Transcript: Max Corden, April 12th 2010, at the Brookings-Tsinghua Center for Public Policy

Title of the speech: China's Options in the Choice of Exchange Rate Regimes

Now I have a limited time, so I'm going to narrow down my topic, so that we have something concrete to talk about. I'm going to consider not just exchange rate policy for China, but related policies as well. But I'll consider it purely from the Chinese point of view. I'm not going to consider the American point of view, or the world system, that would be another lecture. I'm just going to ask myself, suppose I were grandfather Wen, or suppose he asked me to advise him, in purely the interest of this country then what would I suggest. Now I'm not the kind of person who's a professor at Princeton or writes in the New York Times who is very sure about his solutions and has a very specific answer for everybody. So I'm going to do something very academic. I'm actually going to give a list of possibilities, possible policies, all of which would need to be more carefully studied.

What's the central issue? The central issue, what I can see from the point of view of China, is China has very large foreign exchange reserves, mostly in the form of liquid funds, invested in the United States with the US government, the treasury, and so on, which are more than necessary for normal foreign exchange reserves. The case for having large foreign exchange reserves is because things do suddenly turn around, but because of various reasons China keeps on building up these reserves and even now still has a current account surplus. Is this actually the best use of the money? Now this is a country with many poor people and lots of possibilities for development, wouldn't it be better for some of those funds to be invested in China itself? I'm not saying it should all be, you need some liquid reserves. But it's gone rather far. At the minimum, it should stop having a current account surplus, not to please anybody from the New York Times or Princeton University or the government of the United States but for the good of China itself. Let's start that off with this line of thought.

And now I have to ask myself, well, what are the possible ways of doing this that will be for the net benefit of China? I have seven possibilities which I will go over rather quickly, and one or two of them I will dismiss, with others I will point out difficulties.

Option 1:

Well, the first one is to have a nominal appreciation of the currency, so as to make exports somewhat less attractive and to increase imports, associated at the same time with an increase of domestic aggregate demand to compensate the otherwise deflationary effects of the appreciation. Because we all know, appreciation is itself deflationary. That's why governments often hesitate to do it. So we're thinking always here of a package of policies, with an exchange rate adjustment combined with more spending, for some purpose or other. So a lot of the policy package doesn't concern the exchange rate itself. It concerns all the other spending that will be done. Now to put it very broadly, if you can imagine appreciation having an aggregate of negative effect on export industries, in say, primarily one or two provinces, then you can imagine the benefits of the extra spending perhaps having favorable effects in other inland provinces. But immediately, you can see the problem, it isn't a perfect compensation process, because one province gains and another one loses. Well given time, labor will move probably from one province to another so they're offsetting. So one of the big difficulties in a large country like

China is it’s difficult to construct a plan that is completely offsetting. Some of the expenditure would have to be in the countryside, in inland provinces directly.

This appreciation could take the form of a series of small appreciations of the kind that started in 2005 to 2007. And that is probably politically conceivable because if they’re very small, they’re probably not going to make much of a difference.

Well then you can ask the question, why did the previous appreciation which took place in 2005 make so little difference? In fact, apparently, the current account surplus increased rather than decreased. The broad answer is appreciating relative to the US dollar is not very significant when at the same time the dollar depreciates relative to the other currencies. So on a trade weighted basis, there was very little appreciation. In addition, there were other factors which offset the effect.

This is one possible policy, the most feasible one politically.

And I want to keep on emphasizing that when changing the exchange rate (appreciating) you must have the compensating extra expenditure. We can have a long discussion about what is the most useful way of expenditure.

But there’s one special problem on having exchange rate adjustments in a series of predictable stages. If there are predictable appreciations, then of course, what we call the market, in other words speculators, will foresee the appreciation and send funds here and turn dollars into RMB and then later on when the appreciation takes place they’ll bring back in dollars again and make a profit out of this process. If it’s predictable, it’s an invitation to make a profit. And if they make a profit, then who makes a loss? The answer is the central bank makes a loss. So if you want the central bank to make a financial present to the private sectors, speculators, this is a way of doing it. And that is the disadvantage of that approach, which otherwise would seem to be a good approach. Now I leave it at that because you could have quite a long discussion about presentations of this process.

