Professor Hubert Fromlet
Linnaeus University
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hubert.fromlet@lnu.se

China's Options for its Future Exchange Rate Regime from a European Perspective

Abstract

China abandoned its formal currency peg to the U.S. dollar in the summer of 2005. Complaints about what - according to many foreign voices - is an undervalued currency have never stopped since the start of this revised exchange rate system, which appears to be similar to what is more commonly known as a "dirty or managed floating" system or a kind of dollar-peg system - a system that is still determined by China's political leadership rather than by market forces. Currently China is making considerable efforts to internationalize its currency. This strategy should not be equated with a transition to a fully convertible currency any time soon. The latter development assumes much deeper reforms in the domestic financial sector and cross-border financial movements, including the (almost) complete opening of the capital balance. Coming to such a final point should lie a decade or further ahead.

In the meantime, a lot of small and major financial reform steps have to be taken. One of the great challenges is the design of China's future exchange rate regime(s). Some interesting questions emerge in this context. Which currency regime options are realistic, both in the shorter term and in the longer run? What is needed for these - theoretically possible - changes of exchange rate regimes to occur? How will these possible changes of exchange rate policy affect China itself as well as the rest of the world? A group of China experts give their views on this in a special survey.

There is no doubt that future changes in China's exchange rate regime will have an increasing impact on the global economy - and on many companies in China as well as the rest of the world. Many different factors - including non-economic factors - may influence China's future choice(s) of the exchange rate regime. China's road to modifications and real reforms of the exchange rate policy will be part of the changing economic landscape - with effects on Europe, the U.S., and all other continents and countries. In this paper, particular interest is dedicated to the European perspective.

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A. Introduction

China's exchange rate policy has been criticized frequently in the past eight years, particularly by U.S. officials. In the summer of 2005, China made the important decision to formally abandon its unilaterally fixed linkage to the U.S. dollar (USD) at 8.28. From this point until recently (March 31, 2013), the Chinese currency renminbi (RMB, also called yuan or on currency markets CNY), appreciated nominally by a total of about 30 percent at a relatively steady rate, apart from two shorter periods when the exchange rates to the USD were kept more or less stable. The two latter, limited and temporary policy changes happened in order to meet the weakening foreign demand for Chinese goods which itself was a consequence of the subprime crisis and the European debt crisis with their global negative contagion on economic growth.

Opinions differ what concerns the equilibrium rate of the RMB against the USD. Most (foreign) experts assume that the RMB remains undervalued, maybe by 10 -20 percent. This guestimate may be quite realistic - but who knows? Many Chinese economists already view current rates against the USD as being close to the equilibrium. Furthermore, equilibria on currency markets are movable and may look different a couple of quarters or years from now. Assuming further appreciation, the marketization of the financial markets and - hopefully - an increasing economic transparency under the new political leadership, how can we know that the RMB will remain undervalued in the forthcoming years? Besides, no one can rule out that certain imbalances in the Chinese economy will show up more clearly later on - with re-considered, maybe more skeptical views on the exchange rate equilibrium.

There are without a doubt a number of conflicts of goals in Chinese economic policy which the new political leaders have to consider. Some of these have a direct impact on the exchange rate policy, as determined by political priorities. The policy changes that will probably occur during the 10-year mandate period of the new political leadership are to a great extent linked to the conflict between marketization and political influence. A sizeable extension in the marketization of the currency will lead to a declining political influence on financial markets - and possibly to more speculation.

In this context, the sequencing of policy changes will be crucial. In what order should reforms in the domestic financial markets, the liberalization and opening of the capital account and the change(s) to a new exchange rate regime, occur? The right answer to this question is one of the most crucial decisions to be made by the (mainly new) members of the seven-headed Standing Committee of the Politburo, the highest decision-making political institution in the People's Republic.

In this paper a further look is taken at the alternatives for the Chinese exchange rate policy, with both advantages and disadvantages presented. The starting point is the Chinese position, but the European perspective is regarded with special interest as well.

This is a non-mathematical paper that concentrates on conclusions from fundamental theory, historical experience, more recent research and applications of Chinese logic, tradition, and thinking.

There is also an attempt to include some empirically-based conclusions. For this purpose, a survey on China's future exchange rate policy was conducted with about 20 China experts from different countries in Asia, Europe, and the U.S. In my opinion, surveys can work relatively well when doing research on a country like China with all its shortcomings in both transparency and statistics.

B. Theory and research

Usually, I start a paper like this by looking at theory and research that fits with the topic and may be helpful in coming to the necessary conclusions on the chosen topic. This kind of approach is based on qualitative reflections rather than the application of quantitative modeling. Modeling in such a special analytical environment like the large emerging economy of China, with its shortcomings in transparency and statistical standards, does normally not allow for quantitative deepening if we want to consider reality. Thus, arguments for qualitative and logical research should still be stronger in the case of China studies like this one.

Traditional general research on economics, the economics of emerging market countries - or any country - is certainly applicable in a substantial number of issues also when it is comes to China. But it should also be considered that China is special which, for example, can be exemplified by the fact that the country

- represents one fifth of the global population (makes often the “law” of large numbers applicable),
- is the number two country in the world in terms of total GDP (PPP measured),
- accumulates the world’s largest currency reserves,
- has a rapidly increasing global influence on international organizations and decision-making,
- has seen an increasing Western commercial dependence on its goods.

These and other characteristics should imply that Chinese historical experience, statistical indicators and political, social and economic reactions still cannot be expressed reliably in numbers and equations. This opinion of mine - which is not shared by all economists - does not, however, rule out the possibility of looking more deeply at an analysis of what China’s future exchange rate should and will look like. There is also a lot of general research and knowledge available on the economic and institutional preconditions for a successful exchange rate regime that can be applied to China.

