Thank you Mr. Chairman, for giving me the opportunity to make comments on issues that are important to both China and its major trading partners.

**Three Observations**

To start with, I have three observations:

First, nobody is more concerned on the imbalance than the Chinese authorities themselves. The government has put the adjustment of imbalance as the highest priority this year. The difficulty is not whether this imbalance needs to be adjusted; it is to find the best policy combination to do this.

Secondly, the degree of openness in China’s capital account has been increasing over time, as a result, the trade-off between exchange rate stability and the effectiveness of monetary policy may have become more relevant.

Thirdly, RMB’s exchange rate has become more flexible in the past two years, and therefore there is larger room for China’s central bank to implement monetary policy more effectively.

**Un-answered Questions**

The Open Economy Trilemma (hereafter “Trillemma”, Obstfeld and Taylor, 1998) is a useful
analytical framework. However, there are some critical questions that have not been answered. Particularly:

How effective the exchange rate policy could be in an economy with structural imbalance between savings and investment? The Figure 1 shows the development in China’s savings-investment imbalance in recent years.

**Corner vs. Non-corner Solutions**

The corner solution implied by the Trilemma(as shown in Figure 2) is a theoretical answer (Yí and Tang, 2001). In reality, non-corner solutions could be more practical, especially for a developing country like China (Jin, 2007).

**Exchange Rate: Stability vs. Flexibility**

First, it is a demanding process to search for the appropriate degree of exchange rate flexibility, or striking a balance between stability and flexibility.

- The question is: how flexible is flexible? What will be the optimal policy package that can best adjust the imbalance? And, if the imbalance has not been significantly reduced in short term, is it because the exchange rate not flexible enough? Has the underlying structural issues been tackled with sufficient strength? Is it simply due to a time lag of the adopted policies?

- The actual currency regime in most economies lies between fixed and free floating. The Fed has intervened in the FX market many times during late 1970s, 1980s, 1990s and 2000. Even without direct intervention, the exchange rate of USD is not free from effect of government intervention. The US dollar has been subject to strong influence of the federal funds rate that has been heavily intervened by the monetary authority, aiming to achieve macroeconomic stability. Fortunately nobody complains that the interest rate
has been manipulated. Likewise, the IMF also gives its member the right to choose currency regime, in order to achieve economic stability.

**Monetary Policy Effectiveness: beyond Currency Regime**

Secondly, the effectiveness of monetary policy is constrained by factors beyond currency regime.

- In China, the uncertainties in monetary transmission mechanism, the rapid development of financial market, and the technical difficulty in making the price index more reliable, could also have their impacts on the effectiveness of monetary policy.

- According to the GS Financial Conditions Index, although the Fed has tightened its policy stance by cumulatively raising federal funds rate of 425 basis point between 2004 and 2007, real financial conditions have appeared little signs of tightening if judged by higher stock price, smaller term premium and lower credit spread (Hatzius, 2007). Therefore, even if an economy choose a very flexible currency regime, its monetary policy may still not so effective as people expected.

**Capital Account: Capital Mobility is Increasing, but Management Matters**

Thirdly, capital mobility is increasing in China, but the capital account management in both China and its major trading partners can greatly affect the exchange rate formation mechanism.

- On one hand, capital flow in China has become increasingly sensitive to changes in economic fundamentals. To illustrate, we can use an arbitrage indicator GAP derived from interest rate parity and expect that a rise or fall in the GAP will lead to capital inflow or outflow and therefore changes in foreign exchange reserves. Figure 3 shows that in China, since mid-2001, the correlation between the GAP and the growth rate of foreign exchange reserves has been quite obvious in many periods.
One the other hand, the reform on capital account management in China and the removal of investment protectionism abroad will help reduce the pressure of imbalance and potential excessive exchange rate fluctuation.

Until very recently, China’s foreign exchange management system had been biased towards encouraging capital inflow rather than outflow. And that may have significantly exaggerated RMB’s appreciation pressure. The recent surprise performance in the sale of quite a few overseas portfolio investment funds under China’s Qualified Domestic Institutional Investment(QDII) program, has revealed great motivation in making overseas portfolio investment in household sector. In all cases, the subscription greatly exceeded the original quota in a single day. Therefore, without a more symmetric opening-up of the capital account, it will be unrealistic to estimate the equilibrium level of China’s exchange rate.

