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## *policy brief*

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## Living With Inflation in the United States: A New Monetary Rule for China?

By *Ronald I. McKinnon*

China's central bank anchored the national price level from 1994 to Sept. 21, 2005, by keeping its currency, the renminbi, fixed at 8.28 yuan to the U.S. dollar. The policy was a great success: Over the period, China's consumer price inflation dropped to around 1 to 2 percent, from over 25 percent, and inflation-adjusted GDP grew at a healthy 9 to 10 percent per year.

Today, however, the U.S. monetary anchor isn't as stable as it once was. U.S. inflation is spiraling upward, with consumer prices rising to 4.1 percent and producer prices to 4.2 percent on a year-on-year basis through July 2006. Clearly, China's foreign monetary anchor is slipping. Worse, the U.S. Federal Reserve Bank has been indecisive about caging the inflation dragon, leaving the interbank federal funds rate at 5.25 percent – an unduly stimulatory level – at its August meeting.

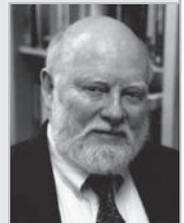
So what should China do? Since July 21, 2005, when the People's Bank of China unhooked the renminbi and allowed a discrete appreciation of 2.1 percent, the mainland's policymakers have allowed the currency to crawl upward slowly. The appreciation totaled 3.3 percent through July 21, 2006 – and seems to be continuing at about this annual rate.

The initial motive for unhooking China's peg to the U.S. dollar was probably to defuse – or confuse – misguided American political pressure to appreciate the renminbi's value versus the greenback. The premise of such arguments, that renminbi appreciation would reduce China's large and growing trade surplus, is widely held but wrong. The trade imbalance between China and the United States results from high saving in China combined with low saving

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### About The Author

**Ronald McKinnon** is the William D. Eberle Professor of International Economics at Stanford University, where he has taught since 1961. He is also a SIEPR/SCID Senior Fellow.



His fields of interest are international economics and development finance. McKinnon has written over 100 articles and several books, which include: *Money and Capital in Economic Development* (1973); *Money in International Exchange: The Convertible-Currency System* (1979); *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, 1993; *The Rules of the Game: International Money and Exchange Rates*, 1996; *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan* (with Kenichi Ohno), 1997; and *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, 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 the world over-including international agencies such as the World Bank and International Monetary Fund.

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in the United States, neither of which is predictably affected by changing the renminbi-dollar exchange rate.

China's inflation *is*, however, predictably affected by sustained exchange-rate changes. Although unhooking the renminbi-dollar exchange rate to reduce China's trade surplus was wrongly motivated, the subsequent small appreciation has had a positive effect: It has helped insulate China from surprisingly high price U.S. inflation. So, should small controlled exchange appreciation now become China's monetary guideline for maintaining internal price stability?

Consider the evidence: China's consumer price inflation registered just 1.0 percent over the year through July 2006, while the U.S. rate hit 4.1 percent. This inflation differential of 3.1 percentage points was consistent with the renminbi's appreciation

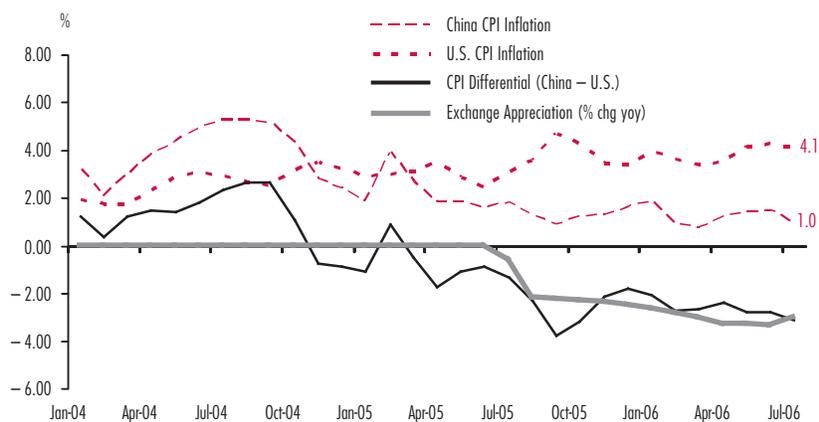
of 3.3 percent year over year, as Chart 1 shows. That the inflation differential mimicked the appreciation so closely is partly a statistical coincidence, and probably unlikely to happen again. Nevertheless, cause and effect are also important. Beyond just U.S.-China trade, the U.S. dollar is an international currency widely used for pricing foreign trade in goods and services in Asia and the world, more generally. When a highly open economy such as China's gears its domestic monetary policy to a slow, but well-signaled, appreciation against the U.S. dollar, its price inflation can be expected to fall correspondingly below the American rate.

