How China has managed to keep the renminbi pinned down

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China's policies have been to keep the renminbi pinned down. The People's Bank of China has been able to sterilize the monetary impact of the massive purchases of foreign currency it has undertaken to buy the exchange rate down (see chart). Moreover, because China's overall savings are so high and its capital market sufficiently segmented from that of the rest of world, domestic interest rates are about as low and a small percentage points below those currently earned on its reserves.

Sterilization — the act of domestic regulations to rig the foreign-exchange liquidity generated by intervention of foreign currency markets — is not merely feasible, but even highly profitable, if one is prepared to ignore the risk of a large ultimate capital loss. In the very long run, the speculating generated by low domestic interest rates is likely to produce enormous demand and inflation, particularly if the economy and the financial system are liberalized. But there is little sign in this that is at all imminent.

The discussion in last week's column concluded that there is a strong case for the Chinese government to adopt the surplus-saving domestic policies, as we've seen in the Chinese people. But the discussion here concludes that they can prevent such an adjustment for a very long time if they wish to do so. So the authorities have a choice. What should they do if they should decide to reduce the surplus account surplus, should they allow large purchases of the renminbi exchange rate or overheat domestic inflation? And how should they do this to avoid real losses? These will be the subjects of next week's final column.


* The data on imports (re-exported) show a significant increase in the first quarter.