In spite of progress in financial globalization, restrictions in many countries on capital inflow and the lack of experience of overseas investment in China have been invisible obstacles for a market-based recycling of surplus. In developed countries, concerns on national security, sector monopoly and interest group could play important role in making many kind of capital movement difficult. Both domestic and international factors have impeded potential market-based recycling of surplus and could also exaggerated RMB’s appreciation pressure.

**Two Additional Comments**

*Another Trade-off: Exchange Rate Flexibility vs. Fiscal Policy Effectiveness*

First: the discussion on Trilemma needs to include the trade-off between exchange rate flexibility and effectiveness of fiscal or structural policy. In the case of perfect capital mobility,
the Trilemma will shrink to a Dilemma, the Mundel-Fleming model (Mundell, 1963), in which monetary policy will be more effective under flexible currency regime and fiscal policy will be more effective under stable currency regime. Therefore, there is also a trade-off between exchange rate flexibility and effectiveness of fiscal policy. Given the structural nature of the imbalance in China, it is a wise decision for the government to adopt various fiscal and structural measures to correct distortions. The more complete the structural reform is carried out, the more effective the exchange rate adjustment will become, and the less demand for excessive exchange rate movement. It may take time for the structural reform to become effective.

*A Cautionary Note: REER May Underestimate Real Appreciation*

Second, the real appreciation of RMB has been underestimated. The IMF and BIS statistics shows that China’s REER has been appreciating since early 2005 (as shown by Figure 4). However, these REERs may have underestimated RMB’s real appreciation due to their inability to accurately measure the price of tradable vs. nontradable goods (Wickham, 1993). They use WPI, PPI or some times CPI for tradable goods and CPI for nontradable goods. CPI in China has large portion of tradable goods, the resulting REER is more like a ratio of two general price levels between the home country and its major trading partners. Figure 5 decomposed China’s CPI and shows their development since the end of 2000. It is clear that the price of those typical non-tradable goods, such as food and residence, has been rising remarkably. And those prices of typical tradable goods, such as clothing, transport and telecom, have been declining steadily. Their diverging trends have become more significant since the end of 2003 and even more so since the beginning of this year. Figure 6 also shows a rapid increase in urban wage level in recent years. They all clearly indicates that RMB’s real appreciation has been much more significant than conventional measurements suggested. The crucial implication is that there is no
way, and in fact no intention for Chinese authorities to take a competitive advantage by choosing a specific currency regime.

**Conclusions**

Policy implications: a practical policy package that can deal with a non-corner solution may have a higher possibility to be successful. Measures may include, among others:

- A reasonably flexible exchange rate as it is that may give the monetary policy a higher degree of effectiveness.

- An active and well-targeted fiscal policy that will help to reduce distortion in the taxation system unduly biased toward tradable sector, absorb excess liquidity and make more active spending on infrastructure, social security and environmental protection.

- A deepening of financial reform that can intermediate saving into investment, including allocate overseas investment, more efficiently.

- A more symmetric capital account management and rapid build-up of expertise in overseas investment that will facilitate surplus’ recycling to international financial market.

- A constructive international environment, including a trustworthy IMF not being unduly influenced by parties in stake in multilateral disputes. This environment can better understand the non-corner solution of the imbalance and facilitate the adoption of a whole package of policies rather than advocating a single tool, and that will help to achieve a win-win solution for both China and its economic partners.

Thank you, Mr. Chairman.

*Fig. 1  Structural imbalance between saving and investment: 1982-2006*

*Sources:* State Statistical Bureau(China), 2006
Fig. 2  Trilemma framework: corner vs. non-corner solutions

Fig. 3  The Arbitrage indicator and monthly reserve increase: Jan. 2001-June 2007

Sources: People’s Bank of China, CEIC, Fed, Bloomberg, SSB and the author’s calculations.

Fig. 4  REER of Renminbi: Jan. 1994-Sep. 2007

Sources: International Monetary Fund and Bank for International Settlement.

Fig. 5  The trend of China’s CPI and it’s components: Dec. 2000-July 2007

Sources: SSB

Fig. 6  China’s average urban wage: 2000-2006

Sources: SSB.
REFERENCES


Figure 1  Structural imbalance between saving and investment

Figure 2

Figure 3
Figure 4

BIS effective exchange rate
Real (CPI-based), Broad Indices
Monthly averages; 2000=100

Figure 5

Dec 2000=100

Figure 6 China: Average Urban Wage (Yearly, in Yuan)