect the exchange rate changes in its own adjustment. China has achieved good performance in the first three of four macroeconomic objectives—namely, growth, employment, and inflation. Regarding the fourth objective, balance of payments, China saw a period when its account surplus was relatively large, but in recent years the surplus has started to converge to normal levels.

The question here is, how can we put this adjustment on a sustainable track? It is very important to emphasize that pursuing a more or less balanced balance of payments account is our goal. And this process of adjustment, which already started years ago, will keep on in the future. The adjustment first started in salary; therefore, we can find a steady increase in labor costs. Recently, especially in the past five years, the labor costs increased even more rapidly.

Since the 1990s, labor costs in China have increased more slowly than productivity increases. In the past five years, labor costs have increased at a slightly quicker rate than productivity, which implies that China's competitiveness has been decreasing. In my point of view, this is a healthy adjustment, for it helps bring up consumption. It can also be viewed as a catch-up effect. This process will continue as long as firms remain profitable, and I am of the opinion that they will.

The second adjustment also regards labor costs, but not in terms of salary. By this, I am referring to the social security system: pensions, medical insurance, other insurance mechanisms, and so forth. In recent years, the social security system for workers has been improved further, and we paid special attention to designing a nationwide social security system that covers not only city workers, but also rural workers; that is, the migrant workers from the rural areas. At the moment, we are striving to further enhance the nationwide social security system and to ensure that migrant workers can enjoy their rights as citizens with regards to social security. If we can make this system work, this part of costs will surely increase, leading to higher labor costs.

The third source of rapid cost increases are environmental costs, which refers to air pollution, soil pollution, and water pollution, all of which have been a serious problem in China recently. The Chinese government and the people have already realized that the current situation is not sustainable, and their investment in environmental protection (which, in other words, relates to cost) has been increasing tremendously. This will also decrease competitiveness of China's products. In the future, it is possible that China's energy prices and prices of other resources (such as water and utilities) will continue to increase until reaching economically sustainable levels. All of

these adjustments that I mentioned above are healthy, but they will undoubtedly affect China's competitiveness.

But what is the bottom line? In my opinion, as long as we can maintain a more or less balanced balance of payments account, this adjustment process can continue, which is healthy for China and will also contribute to the rebalancing of the world economy. As far as I can see, this process will keep going forward, and through channels such as prices it will adjust the economy and achieve what we have been pursuing for years, that is, a relatively balanced balance of payments account. China has become a major importing country. Right now, the annual import volume of China is about US\$2 trillion. If this trend is to continue, a modest estimate suggests that the lower bound of import growth rate for China will be about 6 percent annually. And by the year 2020, China's imports will be around US\$3 trillion, which is helpful to balancing China's current account position.