General theory and specific academic research can certainly contribute to a better understanding of decision-making for Chinese exchange rate policy. In this paper, a limited selection of relevant conclusions will be presented. Exchange rates and exchange rate policy belong to the research areas of economics that have seen the greatest amount of published literature. General research wisdom is not repeated in this chapter. Theory and research is mainly quoted here when direct references to China appear to be obvious. But I must remind the readers once again that the experts are not really united when it comes to the question of whether certain general conclusions are applicable to China or not - because of the size of the country, its status as an emerging superpower, its increasing international influence, etc.

Consequently, there are today two schools of thought when it comes to interpreting the Chinese economy. One camp argues that the Chinese economy presents a challenge to conventional theories and well-known results from empirical research. The other one concludes that China’s success story can be explained by traditional economic principles all the same.[1] My own interpretation of Chinese development since 1979 actually combines these two approaches - but it should be stressed that traditional economic principles should not be underestimated.

For example, current account imbalances still matter in our speedy, globalized word. In the past decade, China has been contributing to these imbalances - contrary to most other countries - by

accumulating large surpluses in the current account and in foreign reserves - and not by major current account deficits. This particular Chinese constellation makes certain areas of economic policy - such as monetary policy and exchange rate policy - more difficult than in the case with more appropriate volumes of the currency reserves. *Obstfeld* concludes that "…current-account imbalances, while very possibly warranted by fundamentals and welcome, can also signal elevated macroeconomic and financial stresses…". [2]

Altogether, there is still no comprehensive theory or model that deals specifically with the Chinese economy and its special status as the second largest economy in the world *and* at the same time considers China's status as an emerging market. This combination is very special. But there is a lot of partial research that is directly/indirectly dedicated or applicable to the Chinese economy.

One of the more general results from research that can be referred to is based on what in the literature is known as the *economics of sequencing*. Two special contributions to this topic may be mentioned in this context: one fundamental breakthrough by Sebastian Edwards and the other - may be more comprehensive - by Pierre-Richard Agénor.

Sequencing is about reforming an economy in the right order and ensuring that the reforms take place at the appropriate pace, with the addition of the issue of credibility. As *Edwards*[3] stresses, conditions for sequencing may differ between emerging and mature countries, but there are also common problems to be solved. Edwards also discusses in his work the policy considerations that are related to the sequencing of micro and macro reforms. This should be particularly important in the case of China. In this context, Edwards develops what he calls "the competition of instruments". It would be a good idea to conduct further research on this topic with special focus on China.

Agénor [4] has developed one of the first - maybe *the* first - comprehensive work on the economics of adjustment *and* growth, with special focus on emerging economies and the sequencing of policy changes. Agénor emphasizes a couple of useful and important conclusions that concern China, too. He shows that globalization has had its setbacks, for example in Mexico, (South-)East Asia, Argentina, Turkey, etc.,where governments could not manage capital inflows because of weak policy and institutions. Agénor's research shows clearly that "… capital account liberalization cannot take place in isolation, without appropriate macroeconomic, exchange rate, and financial sector policies…". Since China still has major shortcomings in all these areas, there is - in my opinion - no reason whatsoever to speed up the process of opening up financial cross-border flows without having seen major reforms in a number of important economic areas.

In other words: the domestic house must be set in order before China can become a significant player on the global financial markets (apart from the administration of its huge currency reserves).

Other relevant research comes from *Acemoglu* who has looked at the importance of institutions in development processes, particularly by using historical experience. My own experience from China confirms the shortcomings of institutions that Acemoglu refers to in his research (often together with his co-author *James Robinson*, more recently in their book "Why Nationals Fall" [5]).

Obviously, a relatively broad analytical approach should be applied in any work that deals with China's future exchange rate policy. Generally speaking, a well-functioning exchange rate policy has a lot do with a country's macroeconomic balance - but also with confidence in the country's *growth*

model. The growth model matters particularly for an emerging economy and the avoidance of the so-called middle-income trap.

In the case of China, there is an obvious need for the country to alter its current growth model, from GDP growth that mainly originates from exports and investment "at any price" to more growth contribution from private consumption and selected future-oriented investments in, for example, sophisticated new or improved industrial products (such as products that can be used to improve the environment or industrial productivity), services (health care, education etc.), necessary and growth-favoring infrastructure, etc. But at the same time it would be very risky to concentrate too much on domestic Chinese markets. In other words: the search for new promising exportable products to foreign markets should absolutely not be neglected. Otherwise persistent deficits in the current account cannot be ruled out in the longer run - a development that could lead to quite different conditions for the future Chinese exchange rate policy than usually discussed these days.

Successful urbanization, improved national health and demographic conditions will be other challenges for China in order to maintain a reasonable rate of GDP growth - or what researchers increasingly call the avoidance of the *middle-income trap*.

The middle income trap is defined as a phenomenon when a country in line with the World Bank's income definitions after years of progress has finally reached middle-income levels - but growth after this catching-up process, unfortunately, starts to slow down significantly or even stagnates.

Eichengreen [6] et al. have done some remarkable research on the middle-income issue, finding that the trap so far has especially affected countries

-that have reached a per capita income (PPP) of USD 15 000,
- that had high economic growth over a longer period of time,
- that had unfavorable demographics,
- that had very high investment ratios,
- that had undervalued exchange rates.

Three out of these five criteria are met by China already today. The fourth - unfavorable demographics - is already developing - and the fifth - reaching the USD 15 000 per capita level (which also can be set somewhat lower) - is on its way, too. Per capita income is currently more than half of this amount according to the IMF. China could get to the USD 15 000 level in about five to six years, i.e. during the term of current president Xi and prime minister Li. Consequently, China's risk of ending up in the middle-income trap cannot be neglected. But it is not yet too late to counteract such a development. Furthermore, *Bertoldi/Melander* [7] prefer to work with an even broader middle-income analysis approach - with different scenarios that include politics as well.