Option 2:

An alternative approach would be to have one large appreciation and to do it suddenly so there won’t be any expectations, and you won’t have the speculation. So suppose you have a 45-50% appreciation, as is sometimes advanced by commentators from outside China, you sort of surprise the market. Nobody could guess that it would happen, there won’t be speculation. And one day there’s a 45% or 50% appreciation, relative to the dollar, or maybe on a trade weighted basis and you’ve done it. And then because it’s so high, the appreciation, people won’t expect anymore and therefore won’t be any more speculation, and so you’ll get your large appreciation which you then have to take on associated demand expenditures. Always have to do that. That sounds smart if you’re talking about doing this without anyone expecting it in advance. Well, the little problem is political here. And I think we can assume that the Chinese authorities will not want that sort of thing. What it means is, in real world terms, suddenly the government imposes a policy that has a serious adverse effect on the exporters and all the people connected to them. They will blame the government for the adverse effects and they will complain that they did not warn them. And I would guess if I were to put myself in the place of the government, I wouldn't do it for that reason. So that's why I'm against it, even though it overcomes the speculation problem.

And when I point out the disadvantage of a policy, that doesn't mean it shouldn't be done, I'm just saying there it is and we can think about it later.

Option 3:

Now, the third policy is the following: I've learned since coming here that to some extent exports of manufacturers get indirect subsidies. One is the energy prices are really below the proper price. Not including the pollution costs and so on. Energy prices are exceptionally low and that's a special advantage for that sector of the economy that is especially energy intensive and that would be I think the export industries. So one of the policies which would certainly appeal to foreigners is to get rid, first of all, of major distortion in the economy which has unfavorable effects on the environment, and general resources, and as a by product you will also get some reduction in exports. And that way you may not need the appreciation. And I thought as a minimum policy this could be good anyway and the proper one. Another distortion, I understand, is that the value of land available to manufacturers, foreign companies etc, is low, artificially below market value. And that should be put right. I just throw that in, and that has to be studied. And so that's another major method which might or could help with this whole current account surplus situation.

Option 4:

All right, so we go on a bit further. Are there any obstacles to importing? Are there any tariffs or general restrictions on imports? Now I don't know the details. I've been told there are some. And a minimum requirement is to get rid, as far as possible, of restrictions on imports because the whole problem of the excessive surplus could be solved not so much from reducing exports but from increasing imports. And if the imports are low because of actual government policies, protectionist policies, well, that is one of the main things that I would recommend to change in any country.

Option 5:

Ok, then what else can we do. Well, floating the exchange rate. I would guess that probably, eventually, a large economy like China will have a floating exchange rate. It would be very strange if it didn't. But that doesn't mean it has to happen straight away. There are practical problems, and I actually would suggest to the government that they should bring in a retired central bank governor from a country that has floated its currency, Canada, Australia, for an example, an advisor for all the details. And then I would think that China is not quite ready for all the implications of floating, but eventually it will happen. Now, if they allow free market processes to take place, and allow a float, which means not normally intervening in the currency market, then we also take away the restrictions on Chinese companies and persons investing abroad. Now if you free the capital market, it may turn out that a free exchange rate would actually depreciate rather than appreciate at least for a limited period as a lot of Chinese people take their money out of the country and invest it abroad. So the objective of appreciation will not actually be obtained. So I just list this as another possibility. And the main objections have to do with the financial system not quite being ready for the float. Certainly the authorities need to prepare for a float in a few years time.

Option 6:

Well, another possibility. This is actually one I thought of myself. This is a country with a lot of poor people and a lot of aspects of the country are not ideal. I don't mean Beijing, everything here is incredible. But medical facilities could be improved in villages, education could be improved. I'm sure there are lots of things that could be done. I could imagine the government developing an expansive program, ambitious program, involving large funds, and this is the part that's difficult to do, highly import intensive. I have ideas, but everyone tells me my ideas are very unrealistic. And then the main objective from the view of the external situation is to increase imports. Because decreasing exports is politically difficult, we increase imports. And we do that in a way that will improve this harmonious society, improving medical facilities in villages. Build hospitals and clinics right in the countryside and equip them with imported equipment. Now they don't have to come from America. I was thinking of France supplying medical equipment. I think they export that sort of thing. And incidentally, there would be a issue of how best to reduce current account surplus. You don't just want to waste goods, you want to improve the conditions of China while doing it.

Option 7:

Well, I've got one or two more. Next, inflation. In general, inflation is a bad thing anyway. And China has a history of bad inflation and politically, concerns have been over high inflation. But the truth is, let's say a few years of moderate inflation relative to other countries, let's say 5 %, or say 7% for three years, with a constant nominal exchange rate, at the same time with lower inflation abroad, would be the equivalent of a real appreciation, significant real appreciation. To some extent, given a few years, China will actually get the real appreciation required to deal with the external problem without altering the nominal exchange rate, or without altering it much. And it could be done in an almost quiet, unplanned way because some of the inflation happens anyway. It's impossible to prevent it.

