Contrary to widely held beliefs, the Quid Pro Quo doctrine — which holds that one party must give up something in exchange for something in return — must discard as firms see China becoming a large trading country.

The Quid Pro Quo
Ending China bashing once and for all is more than just a political issue. In both the U.S. and Europe, economies — and the politicians they indoctrinate — must discard the false theory that one can see changes in the exchange rate control and the net trade balance in a predictable way. Conversely, to widely hold belief in both China and the U.S., a distant appreciation of the renminbi against the dollar would not reduce China’s trade surplus or America’s trade deficit. A distant appreciation of the renminbi could have the perverse effect of causing China’s domestic savings to increase, depressing the global economic recovery while reducing the U.S. trade deficit. The collapse of the housing bubble in 2008–09, U.S. household consumption has plunged and saving has risen, depressing the global economic recovery while reducing the U.S. trade deficit. In order to buoy China’s and the world economy while reining in China’s trade surplus, policymakers must change the exchange rate question, the fiscal stimulus, which Premier Wen Jiabao on January 29 to mount a vigorous defense of China’s existing exchange rate policy. This prompted Olympic Chairman, in mid January that China might be a “currency manipulator.” This prompted a huge trade imbalance be a useful fixed point for China’s engaging in a huge fiscal expansion than the welcome half-trillion dollar amount announced on November 5, 2008. Indeed, as the world goes into a severe economic downturn, the threat of beggar-thy-neighbor devaluations becomes acute—as in the 1930s. Thus, stabilizing the exchange rate between the world’s two largest trading countries could be a useful fixed point for changing the devaluationist policies of other nations around the world. 

Policy Briefs
SIEPR Policy Briefs are meant to initiate and summarize important research by SIEPR faculty selecting a different economic rationale for China’s wanting to keep the yuan/dollar rate fixed, as long as the fixed rate is credible—as it was between 1995 and 2004 at 8.28 yuan per dol-
lar — it served as an effective monetary anchor for China’s internal price level. After in-
flation had exploded to more than 20 percent per year in 1995–96, the fixed-rate anchor helped China regain price-
level stability. Second, the big fiscal stimulus, which Premier Wen is now contemplating, is most effective if continued on inside...
China’s exchange rate were kept stable — as it has been since last July.

Monetary Controversy: Last and Then Regained

However, China bashing, i.e., mainly U.S. pressure to appreciate the RMB, had become intense by 2004. To deflect American protectionist threats, the Chinese authorities began, as of July 21, 2005, to allow the renminbi to appreciate slowly — about 6 percent per year against the dollar (figure 1). But the resulting one-way bet on the renminbi always rose.

To prevent the renminbi from rising, China's central bank sterilized the inflows of commercial banks and other financial institutions refused to acquire dollars. Compounding the situation, inflows of international "hot" money to buy ever-higher renminbi assets led to enormous balance of payments surpluses.

To prevent the renminbi from rising, China's central bank sterilized the inflows of commercial banks and other financial institutions refused to acquire dollars. Compounding the situation, inflows of international "hot" money to buy ever-higher renminbi assets led to enormous balance of payments surpluses.

One-way bet on appreciation:

The authorities in Beijing have now thought through the problem of what to do next. They have realised that it is easier to prevent the renminbi from rising than to keep it from appreciating slightly. But they have also recognised that, in either case, the renminbi always rose.

Figure 1

China’s Monetary Policy and the Yuan/Dollar Rate (1995 – 2009)

Despite massive sterilization efforts by the PBC, including imposing high reserve requirements on commercial banks, excess domestic money growth aggregated inflation from 2000 to July 2008. China's CPI inflation peaked at 8 percent in the spring of 2008.

Then, after the U.S. credit crunch of July 2008, the weak dollar became the strong dollar: the surprise 20 to 30 percent dollar appreciation against all major currencies, except the Japanese yen, that is still with us. This general dollar appreciation carried the renminbi, which was and is pegged to the dollar, upward with it. Unsurprisingly, the PBC stopped the gradual appreciation of the renminbi against the dollar so that the yuan's dollar price has been remarkably stable at about 6.85 to 6.93 percent since last July (figure 2). But the combined effects of the sharp appreciation in China's "real" trade-weighted exchange rate against all countries from 2005 to the present, as shown in the left-hand panel of figure 2.