This reasoning leads to a new monetary rule for China: Pick some target rate for annual inflation in China's CPI, say 1 percent (it could be as high as 2 percent), then see

how much higher American inflation, say 4.1 percent, is above China's internal target rate. The difference, in this case 3.1 percent, then becomes the planned annual upward rate of crawl of the central renminbi rate against the dollar. As is already the case, the crawl would be tightly controlled by China's central bank, with only tiny movements in the central exchange rate on a daily basis – around which the narrow band of  $\pm 0.3$  percent would continue. And the exact timing of these movements would be randomized so that speculators don't get any free lunches. Finally, if U.S. Federal Reserve chairman Ben Bernanke does succeed in reducing American inflation, China's upward crawl would slow accordingly – and stop altogether when American inflation stabilizes at China's internal target rate.

Although this new monetary cum exchange rate rule is straightforward enough, it has strong implications for the behavior of renminbi interest rates. Those that are not officially pegged are already endogenously determined by the expected path of the exchange rate. Chart 2 shows the paths of one-year interest rates for China and the United States and the yield spread. In May, the yield on dollar bonds quoted in London was 5.7 percent, while that on bonds issued by China's central bank was just 2.6 percent – a spread of just 3.1 percent. Chart 2 then superimposes the path

**Chart 1**  
Inflation of China and the United States and Yuan/Dollar Exchange Appreciation, 2004–2006



of the renminbi's appreciation since July 21, 2005. Remarkably, by July 2006, the two curves conjoin: The 3.28 percent appreciation over the year roughly equals the interest differential! Investors in renminbi assets were willing to accept a lower return because they expected the renminbi to appreciate a little over 3 percent. This interest differential of 3 percent or so will continue as long as investors project that the renminbi will continue to appreciate by that amount – as per our new monetary rule for targeting China's domestic rate of price inflation at a lower level than in the United States.

It is important to keep the rate of renminbi appreciation moderate and in line with the inflation differential between the two countries. Suppose the rate of appreciation was accelerated to 6 percent, with U.S. inflation remaining at 4.1

percent and the U.S. dollar interest rate at 5.7 percent. Financial markets, which are very fast to adjust, would bid interest rates on renminbi assets toward zero – from which they would be bounded from below: the infamous liquidity trap. In goods markets, where prices are slower to adjust, inflation would begin to fall below the 1 percent target – and then could even fall below zero, so as to create outright deflation.

Alternatively, suppose that U.S. inflation slowed to, say, 2 percent and dollar interest rates came down toward 3 percent. Then, if China's central bank stayed with its current policy of a slightly more than 3 percent annual upward crawl of the renminbi, Chinese interest rates would again be forced toward zero, with the threat of outright deflation in the general price level. Instead, the correct strategy of China's

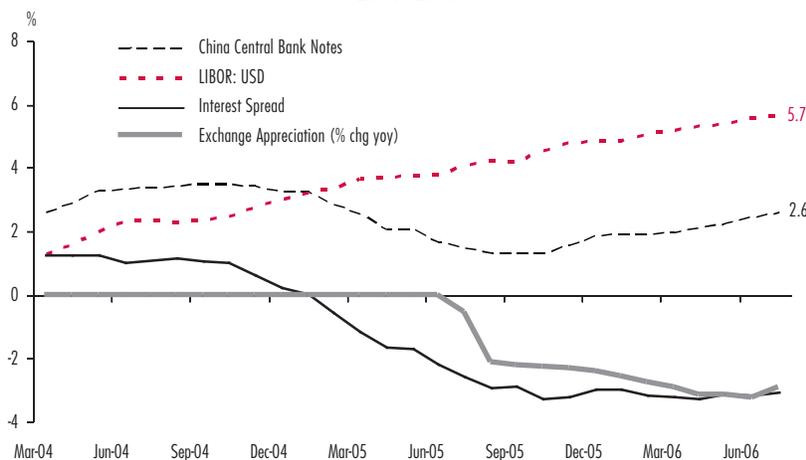
bank becomes, then, to slow the rate of appreciation to 1 percent per year, or slightly less.

Floating the renminbi, which would lead to a large initial appreciation, would be a major policy mistake. China's trade surplus would continue unabated, with a continued accumulation of dollar claims by the private sector that would force successive appreciations of the renminbi until the central bank was again forced to intervene and stabilize the rate at a much appreciated level. By then, expectations of ongoing appreciation and deflation in China would be firmly in place much like what happened to Japan with its ever-higher yen in the 1980s to mid-1990s – leading to Japan's deflationary slump with a zero interest liquidity trap and its "lost" decade of the 1990s.

The bottom line is that China's central bank must carefully watch inflation and interest rates in the United States when formulating its own exchange-rate-based monetary strategy. Any exchange-rate changes against the dollar should be tightly controlled and gradual – as with the appreciation over the past year.

McKinnon is author of *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue*, MIT Press, 2005; Chinese translation, China Financial Publishing House, 2005.

**Chart 2**  
Interest Rates of China and the United States and Yuan/Dollar Exchange Rate Appreciation, 2004–2006



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## Taube Family Foundation

SIEPR Policy Briefs are underwritten by a generous grant from the Taube Family Foundation.