And we say that and there comes a very important point. And needless to say, I owe this to my Australian colleague, Ross Garnaut. I am building on his suggestion. When you take a good look at the prospects of China, the great picture of the Chinese government, at the moment, is it's following a historical process of the movement of labor from agriculture to industry. We saw this in Britain in the 19^{th} century, many countries followed, and the most recent major case was Japan. And China is the new state. That is a process that doesn't go on indefinitely. At the moment, labor is very cheap and that is one reason why China has such a comparative advantage in exporting labor intensive manufactured goods. Well, I assume at some stage, I'm guessing in five years, this process will not come completely to an end, but wages will start rising, significantly. And so the export industries will find their costs going up. Because there's not that enough labor available at the present to feed the growth of the industry and therefore I would think, we'll get to a stage where there's a significant rise in wages, and this will lead to reduced competitiveness of export industries and will in fact be the equivalent of a real appreciation. If we foresee this, we can say that the current account surplus is temporary. And will on its own, as part of the normal process of development, disappear. And this is one aspect, the rising real wages reducing the competitiveness of export industries.

Well, the other aspect is, which is a major one, as this process happens, the income distribution will change. And there will be a shift away from profits, to some extent, to wages. And since savings out of profits tend to be much higher than wages, there will be a reduction in savings, and therefore, expenditure will rise, relative to paychecks. Savings falling is another way of saying spending will increase, and as I told you before, all these policies really require extra spending if you want to remove the current account surplus. And there are two reasons, first, the costs of exporting are higher and second a reduction in savings and this problem that I started off with will disappear. And all that fuss that was coming from outside to a great extent is just a matter of waiting a few years and it will solve itself, and no decisions need be made. In which case, at the policy level, there's no need to do anything, just wait. Or do some other things a little bit or a combination of these policies.

Point 1:

And there's another point that there is some logic for China building up its foreign exchange reserves rather than using these resources at home, in spite of other things I said earlier. And the answer is, for the government to spend funds at home, in good ways, productive ways, reducing poverty, that sort of thing, it's a big organizational problem. In the public sector, it's a public administrative problem. And I understand, other people know more than I do, there is some problem in some of the provinces, the administration process, even a tiny, little corruption here and there. That takes a lot of organizing. And on the private side, the capital market still has a way to go and is not yet working fully, so the resource allocation in the private sector, even including the public enterprises, is not easy to allocate funds fruitfully. It takes time, and this is part of the growth process of China. And so, I suggested the "parking theory." Rationally, China is parking funds abroad and in fact primarily in the United States, until it is ready to use them fruitfully. And that is part of the growth process to improve the administration process and the capital market system. And therefore we don't do anything about it. We let it happen the way it is. We take no notice of what the New York Times and others are telling us. It will go away, as we, the Chinese I mean, greatly improve the public and private sector system of allocating capital. And then when the improvements are taking place, there will be lots of resources available and China can run a current account deficit for quite a while and still have proper reserves left. So that's another item on my list, and which also says, like the previous one, don't actually do anything about the exchange rate at this stage, or nothing major, just focus on improving the system.

Point 2:

Well, that's my broad list of possibilities, none of which, I am going to say, this is the one you should do. You could have a combination of them. As we've said many times, this is a country which is fortunate to be run by pragmatists. I want them to be pragmatic and I want them to appoint a group of people, perhaps from this audience, who will go through each of these arguments and consider the implications, work them out and then go ahead and work out what's necessary. And then if they decide it isn't in the interest of China, irrespective of what is said in other countries, don't do it. That's my general advice.

Point 3:

Now having said all that, I think I'll say one or two words about a broader issue. That's all I will say from the point of view of China. Now of course, it is a fact that China is a more important country in the world and so other countries take an interest in what China does. Now, it's quite a complex matter, but one point, it has been suggested by a colleague of mine whom I highly respect who studies this stuff, our friend, Paul Krugman, that the current exchange rate policy, which really means the situation of the current account surplus, because that's what matters, reduces employment in the United States. To put it more generally, meaning that China is pouring labor intensive goods onto the world market and this reduces employment in industries or fields that produce competing products.