To tackle the trap challenges, Eichengreen [6] suggests even stronger efforts to "produce" skilled people and, thus, more value-added in industrial production and new incentives to China's still underdeveloped service sector. Agénor provides some further suggestions to governments on how to avoid the middle-income trap, such as the development of advanced infrastructure (high-speed communication networks), better or good protection of intellectual property, flexible labor markets and the "… ability to push the technological frontier and move from imitating and importing technology to innovating technologies on their own…". [8] *Hanson,* however, adds in this context that

economists know "… little about the deep determinants of national export specialization patterns…" which means that "…we have little basis for saying whether or not China's export success is unwarranted…".[9]

Fromlet [10] singles out another issue that has not been discussed very much in research and the literature but may play an important role in the avoidance of the middle-income trap: the real situation of Chinese government debt. Total government debt is probably (considerably) higher than officially shown in statistics and does not, by the way, give the impression of applicable transparency. Bringing or maintaining government debt under control - on both central and local levels - is certainly one of the preconditions needed to keep Chinese economic growth on a responsible track and reduce the risk of ending up in the middle-income trap. Let us also remember the opinion of *Malkin/Spiegel* [11] who conclude that the middle-income trap perhaps should only be regarded theoretically since China's per-capita income geographically will remain very uneven.

In my opinion, there is no reason to reject Eichengreen's, Agénor's and Hanson's reflections and the results of their research. But these results should be also interpreted in such a way that China still has its destiny in its own hands and can escape the middle-income trap. However, the fundamentals for such an escape should be settled by the current leadership already within the next five years or so. The clock is ticking.

Conclusion:
General research - and Acemoglu's and Agénor's work in particular - contributes considerably to the understanding of China's future challenges. Seeing, understanding and meeting these challenges should, consequently, also be part of China's decisions regarding future exchange rate policy. The better China does in finding ways to escape the middle-income trap, the more likely it is to create the conditions necessary for China to conduct a promising, in the long-run preferable policy with floating exchange rates.

C. Conflict of goals

Changes in exchange rate systems are in most cases difficult decisions - decisions that usually are made by politicians and not by the central bank. China is no exception in this respect. It should be added once more that changes in the exchange rate system in China are not even made by the government itself - but by the Standing Committee of the Politburo which is the most important group of Chinese political decision-makers. It should also be clarified that the Standing Committee consists of different wings, which include both more reform-minded and more conservative politicians.

At this early stage after the transition to the new political leadership, the international press appears to assume that the more reform-friendly wing of the Standing Committee may have a slightly stronger influence in this center of power concentration. Sure, the new Chairman of the Standing Committee, president Xi Jinping, may be a kind of "primus inter pares" among his top colleagues of the Communist Party but that does not rule out that a majority of the seven Committee members on certain occasions (theoretically) may vote against their Chairman/President. And it is too early to tell

which side president Xi Jinping will represent in different issues -the more conservative fraction or the more reform-friendly part of the Standing Committee.

Nor should one forget the lobby groups within the Communist Party: they may focus on exports, certain regions, certain industrial sectors, certain products, and other structure-conserving factors - or they may represent interests that favor the regions, imports or industries that will be (more) closely linked to the new Chinese growth model - a growth model which aims towards the support of consumption and future-oriented investments to a greater extent than has been the case so far. As already mentioned, this change in the future business model is intended to happen at the expense of exports and less urgent, mostly prestigious investments.

Ultimately, the future exchange rate policy of China will be a choice between

¤ (clearly more) market economy and a simultaneously decreasing political influence on the economy, *or*
¤ a more or less maintained or only slightly decreasing political influence on financial markets and financial cross-border decisions and, consequently, globally lagging domestic financial markets (which will mean limitations to the goal of turning Shanghai into a global financial center by 2020).[12]

This more general goal conflict is one out of a number of contradictory and unwanted reactions to policy decisions. Looking at other policy conflicts that are/may be related to the choice of the future exchange rate regime(s), the following ones seem obvious (yet others may be unknown today):

Conflicts of political goals due to maintenance/change of exchange rate regime from a *Chinese* perspective:

¤ Maintenance/very slow change of the current RMB policy

Plus:
¤ Maintenance /very limited loss of political influence on financial markets (*political power in place*),
¤ limited need for increased transparency on financial markets (*political power in place*),
¤ limited risk of cross-border attack by speculating financial markets (good for *political stability*),
¤ more limited risk for contagion from/to other countries or the global economy (politically good),
¤ more protection for bad banks/bad loans (*politically positive* - at least for a limited time horizon),
¤ safer calculation of return of Chinese investment in USD and vice versa (*politically* good),
¤ protection (short-lived?) in case of future current account problems (good for *political stability)*,
¤ more short-/medium-term planning stability for all agents in the economy (politically good),
¤ less action needed against possibly bursting asset price bubbles compared to a more open economy (*politically good*, maybe only in the shorter term).

Minus:
¤ Risk for delayed reforms in financial markets (*politically unfavorable* for a global superpower),
¤ risk for delay of modernized monetary policy (" underperforming PBoC", *politically dubious),*
¤ Shanghai remaining an underperforming player on global financial markets (*politically sensitive*),
¤ risk for conserving growth-impeding industrial structures (*politically risky* in the longer run),
¤ less competition and weaker supply of goods and services than necessary (*politically sensitive),*
¤ prolonged way to full convertibility of the RMB (see above, long way to reserve currency status),
¤ negative impact on international recognition in the medium and long run (*politically sensitive*),
¤ less highlighted ambitions to improve the quality of national Chinese statistics (*politically "safer").*

¤ Results of a clearly (more) flexible RMB policy

Plus:
¤ Broader global recognition as an economic superpower (*politically mostly positive feedback*),
¤ more influence in international organizations and negotiations (*politically positive*),
¤ faster economic modernization (*more political pressure* on structures, growth model, competition via market pressure),
¤ more openly reflecting the RMB's market valuation (*mostly politically positive* - but not always),
¤ better conditions for efficient monetary policy (*less political influence* - but better monetary policy),
¤ better preconditions for further marketization of financial markets (*politically positive* - normally),
¤ more pressure on SoEs and their reconstruction (*politically more comfortable* when coming from markets - most probably),
¤ more attention to possibly bursting bubble on the real estate market (*good political risk strategy*).