In a world of fluctuating exchange rates, nobody can have any accurate idea of what is a fair or "equilibrium" level for the exchange rate. In economies open to international capital flows, exchange rates can only constranit a country's net trade (surplus) is an oft-used indicator — as discussed below. A more verifiable idea, attributable to the Swedish economist Gustav Cassel writing in 1921, is that of purchasing power parity.

"Accidental" stabilization:

In economies open to foreign trade, a country's net trade surplus is an oft-used indicator — as discussed below. A more verifiable idea, attributable to the Swedish economist Gustav Cassel writing in 1921, is that of purchasing power parity.

Figure 2

China’s Comparative Price Level in Hamburgers

From the Economist magazine with its "Big Mac" hamburger standard. MacDonalds carefully monitors the many ingredients in a Big Mac to be the same in the scores of countries where hamburgers are sold. Moreover, as per capita income rises across countries, the dollar price of a Big Mac tends to increase approximately in line with that found in the decennial estimates in the Penn World Tables. But the price of hamburgers are much easier to collect and are available at frequent intervals. As of January 2009, the upskarking exchange rate in the right-hand panel of figure 2 shows how the dollar prices of Big Macs rise with per capita income. Since July 2008, the appreciation of the dollar with the RMB is that it has lifted the price levels (in Big Macs) of both countries so that they are both on the re-gression line. That is, China's exchange rate and price level are about where they should be for countries of similarly low per capita income, and Big Mac prices in the U.S. are about average for countries with similarly high per capita income. Thus our modified version of purchasing power parity shows that both the RMB and dollar exchange rates, as of early 2009, aligned more or less correctly with each other (at 6.89 yuan/ dollar), and with the average continued on flap...
China's Monetary Policy and the Yuan/dollar Rate

Figure 1

Ties began, as of July 21, 2005, appreciate the RMB, had i.e., mainly U.S. pressure to
Monetary Control: Lost since last July.

5.00
5.50
6.00
6.50
7.00
7.50
8.00
9.00

Source: FRB

However, China bashing, monetary stability
Fixed exchange rate anchor:
Compounding the predictably depreciating dollar
institutions refused to acquire huge trade surplus. Chinese
flows from financing China's prevented private capital out
the renminbi always rises 6 percent per year against

2005 06 07 08 09 GDP per person, $'000, 2007

Figure 2

China's Comparative Price Level in Hamburgers

Food for thought

Sources: BIS; Thomson Datastream; The Economist, Feb 5th 2009

Against the dollar

In economies open to foreign
international capital flows,
rate. In economies open to
international capital flows,
China's CPI inflation
the reserve requirements
China's CPI inflation peaked at 8 percent in the

