Weekly commentary page

Topic: Warning on the over-valuation of the Chinese Yuan (Renminbi)

Reporters: Wu Jinyin, Li Zhenhua, reporting from Hong Kong

Photos on the left hand side, from the top:
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Summary of the introduction:

The Chinese economy seems to be going into a downturn. There are different views as to what the Chinese economy should do when facing challenges brought about by a more volatile international financial market, a slowing down global economy and an inflation internally.

The paper has recently organized a forum with the HKUST Business School to discuss the above issues. Participants included the business dean of NYU, Professor Tomas (sic) Cooley, professors and alumni from the HKUST Business School.

(Note: there was indeed such a forum. The reporters’ interview with Dean Cooley was separate. They made an editorial decision afterwards to combine Dean Cooley’s interview with the forum and in the description they said Dean Cooley “participated” in the discussion. The following summarizes the reporters’ questions and Dean Cooley’s answers.)

Q: Since the reform of the exchange rate regime in 2005, the value of RMB has risen by 18%. Internationally, there are still many people with a view that the RMB should appreciate even more. What’s your view on this? Hasn’t the value of RMB already been revalued to a reasonable level?

A (Cooley): RMB has appreciated near 5% in the preceding 5 months. Many trading partners of China still think that RMB still needs to be revalued upwards. However, even if what they think is true, the revaluation cannot be too much, otherwise it will be the local consumers of those trading partners who will have to bear the consequences.

Q: On one hand, Paulson has called for an appreciation of the RMB, on the other hand he has called for the Chinese government to relax its control over the flow of capital and the financial markets. Some people think that even with the current control on the flow of capital there are still constant streams of hot (speculative) money coming into the China market, maybe
China should just open up its capital markets altogether. That may help solving the problem of a continuous inflow of hot money.

A: In the long run, a free capital market and free currency exchange will be the trend. The question is whether China is ready now. US officials tend to look at the main direction, which is a freer capital market and a freer foreign currency exchange regime. The fact is, China and the US are both huge markets. Any sudden and unexpected change in the main direction will be undesirable.

As regarding hot money, if you want to control the price of something, be it the exchange rate, or a commodity, as long as you have a plan to do that, there will be room for other people to guess what the future price may be, hence the speculation. It is unavoidable.

Q: The central bank of China has been under a lot of pressure lately. On one hand the flexibility of the RMB exchange rate has been increasing, on the other hand the appreciation of RMB has attracted more and a quicker inflow of hot money, which in turn fuels inflation. What is your view on the impact of the gradual appreciation of RMB?

A: In the long run, when the trade between China and other countries becomes relatively balanced, RMB should be floated. In the short run, however, a sudden or large scale appreciation of RMB will not be favorable to the US. This is because it will create a surge in prices. It will hurt China too. Therefore, a slow and gradual appreciation of RMB is desirable. Although I think the current pace is probably too slow.

Q: But this “gradual climbing” may create another problem for China. The unilateral steady appreciation will attract a lot of capital from internationally to flow into China. It will then create more impetus for the currency to appreciate. In turn it will contribute to inflation and this will become a vicious circle. What is your view on that?

A: That could be the price to pay. Mundell’s theory of impossible triangle applies here. Now you have to decide what to choose between the free flow of capital, a free currency exchange regime and an independent monetary policy. If inflation gathers pace, it will slow down the economy. So somehow there will be a price to pay.

My view is that China is already working with her trading partners to find a way to make the trading relationships sustainable. Many people may think that if China has a stronger currency, it will have more power to combat inflation. Part of China’s inflation is import induced. It is partly because of a weak US currency. The US currency is weak because its monetary policy does not proactively fight against inflation. Under the
impact of a weak US currency, some economies, including China, are facing the problem of inflation. But, is a strong US currency the solution to the above problems? I think a strong US currency will contribute to economic retraction, which may bring about more problems than inflation.

A: Appreciation of the RMB will certainly create an impact. For example, some of the manufacturing production may be moved to other countries, such as Vietnam, or even to the western inland of China, where labor cost is cheaper. But if the RMB continues to be undervalued at an unreasonable level, then in reality, what’s happening is that the Chinese labor is subsidizing the consumers in the US. Because everything is so cheap to the extent that the real cost is simply not reflected in the product prices.

Q: It seems that there is a consensus that in the long run capital control should be relaxed. But we know that there will be sacrifices along the way. Examples are the Asian financial crisis in 1997 and the recent tumultuous financial market in Vietnam. Is it an appropriate time now for China to open up the control on the capital market?

A: If we compare Vietnam with China, I think Vietnam is less developed. China has more trading partners and its economy is in a more mature state. If the opening of the capital market has created the crisis for Vietnam, the same will not occur to China. I think China is more ready, compared with Vietnam, in opening up its capital market.

Q: Some people think that it is a conspiracy for the developed countries to ask the Asian economies to open up their capital markets. There is a book called “Money War” which is very popular in China. The book is all about this conspiracy theory. What is your view on this?

A: I am familiar with this view. In fact, there are also a number of economists in US that are against free trade or an entirely free capital market.

Based on experiences over the last 5 or 6 decades, I think we can arrive at two conclusions. Number 1, the market is powerful and it is effective. Market force is more powerful then policies. Of course I am not saying that the market will be able to find the best operating model by itself, it is necessary for the government to play a role too. Number 2, business is the most powerful social institution in changing people’s lives. I endorse a more open capital market. I don’t think there is any conspiracy. Rather I think the market is calling for more openness. India is a good example. Before India opens its markets it is in general very poor. After the opening of trades, etc, there has been a significant improvement on people’s livelihood in general.
Q: Some people think that China’s inflation is imported. It is a result of the oversupply of money and a lax monetary policy of the US. Therefore US should be responsible for China’s inflation. Your view?

A: You mentioned the issue of over consumption, let’s pick it up from there. We often talk about over consumption, as if there is a level of consumption that we will consider to be optimal. In fact I don’t think we know what is optimal consumption if there is such a thing. May be what we are referring to is that the consumers in the US should pay more for what they consume and also consume less. So what will that mean? That will mean their demand on consumer products will decrease. But we also know where those consumer products come from – China. So that will create an impact on China’s export. That will slowdown the development of China.

So why in the US consumption is high and savings low? One of the reasons is that people like to export to the US. Why? Because they think the US is safer. There is a lot of demand on US bonds, especially US treasury bonds. Just now you said that the inflation problem in China is because of US’s over-consumption, that could be true. But you should not lose sight of the fact that there are other economies outside US and China. We are talking about the global economy. They too play a part in the situation as a whole.

A: In the long run, if China wants to have an independent monetary policy, it has to have a flexible exchange currency rate and a free capital market. In the short run, I think China should accelerate the opening of its capital market. It is still a bit tight right now.