China: a myth of currency manipulation.

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One would have thought that the debate about the Chinese exchange rate manipulation was over, but here we go again. Over the last three weeks there has not been a single day without an article or a commentary in Financial Times or elsewhere dedicated to Chinese currency manipulation. You can hardly find, at the same time, a more politically deformed economic issue than this one.

What is going on? Chinese are being accused of manipulating their currency in order to achieve an advantage for their exporters. Let's make that clear, China really manipulates its currency and it maintains a de facto fixed exchange rate or a heavily managed one, if you like it more, against the US dollar. The same, however, do, according to an official IMF classification, other 65 countries and they are not accused of anything. Fixed exchange rate is simply one of possible monetary policy strategies to achieve low inflation. Maybe it is a little bit weird that the fixed exchange rate maintains such a big economy as China, but Russia also tries to fix and … and have you ever heard about that?

The problem with China lays not in its management of the nominal exchange rate, but in the fact that despite fast GDP growth and especially significantly faster GDP growth in comparison to the US or the EU, we do not observe any real exchange rate appreciation. The nominal exchange rate may be interesting for media or politicians, however, when it comes to talk about trade, current account deficits and international competitiveness it is the real exchange rate that matters. Indeed, if you want to compare two countries it is necessary to adjust the nominal exchange rate for prices or labour costs in both compared countries.

In economics there are just few ideas that are strongly and unambiguously supported in the data and one of those is the relation between the fast GDP growth and the real exchange rate appreciation. As soon as a relatively poorer country starts to grow faster and converge to the richer one its real exchange appreciates. It is known as a Ballassa-Samuelson effect and it can be understood as a form of taxation that prevents faster growing countries from using the advantage of low labour cost forever. To demonstrate this principle take Germany as a rich country and Central European Economies (CEC), namely Hungary, Poland, Slovakia and the Czech Republic, as faster growing export oriented economies. What you see is that over last ten years the GDP growth differential has reached almost 3 percentage points and the CEC composite real exchange rate has on average appreciated by 3%. From the attached figure it is evident that the cumulative increase in GDP matches well with the cumulative real exchange rate appreciation.

The same figure reveals, however, that when it comes to China everything is different. While the China's GDP has almost doubled over the last ten years the real exchange has not appreciated at all. Indeed, the Chinese GDP has been growing by 7 percentage points faster than the US GDP, while the average real exchange rate appreciation has reached just 0.8%. But it is so not because China manipulates the nominal exchange rate. It is the basic principle of monetary economics that the central bank cannot influence the real variables in the long run and ten years is long enough. In addition, among the CEC you can find exchange rate floaters as well as managers and they all appreciate in real terms regardless what is the nominal exchange rate doing. Seen from same perspective, Russia also manipulates the nominal exchange rate, but the relation between GDP growth and the real exchange rate appreciation holds, thanks to oil export not as nicely as in case of CEC though.

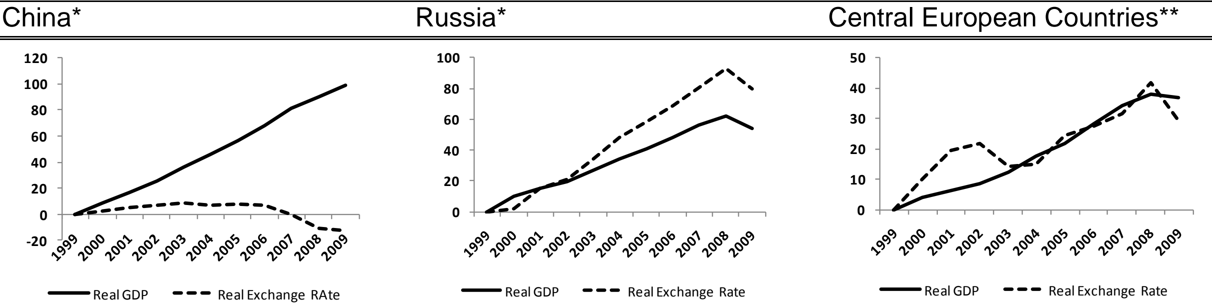
What makes China different from CEC and Russia is the relationship between the real GDP growth and real appreciation. China has apparently broken that. Regardless of what is the reason, whether the flat labour supply curve and low wage growth (not in official data though), high savings because of lack of any social net or any other structural measure, we see a discrepancy between growth of the real GDP and the real exchange rate. Something, which seems to work very well otherwise.

I do not deny that if Chinese let the renminbi float tomorrow we would see an abrupt appreciation of both nominal and real exchange rates. However, appreciation of the nominal exchange rate would sooner or later decline inflation in China, People's Bank of China would react and real exchange rate would return close to its previous value. It is naive to think that China switches the fixed exchange rate for float and nothing else happens. An – other things being equal - analysis works in elementary textbooks but not beyond. Switching from fix to float would mean for China a need to choose a new nominal anchor, and People's Bank of China would probably opt for some version of more or less explicit inflation targeting as well as it would have to allow for free capital movement. Under such conditions, however, one cannot expect the renminbi to appreciate only because China has had a current account surplus. Australia has had a current account deficit since 1953 and have you seen Australian dollar to depreciate steadily? It is accepted in economics that an average movement in the nominal exchange rate depends on inflation differential and eventual trend real appreciation between those two countries in question. Image Chinese change their monetary policy strategy, start float, let the capital move and choose an inflation target of 5%. Then, as long as the real appreciation remains just 1% and US inflation around 2%, renminbi will depreciate, not appreciate, on average by 2%. Quite surprising result, isn't it?

Therefore, it does not make much sense to press Chinese to change their exchange rate regime. Fix or float, as long as the real exchange does not start to appreciate along a trend as it does in many other fast growing economies, we will not see any difference. Renminbi real exchange rate has not been appreciating yet and the exchange rate regime has nothing to do with that. What we need is either get the Chinese workers to be paid what they deserve or at least move them to spend what they get now or some other type of structural policy.

Cummulative increase in real GDP and appreciation of the real exchange rate, 1999-2009, in p.p.

China* | Russia* | Central European Countries**



* Real exchange rate against US dolar
** Hungary, Poland, Slovakia and the Czech Republic; real exchange rate against euro
Source: OECD, IMF and own calculations