Minus:

¤ Loss of *political* influence domestically (*politically risky* in emergency situations),
¤ markets "punish" policy failures more severely (*increased political sensitivity)*,
¤ easier to hit China and the RMB by cross-border speculation (*politically risky)*,
¤ less certain planning conditions (adds to *political uncertainty* when major RMB movements occur).

It is important to add that the number of pros and cons for these two alternatives as such do not matter at all. Chinese political leaders will certainly refrain from such simplified considerations.

Conclusion:
For China's seven top political leaders, the cost/benefit analysis for future revisions or changes in the exchange rate regime appears as follows:
- *How much loss of political influence can be accepted?*
- *How large are the benefits and potential costs/risks of a new exchange rate model?*

D. The issue of sequencing

Emerging countries that change their exchange rate policy may also at the same time conduct an economic reform policy in other areas, which potentially must be coordinated with the envisaged changes in exchange rate policy. In this context, studies by *Edwards* [3] and *Agénor* [4] - as already mentioned - can be regarded as especially illuminating.

Fromlet [13] refers to the Swedish example. Although it was not an emerging country in the 1980s, **Sweden** can serve as an interesting example of how economic reforms and policy changes may be driven in the wrong order. In the second half of the 1980s, Sweden first abandoned its credit ceilings for the banks. Bank lending was no longer limited by the central bank. This relief favored an enormous expansion of new credits which to a great extent were used to finance real estate investments domestically. Another major step was the elimination of cross-border capital controls in 1989 which was the starting point for a gigantic wave of Swedish financial investments abroad, particularly in the commercial real estate sector as well.

In addition, a major tax reform was implemented at the very beginning of the 1990s which greatly reduced the possibility for private households to deduct interest rate payments in their tax bills. It would, of course, have been much better to wait with the elimination of the banks' credit limitations until the end of the timetable. If this had happened, the credit boom could have been much better controlled by the central bank - and maybe the unfortunate development of the Swedish crown as well. In November 1992, the Riksbank could no longer manage to maintain its unilateral linkage to the - then - artificial currency unit of the EU, the ECU (European Currency Unit). The result of this disaster was the transition to a floating currency regime for the crown which - by the way - still exists and works well. Totally, Sweden suffered from a very severe domestic recession during a couple of years in the turbulent 1990s - but it was also the decade when Sweden's economy finally was put on the right track again.

What China could learn from this negative Swedish example is the need to coordinate a new exchange rate policy with other ongoing or planned policy changes that may affect future exchange rate developments - and the other way around, i.e. to consider how a new exchange rate system may affect the rest of the economy.

In this context, early research results from *McKinnon* [14] may be helpful. Already in the early 1970s, he drew some interesting conclusions on the order of liberalization. McKinnon promoted very strongly the view that capital account regulation should not be abandoned before trade and other industrial distortions have been successfully attacked. McKinnon illustrates this problem mainly by pointing at the risk of non-desirable inflows of capital. In my view, this general kind of approach is still valid - but should in a modernized version focus more on the negative speculation and damage that could come from insufficient structural homework in the financial sector when finally confronted with strong global currency flows. A decade later, McKinnon [15] explained the economic success of Chile by referring to Chile's preference to keep the capital account closed while trade tariffs were reduced and other structural measures were taken.

There is altogether no doubt about the far-reaching consequences which a new exchange rate policy usually has on the whole economy. When it comes to China, strategic exchange rate policy changes are - as already mentioned - decided by the seven members of Standing Committee of the Politburo, which indeed is the institution where all really important strategic political and economic decisions are taken. This fact may lead to two conclusions:

-*first*, that these Chinese decision-makers should have good insight into other reform plans and processes to achieve the necessary understanding of the above-mentioned issues of sequencing;

- *second*, that future changes in the Chinese exchange rate system probably should - and probably will - happen very cautiously.

Conclusion:
As far as the future can be understood in this context, only cautious and gradual changes in the Chinese exchange rate policy should be expected in the foreseeable future - hopefully without neglecting the important issue of sequencing. Both research and practical experience urge for a cautious deregulation of the capital account. Altogether, this should mean limited uncertainty at least about the course of short-term Chinese exchange rate policy.

E. Current Chinese exchange rate policy

China's modern exchange rate history can be summed up very briefly. From the middle of 1994 to the summer of 2005, China officially already had a managed floating system with the USD as *the* benchmark or pegged currency (8,28 in the middle of July 2005). From July 2005 onwards - after a minor revaluation to USD 8,11 on July 21 - the previously, officially not really correctly defined "system of managed floating based on market supply and demand" received the official supplement "*managed floating exchange rate regime based on market supply and demand <u>with reference to a basket of currencies</u>"* [16] (which so far meant an appreciation by about 30 percent against the U.S. dollar - and probably not very different from this percentage against the unknown composition of the currency basket). The link of the RMB to the USD remained very strong until now - despite previous official statements to decouple more from the USD and the supplementary basket construction from 2005 (which actually did not add much to transparency).

Oksanen [17] estimates that as much as 95 percent of the RMB movements may be related to the USD which would mean that the euro's role in China currently must be regarded as even weaker than many observers believe. Since the PBoC in 2011 commented that the currency basket gathers around 20 different currencies - half of them from mature countries, the other half from emerging markets - the USD without a doubt has to be viewed as overrepresented in the Chinese exchange rate policy. Oksanen also points at an important focus, i.e. "the volatility and unpredictability of the RMB against currencies others than the USD and against a broad basket".