3
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After the U.S. credit

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the dollar price of a Big Mac: $2.00...as per capita income
the scores of countries where
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the right hand panel of figure
2 shows how the dollar prices
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continued on flap...
China’s Monetary Policy and the Yuan/dollar Rate to allow the renminbi to deflect American protectionist and Then Regained Monetary Control: Lost since last July. kept stable — as it has been 5.00 6.00 6.50 7.00 7.50 Yuan / Dollar Source: FRB 1995 1996 2004 2005 2006 2007 2008 2009 However, China bashing, “Accidental” stabilization: “One-way bet on appreciation of the yuan/ dollar rate has been against the dollar so that the yuan’s dollar has been appreciating slowly — about 6 percent per year against the dollar (figure 1). But the resulting one-way bet on the renminbi always loses prevented private capital out-flows from financing China’s huge trade surplus. Chinese banks and other financial institutions refused to acquire a predictably depreciating dollar asset. Comprising the situation, inflations of interna- lional “bet” money to buy ever-higher renminbi assets led to enormous balance of payments surpluses. To prevent the renminbi from ratcheting upward, the People’s Bank of China (PBC) intervened massively to sell renminbi and buy dollar as- sets. By July 2008, China had accumulated about $2 trillion in official exchange reserves. Despite massive sterilization efforts by the PBC, includ- ing imposing high reserve requirements on commercial banks, excess domestic money growth aggraded in-flation from 2000 to July 2008. China’s CPI inflation peaked at 8 percent in the spring of 2006. Then, after the U.S. credit crunch of July 2008, the weak dollar became the strong dollar: the surprise 20 to 30 percent dollar appreciation against all major currencies, except the Japanese yen, that is still with us. This general dollar appreciation carried the renminbi, which was and is pegged to the dollar, up with it. Unsurprisingly, the PBC stopped the gradual appreciation of the renminbi against the dollar so that the yuan’s dollar has been appreciating at a rate of about 6.95 to 6.50 percent since last July (figure 2). But then the surprise ratchet- ing up of the dollar from July 2008 to February 2009 against most other currencies was another 25 percent. So the combined effect was a sharp appreciation in China’s “real” tradable-weighted exchange rate against all countries from 2005 to the present, as shown in the left-hand panel of figure 2. In a world of fluctuating exchange rates, nobody can have any accurate idea of what is a fair or “equilib- rium” level for the exchange rate. In economies open to international capital flows, exchange rate (buy- ing) surplus is an oft-used indicator — as discussed below. A more ven- Figure 1 China’s Monetary Policy and the Yuan/Dollar Rate (1995 – 2009) Figure 2 China’s Comparative Price Level in Hamburgers Final food thought: The same, January 2005 = 100 Big Mac prices versus GDP per person Second course. 8.28 6.84 6.50 6.00 5.00 Average index In a world of fluctuating exchange rates, nobody can have any accurate idea of what is a fair or “equilibrium” level for the exchange rate. In economies open to international capital flows, exchange rate (buying) surplus is an oft-used indicator — as discussed below. A more ver- stable idea, attributable to the Swedish economist Gustav Cassel writing in 2021, is that of purchasing power parity. In economies open to foreign trade, Cassel suggested that, on average, exchange rates should line up so that country X’s currency has the same purchasing power over a representative basket of goods and services as country Y’s. However, in a world of both rich and poor countries, Cassel’s theory has a generally accepted modi- fication. In poor countries with low wages, the prices of nontradable goods and services (such as haircuts) are much lower than the prices of nontradables in wealthy (high wage) countries— even though the price of highly tradable goods such as textiles and automobiles are similar. So one dollar will have greater purchasing power in a poor country. But how much lower is “normal”? Using data from more than 100 countries, researchers at the University of Pennsylvania have made such a calculation by picking out a common “in-ternational” basket of goods in each currency. They found that, at prevailing exchange rates, poor countries do have much lower price levels. But the data collection is so onerous and expen- sive that they can only construct the Penn World Tables” once every 10 years. Enter The Economist magazine with its “Big Mac” hamburger standard. Mac- Donald’s carefully monitors the many ingredients in a Big Mac to be the same in the many countries where hamburgers are sold. Moreover, as per capita income rises across countries, the dollar price of a Big Mac tends to increase approxi- mately in line with that found in the decennial estimates in the Penn World Tables. But the prices of hamburgers are much easier to collect and are available at frequent intervals. As of January 2009, the upholding regression line in the right-hand panel of figure 2 shows how the dollar prices of Big Macs rose with per capita income. Since July 2008, the appreciation of the dollar with the US$ index is as fas- tened the price levels (in Big Macs) of both countries so that they are both on the re- gression line. That is, China’s exchange rate and price level are about where they should be for countries of similarly low per capita income, and Big Mac prices in the US. are about average for countries with similarly high per capita income. Thus our modified version of purchasing power parity does that while both the RMB and dollar exchange rates are, as of early 2009, aligned more or less correctly with each other (at 6.49 yuan/ dollar), and with the average continued on page...
exchange rates of other trading partners throughout the world economy.

The Quid Pro Quo

Ending China bashing once and for all is more than just a political issue. In both the U.S. and Europe, economies — and the politicians they indoctrinate — must discard the false theory that one can see changes in the exchange rate control and the net trade balance in a predictable way. Contrary to widely held beliefs, the collapse of the housing bubble in 2008–09, U.S. household consumption has plunged and saving has risen, bringing the global economy while reducing the U.S. trade deficit. In order to buoy China's and the world economy while further correcting the foretelling trade imbalance between China and the United States, fiscal expansion in surplus-saving countries like China is desperately needed. Because U.S. fiscal expansion would enlarge the U.S. trade deficit, better to convince the Chinese that they should do most of the fiscal stimulating.

