Hu Xiaolian: Exchange rate regime reform and monetary policy effectiveness

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The Chinese economy is growing rapidly, and is becoming increasingly market-based and more open. As a result, China needs to deal with a much more complicated economic situation. In this context, the ability to conduct macroeconomic management is critical for ensuring sound, rapid and sustainable growth, and the effectiveness of monetary policy has also taken on greater importance. At the current stage of development, China needs to employ monetary policy to accommodate four broad objectives, i.e., price stability, growth, full employment and balanced BOP account. Exchange rate policy has played a role in achieving these macroeconomic objectives. It also has an impact on China's competitiveness, trade relations and resources allocation. Therefore, improving the managed floating exchange rate regime and gradually enhancing exchange rate flexibility will help make monetary policy more flexible and effective, and strengthen the ability to conduct macroeconomic management.

I. Monetary policy is an important means of macroeconomic management in China

Monetary policy is one of the important means through which China manages the economy. Its effect is transmitted through the financial system, the core of a modern economy. The effect of monetary policy is not limited to one sector or one area. More broadly, it is felt in every part of the economy and affects individual economic behaviors at the micro-level. In this sense, monetary policy carries more system-wide implications and is more systemically important than exchange rate target. Monetary policy flexibility and effectiveness are particularly important under China's unique circumstances. As a big developing country undergoing reform and transition, China has to deal with complicated and rapidly changing economic situation, and its macroeconomic policies are therefore designed to meet multiple objectives, such as reform and development. More specifically, monetary policy also has various objectives, including managing inflation, supporting growth, promoting a balanced BOP account, boosting employment and facilitating financial reform. This fact highlights the importance of making flexible and effective monetary policies.

The Chinese economy was put under critical test since the global financial crisis began to unfold in the second half of 2008. To deal with the extremely complicated situation both at home and abroad, the Chinese government implemented a proactive fiscal policy and relatively easy monetary policy, and adopted a comprehensive policy package. The economy was among the first to recover in the world. In response to the rapidly changing situation, the Chinese government decided to focus on making substantial progress in shifting the development pattern, and make sure that progress in this front is in line with the objective of supporting sound and rapid economic development, so that the two facilitate and reinforce each other. Recently, in parallel with rapid recovery, China observed a rapid increase in foreign exchange inflows and a substantial rise in liquidity, which remains abundant despite of vigorous sterilization efforts. This leads to potential risks of heightening inflation expectation and asset speculation. In this context, economic policy makers need to carefully balance the relations between supporting sound and rapid growth, restructuring the economy, and managing inflationary expectation.

Historical experiences from many countries show that inflation and inflation management is not only an important topic in the study of economics, but also a key issue that affects social and political stability. Inflation, as put by Milton Friedman, the Nobel laureate in economics, is a dangerous disease that can be fatal and destroy the whole society if unchecked. In China, it is the low-income groups, especially over 40 million urban low-income groups and nearly 100 million migrant workers that will be hit the hardest by inflation. Any mismanagement in this issue would undermine social justice and stability. For the central bank, this means it should take preserving the value of domestic currency as the primary responsibility and prevent risks of high inflation. As monetary policy proves to be the most important and effective tool in managing inflation, the central bank should enhance the effectiveness of monetary policy to ensure price stability and, by doing so, promote economic growth.

II. Monetary policy effectiveness has faced challenges in recent years

The independence and effectiveness of China's monetary policy has met with serious challenges from rapid expansion of RMB supply as a result of foreign exchange purchase. Prior to 1993, China ran current account surplus and capital and financial account surplus on an alternate basis. The situation changed in 1994 when China began to have twin surplus, and intensified following China's accession to the WTO in 2001, as current account surplus widened markedly and became the major contributor to BOP surplus. In the context of relatively stable exchange rate, the expansion of BOP surplus and inflow of foreign exchange forced the PBC to passively inject base money via foreign exchange purchase.

In recent years, the PBC has strengthened the capability of macroeconomic management according to the overall arrangements of the central government in line with the country's development strategy. In response to changes in economic and financial circumstances and foreign exchange flows both at home and abroad, management of the banking sector liquidity has become an important part in the PBC's monetary policy conduct. Instruments such as open market operations and reserve requirement ratio have been adopted to sterilize the growth of RMB supply as a result of foreign exchange purchase, and to absorb excessive liquidity in the banking system. Nevertheless, the root cause of the liquidity problem has not been solved. The RMB equivalent to foreign exchange purchase has become the major source of base money supply while central bank lending to financial institutions accounts for a smaller share. This undermines the independence of monetary policy and makes money supply a more endogenous factor. In recent years, though CPI has remained basically stable at a fairly low level, broad price levels such as PPI and asset prices such as housing prices have increased significantly. Moreover, the issuance of central bank bills and the frequent adjustments of reserve requirement ratio in the banking system have also affected the operational behaviour of commercial banks and even the efficiency of the financial system. The sterilization cost for the central bank has also been on a rise.

III. A more flexible exchange regime helps enhance the effectiveness of monetary policy

According to the argument of Impossible Trinity, capital and financial account convertibility, independent monetary policy and exchange rate stability cannot be achieved at the same time. It is feasible for a small and open economy to pursue exchange rate objectives at the expense of monetary policy independence. The Hong Kong SAR is such an example by adopting a currency board system, where the Hong Kong dollar is strictly pegged to the U.S. dollar and the Hong Kong Monetary Authority follows the Federal Reserve in its adjustment of Hong Kong dollar interest rates. As for Singapore, exchange rate instruments, rather than interest rates, are used more frequently in macroeconomic management, as exchange rate is taken as the intermediate monetary policy target. China is not a small economy. With a population of 1.3 billion, China cannot afford to lose monetary policy independence and subject itself to economic policies of other countries. Adopting a more flexible exchange rate regime serves China's long-term interests as the benefits of long-term price stability and economic restructuring far exceed the cost in reorganizing certain industries and removing outdated capacities.

At present, a more flexible exchange rate regime will help curb inflation and asset bubbles. When domestic inflationary pressures are heightened, a stronger domestic currency will help bring down the price of imports. The role played by exchange rate in easing imported inflationary pressures is particularly important for a country like China that has a robust demand to import primary products due to unfavorable resource endowment.

Economic restructuring and growth pattern upgrade, as urgent tasks of strategic importance, cannot be accomplished without persevering efforts. When doing so, it is desirable for China to seek more balanced trade development. Price tools such as exchange rate can be adopted to adjust trade and BOP imbalances. This will help ease pressure of inflows of foreign exchange and rapid build-up of reserves, promote sound and sustainable development, and realize stable and orderly growth of money supply.

According to international experiences, a flexible exchange rate regime helps mitigate impacts of external shocks and enhance macroeconomic resilience. Financial crises in the 1990s have shown that a rigid exchange rate regime is vulnerable to speculation and may even trigger self-fulfilling currency crisis.

Stronger exchange rate flexibility also helps improve the transmission mechanism of monetary policy. Since 2005, the RMB exchange rate regime reform that has progressed in a self-initiated, gradual and controllable manner has enhanced market players' awareness to adapt to exchange rate movements and made them more responsive to market changes. The money market and foreign exchange market have developed both in breadth and in depth. Adapting to more flexible exchange rate, financial institutions have strengthened risk management, improved financial services and come up with more product innovation. These have helped improve the transmission of monetary policy at the micro and market levels and played a positive role in enhancing the effectiveness of monetary policy.