Although many comments seem to give the impression that the Chinese exchange rate policy is very rigid, such a conclusion is not quite correct when currencies other than the USD are examined. Oksanen confirms this view. But changes and fluctuations of the RMB also happen vis-à-vis the USD - albeit within strict limits. That is why current Chinese exchange rate policy should still be called *"strictly managed floating"* (which it is *de facto*) rather than - as it is said *de iure* and officially - a "managed floating exchange rate regime based on market demand with reference to a basket of currencies" - whatever the latter definition may mean exactly. This vague information can be completed by the change from April 2012 which allows the RMB to have daily fluctuations in either direction against the *U.S. dollar* by 1 percent (before that it was 0.5 percent). Of course, the PBoC

decided to apply this widened fluctuation - which is a step in the right direction - against the U.S dollar in order to avoid the publication of further details on the composition of the basket.

The status of a "strictly managed floating currency regime" is certainly relatively easy to manage in a technical sense since the more than 100 foreign-funded banks in China account for only 2 percent of the whole banking system's balance sheet. The rapidly increasing international use of the RMB in trade-finance transactions should not serve as an argument that Chinese politicians - and to some extent the PBoC - will be losing their influence on the trend of the Chinese currency any time soon.

It should be added that the website of the People's Bank of China still makes a very opaque and inadequate impression when it comes to online information on the exchange rate policy of the second largest economy in the world. How long will this shortcoming continue in the future?

F. Preconditions for the different policy options - and which risks should be avoided?

There are no general rules for an optimal exchange rate policy in a country. An optimal exchange rate policy of a country may be a function of the status of, for example (without ranking),

- the political system and its political relations to other large global economies,
- the different structures of the economy,
- macroeconomic fundamentals,
- the country's most important trading partners and their development,
- international competitiveness,
- different national resources,
- institutions (transparency and quality of statistics included),
- the degree and speed of domestic financial deregulation,
- the degree and speed of financial cross-border deregulation,
- the maturity of financial markets and the modernization of the banking system,
- the health of the domestic banking system,
- international/global market considerations and external confidence in the country, etc.

The importance of these different indicators for the choice of exchange rate regime may vary substantially from country to country. The complexity of these preconditions has to be considered very carefully in the process of making future change(s) to the Chinese exchange rate system. Making sure that the above-mentioned risk factors - and certainly a number of other sources of possible distortion - are well under control would certainly facilitate China's probable future entry into a new, more market-oriented exchange rate system.

One specific issue in this context is the sustainability of China's surpluses in the current account - surpluses that have come down substantially on trend (2012: 2.6% of GDP) and that may be affected in the future by both ongoing real appreciations of the RMB and China's move to a new, probably more import-intensive business model. But it is too early to predict to what extent the increasing demand for consumption goods in line with China's new business model will be produced in China or

will be imported. We are talking here about a time frame of a couple of years from now, probably even longer.

The risks that may be connected with amendments or changes to the Chinese exchange rate are indirectly listed at the beginning of this chapter. Trends in the wrong direction or policy failures can do a lot of harm and cause major troubles for the RMB. Nobody can regard the RMB as an ever appreciating currency. Therefore the opposite angle should also be considered in a more profound kind of analysis. China's economic catch-up process also means increased responsibility vis-à-vis neighboring countries and the whole global economy.

More details on preconditions for China's different currency policy options can be found in chapter I.

G. Appropriate choices for the future exchange rate regime(s)

Very generally speaking, countries have a choice between flexible and fixed exchange rates. Then there are a number of options that are situated somewhere between these two ultimate alternatives, i.e. with varying focus on either flexibility or stability of exchange rates.

It should be repeated for the introduction to this chapter: currently, Chinese exchange rate policy is mostly in line with a relatively fixed (pegged) system or rather what could be called a *strictly managed floating system*. This managed floating system still exists after officially almost two decades - and since 2005 combined with China's intransparent basket system (which makes the IMF's classification system of de facto regimes somewhat complicated). As mentioned before, the composition of this basket is treated as a state secret. For this reason, financial markets are still mainly watching the RMB vis-à-vis the USD. There is no reason to make a different interpretation these days. In other words: Chinese exchange rate policy is quite opaque, incidentally, as is the case in many other countries.

In previous chapters, it has been shown several times that there is still a need for a large number of extensive economic reforms. For this reason, it will take quite some time before China has reached a position when ambitious - and possible more rapid - financial cross-border deregulations have been achieved.

There is no doubt that China's preference is to maintain for quite some time an exchange rate regime that to a high extent can be influenced by political decision-makers and not by global financial markets. This conclusion means that only two different exchange rate systems seem to be applicable in the coming decade or so. They are:

- (more or less) strictly managed floating (some gradual softening included, in line with possible economic progress what concerns economic and financial structures),

- a new kind of basket system (which should include sufficient transparency; basket vis-à-vis SDR?).

A relatively clean floating exchange rate regime cannot even be expected in the longer run (which, by the way, Japan yet has not achieved either). *McKinnon* [18] some time ago published an article on the issue "why China shouldn't float". His point is mainly that "there is no market exchange rate solution

for an immature creditor country". This view should be shared, particularly in the case of China's large economy - and it should be reminded that China's road to a mature creditor country remains long.

However, if we assume that China's RMB will eventually reach the status of a (nearly) convertible currency, there will be different appropriate or optimal policy choices for the (most probably) long way to a more - let's put it that way - "final" exchange rate policy.

Looking at least ten years ahead - as LNU's China Survey Panel does in the next chapter - different developments will imply different conditions for the optimization of Chinese currency policy. Depending on the future course of institutional reforms and other necessary changes, the alternatives for the most appropriate exchange rate regime may differ considerably. *Christoph Fischer* [19] points very clearly to his results from a nested-logit regression model that long-term structural variables nicely explain the choice between a floating or fixed/pegged exchange rate system.

