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## **An Argument about the RMB Exchange Rate**

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The issue of the exchange rate of Chinese Renminbi (RMB) has been one of the most serious arguments among and between the economists and politicians in the past decades. Especially during the period of the 1997-1999 Asian financial crisis, the debate on the subject had become very political, international and emotional, beyond the boundary of economics and countries.

The Asian financial crisis has been over for nearly ten years but the arguments on the RMB exchange rate are still going on. Therefore, the purpose of this paper is to rethink the debate on the RMB exchange rate held at that time so as to draw some lessons for the present and future discussions on the subject. Of course, as Chinese economists who had been involved in the debate, we have no intention to re-open or to re-provoke such an argument; therefore we shall not cite the names of the scholars, the titles of the publications, and the speeches of the business and the political leaders at the time, which usually will appear in the notes or references of a standard academic literature. However, the lessons or implications, we think, would still be useful for the study of this subject.

### **The different opinions of two economic groups**

It is well known that the most serious financial crisis after the World War Two suddenly happened, without any premonition, in the East Asian region between 1997 and 1999. Since July of 1997, with the attacks of the international speculative capital, the currencies of the Thailand, the Philippines, Malaysia, Singapore, Korea, Taiwan, crashed one after another rapidly. Finally the Japanese Yen, under the tremendous pressures of the international speculators, had been shaken. It seemed that within more than one year the whole area, which had been admired in the world widely through many years, transformed itself from a birthplace of the miracles (e.g. the Japanese Miracle, the Han River Miracle of Korea, the emergence of the 'four tigers', the fast growth of the Southeast Asia and China) into a source of terrible crises and plagues. Although some American economists had given their Asian counterparts the warnings about over-heated and unbalanced growth booms in this area, their words had not been taken seriously because such cautious arguments did not coincide with the tone of mainstream economists, business leaders and politicians at that time.

As a result, when the financial crisis broke out, a large number of unemployment, bankruptcy, economic recession, social turbulence, and political crises occurred in the Asian region. Besides the sharp denouncements to the international financial speculators, one of famous political leaders in Southeast Asia pessimistically forecasted that the economic development of his country might be forced back at least ten years.

Only one bright spot could be seen in the dark sky at the time, however, that was the incredible stability of the Chinese RMB, which had remained at an unchanged exchange rate of one U.S. dollar to 8.26 Chinese yuan.

If we think of this phenomenon from a pure economic perspective, the reason was very simple: the RMB is not a freely exchangeable currency; therefore, it is capable to isolate itself from the international financial market because of its relative independency and security. This may be regarded as a strong point of weak money.

However, it seemed that this strong point of the weak money confused and divided the Chinese economists and the government officials at that time. Therefore, when being asked whether RMB's exchange rate should be changed, or more frankly, whether it should depreciate just as what its neighboring currencies had done, the most economists' answered 'NO'. And, of course, the same or similar opinions, speeches, and publications had become the mainstream in international forums at that time, not only in China.

Meanwhile, there were only a very few economists who believed that the RMB should depreciate. Their arguments were that when the currencies of the surrounding countries had depreciated one by one, the RMB, if remaining fixed, would have appreciated in effect, resulting in the decreases in China's export and employment, and finally leading to the economic recession of the country.

Apparently, it might have been accused as a selfish, recreant and negative idea, as it seemed to escape from the responsibility China should take of maintaining the regional economic and financial stability. On the other hand, the mainstream opinion had been regarded as a brave, valorous and adventurous stratagem that encouraged China to endure the pressure of international speculative capital. However, essentially, the minority's idea was misunderstood widely. Suppose China's economy went to the recession caused by the export decrease as a result of currency appreciation, the region and the rest of the world might suffer more. And to avoid such a nightmare, the RMB ought to depreciate at that special time.

Today, when the time and space has passed nearly ten years, there may not be many readers who would argue that the above suggestion is unrealistic or unpractical or immoral. However, at the time of the Asian financial crises, this opinion had been ignored or criticized widely within and outside the academia. Meanwhile, the opposite opinion of keeping the RMB exchange rate unchangeable, namely, to put the RMB's value upward, had been overwhelmingly appreciated.

We, who had been the members of the non-mainstream scholars at that time, have no intention to reargue with the mainstream economists on the issues such as who has said what, or who were right or who were wrong. What we want is to rethink the discussions on the RMB exchange rate at that time and to provide our readers with some lessons for the future discussions and reform of the issue.

### **Improper methods of mainstream scholars**

The term "mainstream" has multi-meanings. In this paper the mainstream means a group of economic authorities and their followers who can influence, or even directly involve in, the policy-making decisions of the government and the public opinions. This phenomenon can be seen not only in China but also in other countries, not only in academia, but also in other social structures and institutions.

In fact, without a clear statement, this group is not a well-organized institution; their opinions and members often change; and their suggestions are not always accepted time by the government. However, in discussions of the RMB issue during the period of the Asian financial crisis this group became a very strong academic existence and successfully made their opinions into the theoretical background of the government's policies.