Because fiscal expansion in China would be most effective in buoying the Chinese economy when the exchange rate is stable, having American agree to the PBC stabilizing the yuan-dollar rate is the natural quid pro quo for China's engaging in a much greater fiscal expansion than the welcome half-trillion dollar amount announced on November 5, 2008. Indeed, as the world goes into a severe economic downturn, the threat of beggar-thy-neighbor devaluations becomes acute as in the 1930s. Thus, stabilizing the exchange rate between the world's two largest trading countries could be a useful fixed point for checking the devaluationist proclivities of other nations around the world.

Tensions between the U.S. and China escalated recently when the new U.S. Secretary of the Treasury, Timothy Geithner, suggested in mid-January that China might be designated as a "currency manipulator." This prompted Premier Wen Jiabao on January 29 to mount a vigorous defense of China's existing exchange rate policy at a high-level meeting of world leaders at Davos, Switzerland. Mr. Wen pledged to keep the renminbi at a "reasonable and sustainable" level. Mr. Wen promised to help China regain price-level stability, the big fiscal stimulus, which Premier Wen is now contemplating, would be most effective if continued on inside...
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The Quid Pro Quo

Ending China bashing once and for all is more than just a political issue. In both the U.S. and Europe, economists — and the politicians they underestimate — must discard the false theory that one can use changes in the exchange rate to control the net trade balance in a predictable way. Contrary to widely held beliefs in both China and the U.S., a discrete appreciation of the renminbi against the dollar would not reduce China’s trade surplus or America’s trade deficit. A discrete appreciation of the renminbi could actually increase! Indeed, of being an exchange rate question, the huge trade imbalance between the two countries has two related causes: “surplus” saving in China, i.e. domestic saving far beyond that which is needed to finance domestic investment, and from an even bigger net saving deficiency in the United States. Since the collapse of the housing bubble in 2008–09, U.S. household consumption has plunged and saving has risen, depleting the global economy while reducing the U.S. trade deficit. In order to buoy China’s and the world economy while further correcting the foretelling trade imbalance between China and the United States, fiscal expansion in surplus-saving countries like China is desperately needed. Because U.S. fiscal expansion would enlarge the U.S. trade deficit, better to convince the Chinese that they should do most of the fiscal stimulating. Because fiscal expansion in China would be most effective in boosting the Chinese economy when the exchange rate is stable, having Americans agree to the PBC stabilizing the yuan-dollar rate is the natural quid pro quo for China’s engaging in a much greater fiscal expansion than the welcome half-trillion dollar amount announced on November 9, 2008. Indeed, as the world goes into a severe economic downturn, the threat of beggar-thy-neighbor devaluations becomes acute—as in the 1930s. Thus, stabilizing the exchange rate between the world’s two largest trading countries could be a useful fixed point for checking the devaluationist proclivities of other nations around the world.

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SIEPR policy brief

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China’s Exchange Rate Policy and Fiscal Expansion

By Ronald McKinnon

Tensions between the U.S. and China escalated recently when the new U.S. Secretary of the Treasury, Timothy Geithner, suggested in mid-January that China might be designated as a “currency manipulator.” This provoked Premier Wen Jiabao on January 29 to mount a vigorous defense of China’s existing exchange rate policy. At a high-level meeting of world leaders at Davos, Switzerland, Mr. Wen pledged to keep the renminbi at a “reasonable and balanced level.”

There is a good economic rationale for China’s wanting to keep the yuan dollar rate fixed, as long as the fixed rate is credible — as it was between 1995 and 2004 at 8.28 yuan per dollar — it served as an effective monetary anchor and for China’s internal price level. After inflation had exploded to more than 20 percent per year in 1993-95, the fixed rate anchored China’s internal price level stability. Second, the big fiscal stimulus, which Premier Wen is now contemplating, would be most effective if continued on fixed exchange rates of the fiscal stimulating.

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International Monetary Fund.

His fields of interest are international economics and development finance. McKinnon has written over 200 articles and several books, which include: Money and Capital in Economic Development (1963); Money in International Exchange: The Commandable-Government System (1965); The Order of Economic Liberalism; The Financial Contrivance of a Market Economy, 1940; The Rules of the Game: International Money and Exchange Rates, 1945-85; and Dollar and Yuan: Economic Conflict Between the United States and Japan (with Abraham Chen), 1945, and Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Price, in 2005.

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries worldwide over including inter- national agencies such as the World Bank and International Monetary Fund.

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Ronald McKinnon is a William Search Book Professor of International Economics at Stanford University where he has taught since 1963. His alma mater is the University of Chicago.

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