This whole selection process for the optimization of exchange rate policy can be summarized according to the matrix in chapter I. One should also consider that there may be options between the different exchange rate alternatives given in this chapter.

H. LNU's Survey Panel on future exchange rate policy [20]

It has already been mentioned in this paper that modeling of future Chinese exchange rate policy and the consequences for China and the rest of the world still has to be regarded as far too complex. As demonstrated earlier in this paper, the whole development of the Chinese exchange rate policy must be contemplated from a number of different angles, non-economic and non-financial ones included.

This constellation of complexity means it makes sense to recognize the benefits of surveys on China - surveys that are addressed at specialists on the Chinese economy. Sure, there are econometric models available on the long-term economic outlook of China, but using them in the context of this paper would not lead to greater clarity.

Around 20 economists from academia, the financial industry and other sectors of the corporate world participated in *LNU's China Panel Survey* on future Chinese exchange rate policy in the spring of 2013. The results are as follows:

LNU's China Panel Survey on Future Exchange Rate Policy - Spring 2013

***1.**Do you see any change in China's cautious appreciation policy against the USD in the next few years?* (Not regarding temporary attempts to keep the rate more or less unchanged!)

Yes: 34% No: 66%

My comment:
Two thirds of the panelists do not believe that China will abandon its cautious appreciation policy any time soon. I share this view. There is currently no reason to believe anything else.

2. *When having abandoned the current exchange rate regime…*

	2a)…what **should** be the next step? %	**2b**)…what **will** be the next step? %
Somewhat freer (managed) floating	28	55
Relatively free floating	36	9
Currency basket ("clean")	36	27
Renewal of a kind of fixed regime	-	9

My comment:
Two thirds of the panelists would like to see a kind of freer floating system as the next step, the remaining third the creation of a "clean currency" basket, i.e. with substantially higher weights for other currencies than the dollar, and better transparency. The picture of the most likely outcome, however, looks somewhat different. Here, slightly more than 50 percent of the panel believes in only cautiously relaxed managed floating, and one fourth in a currency basket when the next visible policy step will be taken. The latter answers confirm the conclusions that have been reached in the previous, more basic chapter.

2c) When could this next step happen?

0 – 5 years from now: 19% > 5 years from now: 81%

My comment:
A clear majority of our China Survey Panel does not believe that any *major* change in China's exchange rate system will take place in the next five years. This view also seems to be the most probable outcome.

3) *Which are the __three__ main preconditions for changing from the current exchange rate system to a __clearly__ more flexible/freely floating exchange rate regime?* *__Please rank!__*

No 1: Modernization of the domestic financial market
No 2: Stable domestic conditions
No 2: Further (visible) opening of the capital account
No 4: More transparency

My comment:
The answers to the question above are not surprising. China urgently needs in the first place much more advanced financial markets in order for anything other than very slow changes in exchange rate policy to occur. Secondly, a more flexible/freely floating Chinese exchange rate cannot work without broadly stable conditions at home, i.e. in China itself. Having taken important steps to meet the challenges of the two criteria for modernization of financial markets and necessary domestic stability would also allow for a more visible liberalization of the capital account. More transparency in financial market developments is another point that is mentioned quite frequently by the panelists.

3b) How much is the transition to another - relatively flexible - exchange rate regime linked to the considerable opening of the capital (financial) balance for financial cross-border transactions?

Strongly	Quite strongly	Not so much	Not at all
9%	73%	18%	-

***My comments**:*
Question 3b confirms the previous answers to a more general question about the preconditions for a freer floating exchange rate regime. More than 80 percent of the survey participants confirm here that a considerable opening of the capital balance has to be regarded as relatively substantial for such a change of exchange rate policy to occur.

3c) How much is the transition to another - relatively flexible - exchange rate regime linked to a considerable modernization and marketization of domestic Chinese financial markets?

Strongly	Quite strongly	Not so much	Not at all
18%	64%	18 %	-

My comment:
The answers to this question are almost in line with the previous one in 3b) - with a somewhat stronger emphasis in 3c) on the first alternative what regards the strength of the impact. This is probably the main formal explanation as to why the panel ranks the modernization/marketization of the domestic financial market in the first place in our general, introductory question 3.

3d) Do you see the processes of 3b) and 3c) as a development probably taking place

- in the next 5 years or so 44%
- in the range between 5 and 10 years 56%
- more than 10 years ahead -
- not at all -

My comment:
100 percent of the LNU's panelists foresee that China will take important steps towards a more considerable modernization of domestic financial markets and a more decisive opening of the capital account balance within the next five to ten years. This is my opinion too, but a lot of political will and readiness will be needed to get there.

4) *Your forecast for 2023, i.e. on the China's exchange rate regime 10 years from now – what will it be?*

- Somewhat freer (managed) floating 33%
- Relatively free floating 42%
- Free floating 25%

My comment:
The panel underlines firmly that future moves to a (clearly) more flexible exchange rate system will have taken place by 2023. There are many good reasons for this assumption (rather than forecast). However, more evidence will be needed about the willingness of the recently installed leaders to conduct such a policy which at the same time will lead to a loss of political power. Furthermore, nobody can know today what the domestic and external conditions that influence exchange rates will look like in five to ten years. Logically, bad developments or events are usually not part of the main scenario. Intellectual and commercial flexibility, however, have never be proved to be a bad tool for managing the globalized economy. This general conclusion can also be applied to the future Chinese exchange rate regime(s).

5) *Your forecast for 2023, i.e. on the status of the Chinese currency 10 years from now – will the RMB be fully convertible?*

Yes: 54% No: 46%

Own comment:
Our expert panel is very much divided on the question if the RMB ten years from now will have attained the status of a fully convertible currency - "fully convertible" in the sense

- that the RMB is traded globally,
- that the RMB can be bought and sold anywhere at any time,
- that other central banks keep the RMB in their reserves.

