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# Policy action on Chinese Yuan in light of Japan's experience

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## Introduction

Global financial markets appear to show the early signs of stabilization from substantial reactions to the recent series of policy actions on CNY rates by the PBOC. At this moment, I would like to review the discussion with this regard in light of our experiences of economic policy.

## From the perspective of macro economic policy

As discussed by many reports, Chinese government seems to have good reasons for enhancing the economic stimulus, having observed a series of weak economic indicators.

From longer-term viewpoint, policy makers might have been frustrated by deteriorating efficiencies of macro policy measures. While they still have sufficient rooms for conducting fiscal stimulus, they may have already noticed some side effects including further deterioration of excess capacity. In terms of monetary policy, our experiences suggest that its effectiveness could be hurt when and if the banking system would not function very well.

Taking account of these conditions, it could be argued that Chinese government may have decided to use foreign exchange policy to help stimulating the economy. If it would be the case, however, its transmission and absolute effects would be different from those in a textbook.

A number of reports expect that cheaper CNY could increase their net exports. Recent developments of external demand for major economies suggest, however, growth of global economy would be more important factor for international trade.

In fact, our case of QQE implies that depreciation of JPY has worked through 1) inflating overseas profits of our firms, and 2) supporting our rate of inflation to help removing our deflationary minds. We could claim that these would also be the case of China. Nevertheless, regarding 1) above, overseas activities of Chinese firms are on the developing stage.

Transmission mechanism of 2) would be related to another interesting aspect of Chinese economy. As my colleague has often insisted, PPI inflation rate has already been negative for lengthy period of time, while CPI inflation rate has been supported by structural upward trend of food prices. With these backgrounds, policy makers could have motivation to have higher rate of inflation by way of depreciation of CNY.

For the moment, however, policy debate of this kind would not seem to be powerful as it was in Japan in recent years. Probably, positive rate of CPI inflation has prevented deflationary minds; alternatively, higher real interest rates may not have caused serious problems to economic activities in light of still high potential growth rate of Chinese economy.

## From the perspective of foreign exchange policy

According to press reports, officials of the PBOC insisted that their recent policy actions are the part of initiative for flexible exchange rate. This line of thought would make sense from longer-term perspective. Flexible rate regime could contribute to flexible monetary policy when it is absolutely necessary. Moreover, CNY as market driven currency could satisfy an important condition for international currency.

With this respect, it is interesting to note that some reports suspected that the most important purpose of recent policy actions would be to appeal to international financial community, which would pave the way to the inclusion of CNY to SDR. While the welcome comments by Ms. Lagarde on recent policy actions by the PBOC seem to provide supports for this interpretation, we would need to take into account of non-negligible side-effects as discussed below.

Alternatively, even if the policy actions were simply intended to devalue its currency, its implications would not be so straight-forward. As we discussed in the first part, its expected impacts on Chinese economy would not be so simple. Moreover, there remains the issue of its rationalization in international financial community.

With this respect, a number of reports highlighted the fact that the effective exchange rate of CNY has substantially appreciated largely due to "stable" relationship with USD which has considerably appreciated because of the obvious reasons. This is the absolute truth and has important implications for Chinese economy.

Nevertheless, whether CNY would be misaligned or not could be discussed regardless of this fact, because substantial appreciation would already been taken into account for estimation of its "equilibrium" rate. Furthermore, you could argue that any deviation of CNY from recent levels could raise the policy issue, because current account of China has been more or less balanced as my colleague insists.

In any case, however, we could rely on the comments of officials of the PBOC today that allegedly implied the "task" is accomplished. Because, deeper and/or accelerated rate of depreciation of CNY would not bring about benefits to Chinese economy in terms of number of aspects. Most important one would be to stimulate "unofficial" outflow of capital when Chinese government is making efforts to maintain stability of the financial system.

## From the perspective of international finance

As already discussed by some experts, there seems to be less probability of this policy action to trigger "competitive devaluation" in our economic region. First of all, economic relationships of Asian economies (including Japan) with China have become more "vertical" ones except for some cases. In addition, for many of these economies as well, it would not be a good time to conduct a kind of policy action that could stimulate capital outflows from the region.

We would nevertheless need to take into account of political aspects of implications of this policy action. If and when international community would identify some signs of spillover of "cheap currency policy" in our economic region or global emerging economies, tension of the discussion could be heightened at international financial fora. It would not only have some impacts on Chinese policy, but could also have a ripple of effect on future management of QQE.

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