Now it's never as bad as it looks on that score. Let me give you an example. If you go to the shops in Australia or in the United States it seems all the goods you buy are made in China. Now, I haven't checked, but I'm sure I'm wearing something at the moment apparently made in China. But it really should have written on it, processed in China, or 30% made in China. Value added is not going to be 100%. So when you think everything is made in China, it maybe a Korean product combined with a Thai product, combined with the entrepreneurship of an American firm, and then adding some Chinese value added. And so the apparent conquest of the markets by China, the impression you get when you go to the shelves, is a bit illusionary. That doesn't mean there hasn't been a very significant impact. When one considers the fragmentation of production, a subject that many economists are studying currently, it puts it a bit more in perspective. There is an issue, but it is certainly overrated because of this illusion. Furthermore, of course, we can take other countries, let's say, Germany. Well, the kind of products that Germany exports are not the kind that the average consumer sees all the time in the shops. It's machinery. Or the French, they export transport goods and so and so forth. And you don't get that feeling that this country is taking over everything. And so once you allow for the value-added aspect, I think people have estimated 30% or so true value is added in China, and that would include this Chinese labor, not just the profits that are made by working in China by companies from the United States and the benefits of the dividends to the United States. And so one can overdo this aspect.

And that's just a small point. A more important point that I want to mention is the following. This one involves international general equilibrium theory. I will try to explain it simply. When a country runs a surplus like Japan or China or Germany, and remember China is only a member of a group of countries, the biggest group have been the oil exporters actually, that reduces employment on that ground, in the immediately effected industries. Ok, but what about the following consideration. This is all a result of savings. Let's go back to China. The savings that result from this policy of having a current account surplus went abroad. They go into a world capital market and, in the case of China, they go primarily to the United States government. And this means, focusing on the budget deficit side of it, all over the developed world there has been an increase in budget deficits and in public debt. If you read the Financial Times, in one section of the Financial Times, my former student Martin Wolf, worries a lot about the employment effects of these current account surpluses and reprimands Germany and perhaps China for that. In another section of the paper, there are articles about the bond markets. They worry the bond market may not lend enough money to Great Britain to finance the big debt that Great Britain is accumulating. And presumably, that is general too, because a lot of European countries have debt, and so does the United States you see. Well now, the more China and other countries lend, the more they put it either directly in general on the bond market, or they lend it to the United States and therefore they ease that problem. And by easing that problem they allow countries to have bigger budget deficits than otherwise. If you were managing the financial affairs of a country, and you endlessly worried about financing your deficit, and worried about different terms, and the bond market going on strike, meaning that they refuse to lend any more to Great Britain, even though the government of Great Britain has never defaulted. And for that matter, the Federal Reserve, the federal government of the United States has never defaulted. Because they're so worried, it's one reason to try to reduce these deficits and therefore not follow the Keynesian fiscal stimulus policies which are appropriate in the current situation. And one of the big issues of the world today is should one have big deficits for the sake of a short-term Keynesian problem or should one reduce the deficit because of the long-run problem that has to do with developed countries having excessive budget deficits. And if both elements are true then the job of economists is to trade off intelligently unemployment versus inflation for example, or short-term versus long-term policy with regards to budget deficits. So when China and Japan and Germany and the oil exporters are taking the surplus money and easing the deficit problems of other countries, they therefore allow the other countries to have a bigger fiscal stimulus and to employ more people than otherwise. So, the message I'm now saying to Paul, Mr. Krugman, who said that there's a big unemployment caused by these policies, is that you're half right. One side is right. You increase unemployment in the tradable goods sector. On the other hand, you are going to actually reduce unemployment in various sectors that benefit from more government spending or tax reductions and may be able to build on this model for tradables and non-tradables where you get the answer that the public sector spends mostly on non-tradables, that's a very simplified model, while these labor intensive goods are mostly tradables. So we have a case of more employment and you don't necessarily get more unemployment. There are two opposing facts at work and one is dominating the other effects. So that's my answer to the argument that the current account surplus in China caused unemployment in the United States.

Because you can build specific cases where it clearly goes one way or the other. For example, once you bear in mind that there are many countries in the world, you could look at the United States and you could say the United States from the capital asset aspect, the financing aspect is more important than all the countries that lend to the United States, like China. On the other hand, the problem of labor intensive goods causing unemployment to increase may be felt more by, say, Italy or various other countries. So you can separate them out. But as a general statement, there are opposing forces at work and you can't say there's a general statement that it causes unemployment. That's my small contribution to this question of international general equilibrium.