The percentage of roughly 50/50 reflects the great uncertainty on this issue since it is not only an economic forecast that lies behind this estimate - which is difficult enough to handle - but it is an issue that also has political, social and psychological dimensions. One of the main problems in research on China of the type conducted in this paper is that the standard approach to policy making and advice in economics ignores politics and political risks - a phenomenon and deficit that Acemoglu/Robinson very clearly point out. [21]

Conclusion:
The results of LNU's "Special Panel Survey", conducted with China experts from ten countries, provide good support for what has been written in this paper using other, sometimes quite different angles and approaches. The survey confirms, for instance, the elaborated view stated in this paper that China's move to the next exchange rate system(s) will be cautious and gradual. The "journey" to a relatively free floating currency regime is expected to last up to ten years - a development which assumes positive developments in economic and many non-economic respects. In the meantime, China has to do a lot of homework when it comes to the modernization/marketization of its financial markets and the creation of all conditions to accomplish the necessary, relatively far-reaching further opening of the capital account.

I. The European perspective

It is, of course, a rather narrow view to give a future Chinese exchange rate policy a European dimension. China has become a global player both politically and economically. The whole world can benefit from a prospering development in the Middle Kingdom - or the other way around if things go wrong there. This means that the social, economic and financial stability of China most certainly is crucial to the rest of the world, including the United States and Europe.

Nonetheless, it makes sense - despite China's global role - to look at a future Chinese exchange rate policy with European/EU eyes. In this context, this division is caused by the fact that the U.S. dollar and the euro - we assume here that the euro will survive and strengthen its global position - have to be treated as polar opposites on the global currency markets. When the dollar goes down, the euro goes up - and vice versa. It is assumed in this paper that also this relationship will be maintained and will have an increasing impact on the EUR/CNY exchange rate.

This phenomenon/assumption for the future indicates that the U.S. and the EU/EMU countries are not necessarily in the same boat when it comes to reactions to the Chinese exchange rate policy. This means, of course, that over time different preconditions for trade flows between China and the U.S. on the one hand and between China and the EU/Europe on the other hand will occur. For this reason, a European perspective on Chinese exchange rate policy is motivated.

It can be concluded in general terms that any Chinese strong move or trend away from the American currency to the euro would be positive from a European hedging perspective. This will not happen significantly in the near future. At the same time we know that China is very interested in currency risk diversification, i.e. in giving the euro more importance with regards to investment in foreign currency. This would also be more in line with the commercial links of China to Europe/EU. Considering this aspect, it seems very natural for Chinese interests to see the euro fundamentally strengthen its position on global currency markets. Eichengreen expresses this need the other way around, i.e. by "the need of a less dollar-centric international monetary system". [22] However, such a development cannot be achieved without the active contributions of single EU countries by establishing a fundamentally healthy economic policy.

The table below summarizes China's main exchange rate policy options in the future. In line with chapter E, the more detailed policy alternatives of the IMF are not applied in this context. Instead,

the already mentioned special selection of policy options is chosen in the table below - options which in reality also can be located in between our five alternatives.

As far as the other issue of choice is concerned, i.e. between what the IMF calls “de iure” and “de facto”-exchange rate policy, the preference of the IMF since 1998 for the “de facto” policy option - which has been mentioned earlier - is also made in this paper. This position is important when now looking at the European perspective of future Chinese exchange rate policy. However, I cannot share the introductory view of Rajan from the Asian Development Bank’s Research Institute (ADBI) that there is no discrepancy between the de iure and the de facto exchange rate regimes of China (which - initially more or less correctly expressed by Rajan - “operates an exchange rate fixed to the US dollar”; somewhat further on in the quoted paper he adds, however, that “… according to the public statements of the PRC’s authorities, the exchange rate is based on a basket, though the IMF classifies the PBC’s system as a crawling peg…”. [23] Again: I clearly prefer - though not officially used - the de facto-term *“strictly managed floating”* since all other applied terms may be confusing.

Americans or Europeans certainly will not have any direct influence on any future changes in China’s exchange rate policy. China is independent in this respect. But it would, of course, be very valuable if China could give its future exchange rate policy a stance that is in line with its increasingly strong role in the global economy.

This should include a speed in China’s reduction of USD reserves that avoids a sizeable crash of the USD - but also a “greater will to redirect China’s growth model towards a more sustainable path”, as *Dorrucci, Pula* and *Santabárbara* express this need. [24]

Finally, it should not be forgotten that it is not just the issue of sequencing that will be essential for the success of a future change of Chinese exchange rate policy but also the *timing* of such a change. As said several times before, China still has an exchange rate system that can be called “strictly managed floating” - or a “managed pegging to the USD” as other economists may call it. *Frankel* [25] concludes in this context that the experience of exiting from a peg is much better in good economic times than in bad times when the currency may be under attack. In the table below, the whole issue of China’s future exchange rate options is summarized from a European perspective.

Future Chinese Exchange Rate Policy in a European Perspective

	Advantages for EMU countries	*Disadvantages for EMU countries*
Fixed exchange rate policy Preconditions for "success": - Stable macroeconomics - Sustained competitiveness - Economic reforms	- No ex ante advantages (assumption: fixed to the USD)	- RMB may be above or below equilibrium - Locked currency may affect China's GDP - Remaining strong influence of the dollar - Changes of FX regime should happen in a longer perspective (uncertainty)
Basket of various currencies Preconditions for "success": - Stable macroeconomics - "Right" composition of weights - Transparency of the basket - Weight adjustments in time - Good timing for changes	- Higher weight for the euro - Adjustable weights (closer to euro) - More flexibility than fixed system - Trade-based basket closer to reality - Commonly less risky for corporations - If designed well, more transparency for markets	- Uncertainty about future weight changes - Risk of insufficient transparency
Strictly managed floating (without real basket guidance) Preconditions for "success": - Maintained competitiveness - Broadly based stability (good for future policy changes)	- No ex ante-advantages - Relatively well-known for traders (since it is today's system)	- Probably too strong linkage to the USD - The euro remains underweighted - Lagging transparency means shortcomings in the analysis of China
Less strictly managed floating Preconditions for "success": - Macroeconomic stability - Reforms of financial markets - More deregulation of capital account - Increase of transparency	- Better picture of market conditions - Better for Chinese monetary policy - Earlier signals from markets - Better conditions for the PBoC's function as financial stabilizer (via interest rates) - increasing weight of the euro probable	- More space for speculation against RMB - Possible RMB overshooting - Additional uncertainty for planning
Free floating Preconditions for "success": - Stability in all areas - Strategic economic policy - Continuous reform policy - Well-working financial markets - (Almost) complete deregulation of the capital account - Realistic write-offs of bad loans - Satisfactory transparency	- Market conditions determine - Enabling efficient monetary policy - Stronger role of the euro - Better conditions for analysis - Chinese inflation targeting possible	- Vulnerability when "things go wrong "- with negative impact from China on the entire global economy - No "eternal" guarantee for Chinese surpluses in the current account ->may add to uncertainty in the long run with effects on Europe as well - Risk for psychological overshooting

*This matrix is valid under the assumption that euro still exists, and relates, thus, mainly to EMU- or ERM2-member countries.

The table above leads to the conclusion that there is no ex ante preferred choice for a future Chinese exchange rate policy when applying a European perspective. Changing endogenous and exogenous developments with impact on the RMB regime may mean new conditions vis-à-vis the euro as well. Furthermore, it is impossible to say where the euro will stand and what it will be doing five or ten years from now.

Conclusion:
There are no secure ex ante-conclusions on the most advantageous future Chinese exchange rate system from a pure European perspective. Two general conclusions, however, should be noted:
E(M)U countries benefit in general from a decreasing importance of the USD in the future Chinese exchange rate system(s) ***and*** *from stable economic and social conditions in China.*
More cannot be said at this moment.

J. Final conclusions

¤ China's current political leadership has the toughest economic policy job ahead since the start of the opening-up and reform policy in 1979. The main mandates are difficult to handle, among them the avoidance of the threatening middle-income trap - a growth brake that Chinese politicians simply cannot afford, despite all the environmental challenges that plead for a more visible slowdown in industrial growth. Without a doubt, these developments will also have an impact on China's future choices of exchange rate regime.

¤ There are only two logical currency regime options for China in the coming five to ten years, either

- strictly managed floating that may be cautiously relaxed in connection with further reforms, *or*
- a kind of currency basket (giving the euro substantially more weight than is currently the case).

Considering China's antipathy towards major policy experiments, the continuation of a more or less strictly managed floating policy remains the most plausible currency option in the coming years. The strictness may be gradually relaxed in line with the realization of desirable positive structural reforms and the more fundamental establishment of China's new growth model with emphasis on domestic demand.

¤ A Chinese currency basket would be positive for the euro - provided that the euro still is *the* European currency - since it would allow for a closer relationship of the RMB with the euro and vice versa. On the other hand: a real Chinese currency basket would not work well without sending a clear message to financial markets about the composition of the basket and which countries' currencies are/will be part of it. And another detail - the intervention points for possible action/intervention by the PBoC - will probably never reach the general public (which per se would be understandable).

¤ There is no real reason for European or other global companies to include forecasts on the RMB in more strategic investment decisions. There will develop a (somewhat) closer RMB relationship to the euro in five to ten years' time - provided that the euro is still a strong or stronger global currency than today. However, predicting the EUR/CNY rate will not only be an issue based on European developments, but also to a great extent a function of China's quite unpredictable domestic future.

Anyway, the RMB will probably never again be linked closer to the USD than it is currently the case (and for the time being).

¤ Consequently, the optimal Chinese exchange rate regime from a European/EU perspective is a function of conditions for the RMB and for the European counterpart when the time has come for a revised or changed Chinese exchange rate system. Smaller amendments may take place in the coming years - but the really major currency regime shift to a relatively freely floating system may only happen in ten years or so, or even further in the future.

¤ Scenarios can be found for both a stronger and a weakening RMB in the medium and long term. Both alternatives should be considered seriously. Avoiding the so-called middle-income trap is very important in this context. China still has a good chance of escaping the middle-income trap if the new political leadership really wants to put China forward structurally; this would, however, at the same time imply decreasing political power and influence when it comes to important economic and social areas, the exchange rate regime included. Is this what president Xi Jinping and prime minister Li Keqiang really want? The answer is hopefully “yes” - but it is still too early to tell.

¤ *The European dimension:*

Future Chinese currency policy will, of course, be important to Europe. However, economic developments and conditions for the Chinese exchange rate policy five, ten or fifteen years from now are certainly not predictable. This means that the best contribution that Europe can get from China to its EUR/CNY relations must be stable/improving economic and social conditions in China, a nicely re-structured economy (modern financial markets included) and a well-functioning market economy with fairness, honest competition and transparency. E(M)U countries have to make further structural and political progress, too.

It won’t be easy to get there. But both China and Europe have a chance to improve their fundamentals for their mutual benefit - last but not least supported by relatively uncomplicated currency relations. Sure, China has to work hard to achieve the status of a serious partner on the global exchange rate markets. But Europe (EU) has - as already singled out - a lot of homework to do as well in quite a number of different fields in order to achieve satisfactory or good political and economic convergence - and hopefully not the opposite. China would most probably appreciate such a development - an appreciation from China that probably would be beneficial for the euro (ceteris paribus).

All in all: Currency relations between the euro and the RMB may be much more important and exciting five, ten or fifteen years from now than anyone currently could imagine. Consequently, Europe - its politicians and companies included - should use this time to improve their understanding of China as much as possible and establish itself as a continent with new visions and energy.

Hubert Fromlet

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