Anyway, my recommendation to China is just look after your own interests. That's a big enough job, especially given that the current regime in China has been so incredibly successful in many ways, including the rapid employment of Keynesian policies, with prizes. The United States also followed Keynesian policies, but clearly there was not enough, as I must say, some have pointed out. Again, it's difficult to know in advance how much is enough. It is difficult but there wouldn't be 10% unemployment in the United States right now if the fiscal stimulus policy had been bigger. Now I'm not blaming them, it's easy to get these things wrong. But in Australia, we had been quicker and bigger, and the result is that we had only 5% unemployment instead of 10%. So, the crucial issue is actually, at the moment, applying the appropriate fiscal policies as Keynes would recommend. And knowing when to switch around to the opposite when you take the long-run view of the problems.

Xiao Geng: Max, thank you very much. I think this is a very complete and thorough analysis, and also balanced, about the exchange rate issue. I think those countries like China and the United States, their policy-makers, will study this analysis. Unfortunately, we don't have much time left, Max needs to go, but let's just take two or three minutes to see if anyone has any questions.

Student: [A question on Chinese worries of the size of the recent Chinese fiscal stimulus]

Huang Yiping: Just quickly, I thought it was really exciting. But I was a bit intrigued by your last advice, saying China should just look after its own country. If it does its own things it should be fine. But I'm worried that may be mis-integrated in China, meaning, we don't care what others say. Given that you're a large country, given that it's a globalized economy, I suppose taking into account the reactions of other countries is also a behavior which would count as looking after oneself.

Chen Ping: I strongly support your last statement because China can contribute more to solve the debt financing problem. After this financial crisis we see a very abnormal capital flow from developing countries. And we have a big problem to deal with the government debt due to stimulus programs. I proposed in my book that China could open a dollar market to finance the sovereign debt around the world, to stabilize the international financial order. I think your last idea can be further explored.

Xiao Geng: Thank you all very much. Max, you have just a few minutes to answer these questions.

Max Corden: Yes, can I take the second point first? Broadly speaking, the more a country grows and expands the better for other countries and itself. For example, the United States can overcome its recessionary situation by itself. That increases demand for other countries' goods, terms of trade will improve and fortunately what's good for the country for itself is good for the rest of the world. Of course, there are other cases to bear in mind. But take for example, this crisis that was caused in the United States. It was bad for other countries, and it was also bad for the United States. And the case that what is good for one country is bad for another, there are cases I can think of, but they are exceptions. That would be my general answer. But I agree, I could think of cases. But also you don't necessarily have to coordinate policies. Every country does as much as it can for itself, and on balance, unless they overshoot, it will improve the whole system. That's my general answer here.

Can I come back to the last point? You have to bear in mind that China and other countries build up foreign exchange reserves as an insurance against, I mean, either as an accident of having a surplus, too much so, or as an insurance against needing them in some future time, something adverse. So the decision really should depend on where the funds are most secure and where they are most liquid. The reason that so much is in the United States is it's a big and liquid market. And so if you start putting it into small Asian countries, it would be helpful for them, but it doesn't necessarily meet the needs of China. The needs of China might well be met by more diversification of reserves and by more euro denominated or yen bonds or a little bit of sterling. The criteria again has to be saving in a really safe and liquid form, rather than just with whoever needs it.

Has there been too much spending? Well, I made a general point that economic management is very much a balancing act. You want to know the theory, on the one hand, on the other hand. Inflation's bad, unemployment's bad. Is a certain policy going too far? Is inflation going too far the other way? And you can always make mistakes and it's impossible to get it right. Now what you're really saying is if the general direction of the policy is correct, it may have gone too far. Or maybe the government has lost control of spending and some provinces. It's quite possible. And so the idea of discipline, in the back of your mind, should not go away. So even when you want to spend a lot, there's still a question of whether you're spending it well or badly. And this is the normal preoccupation of economists. What has happened, I vividly remember this, in 2008, there was a sudden change of the world situation. This was really almost from one month to the next I remember this in Australia and Australia is just one country of many. We were typical economists worrying about inflation and too much government spending, all this sort of thing, and the whole world situation shifted, within say three months. And then, one really has to be flexible. Well, I happen to be elderly and therefore I was educated on Keynesian economics, and it became clear to me this is the world of Keynes, suddenly it came out of nowhere and you have to have different policies. You worry much more about not spending enough than about spending too much. So that's part of the art of economics, to know how to go from one thing to the other thing. And you're pointing out correctly, that there can be waste and overdoing it in China, as in any other country, and I'm emphasizing that at certain times you should bear in mind it's quite a good thing to run a budget deficit or have a big monetary expansion. That's all. Thank you.