Of course, it is not a problem that some scholars are very enthusiastic about or interested in national or international politics. But the problem we thought of is their methods used for supporting their opinion of the RMB appreciation at that time. Namely, it seemed that they

did not pay enough attention to the differences between economics and the politics. To be more specific, the methods they used were not based on the knowledge of economics, finance and currency, which they were familiar with for many years, but the theories or deductions of the international politics that they were not good at. This made their arguments less reliable. The following are three typical opinions they had frequently expressed at the time:

The first widespread opinion of the mainstream scholars was that keeping the exchange rate of the RMB unchangeable was a symbol of the ‘gibbous’ emergence of China, a demonstration of the ‘manner of a big country’, and a ‘responsibility’ that China should take for both the region and the rest of the world. Some went even further by saying that the regional crisis had ‘brought the time of becoming a world power of China more than twenty years ahead’. Otherwise, according to their theories, if the RMB did depreciate, it seemed that China would not have been regarded as a ‘responsible country’, or a ‘big country’, and of course, the ‘time of becoming a world power’ might be delayed more than twenty years later. In fact, they are wrong.

The second mainstream theory which had been frequently accepted was similar to ‘inaction’, an ancient Chinese political philosophy stated by Laozi nearly 2500 years ago, which means to do nothing when one faces challenges or problems. Therefore, to the question whether the RMB should be stable or flexible at the crucial time when the relative appreciation of the RMB had caused the sharp decrease in the Chinese exports, their answer was simply that ‘an action is not better than an inaction (*Yi Dong Bu Ru Yi Jing*)’, and the best choice was to wait and see, or to do nothing to the existing exchange rate of the RMB. This was just like that a doctor did nothing when he faced a patient in danger.

And the last, somewhat gallant and proud theory of mainstream scholars was a moral one: if the RMB did depreciate just like what the currencies of its neighbors did, it would be ‘immoral’. Some put this in a Chinese idiom of *Yi Lin Wei He*, i.e. to treat my neighbors as a gully (in order to contain the flood or disaster from my side). However, they apparently ignored that, if and when the depreciation of the RMB was immoral, then what we can say about the depreciation of the currencies of the neighboring countries? Did they treat China as a ‘gully’ to contain their ‘flood’ of the currency depreciation? Or, can we say that the international speculators were immoral, because they caused the turmoil and crises in the region? Or, shall we accuse the international financial market itself where the hot money can freely flow in and out without any punishment?

Besides the above theories, there were also a lot of other familiar opinions published by the mainstream scholars at the time. It seemed that they were the truth but in fact only the myth. And the myth would not last long. Following the change of exchange rate of RMB took effect from July 21, 2005, all theories of the mainstream scholars mentioned above came to an end. Although the change was only a small step for the RMB’s reform but it

certainly was a big step for the arguments on the subject.

### **The Cases of the Yen and the Dollar**

Another weakness in the theories of the mainstream scholars was that they nearly ignored all the significant facts of the evolutionary history of the main countries and their currencies in the modern world. For example, the cases of the changes of the Japanese Yen and the U.S. Dollar have provided the different theories of the exchange rate against the ideas presented by the Chinese mainstream scholars.

First of all, the depreciation of currency is basically an economic phenomenon, which has no any causality with the size, reputation, feature, responsibility and morality of a country. Since the beginning of the birth of money, its long-term trend, if we have data of an enough long time, is to depreciate but not to appreciate, regardless of its true value or its exchange rate. There is no exception in the world. The reasons of the depreciation could be attributed to the external causes such as the wars, revolutions, recessions, or diseases, flood and so on, as well as to the internal factors such as the intentional or unintentional inflations resulted from unsuccessful economic or monetary policies of the governments. And the final outcome of this long-term depreciation is the death of that currency, namely, that money would exit the circulation and become a part of the collection of someone's hobby. So far, it is difficult to calculate how many kinds of money have experienced such a process of birth, growth and death. However, the following cases of the Japanese Yen and the U.S. Dollar could illustrate as good examples.

Firstly, when the Yen was officially issued by the Meiji government of Japan in 1871, one yen contained the amount of 1500 mg gold at the time. In 1971 when its 100-year birthday came, the gold amount in one yen dropped to only 2.5 mg, or 1/600 of its original gold value in 1871. Similarly, the exchange rate of the yen changed, from that two yens equaled one U.S. dollar in the 1930s, to that 360 yens equaled one dollar in the days of the post-war from 1946 to 1971; it means that if we use the dollar to assess the value of the yen, the latter only equaled 1/180 of that of the 1930s. Therefore, although we see that the yen is 'going up' or 'going down' every moment in the international financial market, it is obvious that, in the historic trend in the last more than one century, the Japanese yen has continually depreciated; and the so-called 'up-going' in the daily market is, in fact, mere a segment and temporary phenomenon of a long-term trend of depreciation.

We would like to take the U.S. Dollar as another example. If we use the gold as a measure to assess its value, we could find in the record that one ounce gold was worth 20.67 dollars in the year of 1837. But in 1934, nearly 100 years later, one ounce gold was worth 35 dollars; in other words, the dollar depreciated by more than 30 per cent, which could be thought of as a modest pace in the time span. In the 1970s the amount of gold of the dollar

dropped dramatically, and in recent months, one ounce gold even reached the highest level of more than 600 dollars. In other words, presently one dollar's gold value is only about 1/20 of that in the 1930s. And no one dares to predict whether such a depreciation process of the dollar would cease or not in the future.

The same cases, of course, could be seen in the other strong currencies of European countries, such as the British Pound, the French Franc, Deutsche Mark, and so on. Furthermore, some of those currencies, which had played dominant roles in the past, already exited the historic arena of international finance. And the Euro, a new European currency has totally replaced all old ones.

So, how about the RMB? Will it be an exception? This is the sticking point that the mainstream economists have intentionally avoided or refused to answer. Frankly speaking, in our point of view, the RMB is not and could not be an exception. For example, the exchange rate between the U.S. dollar and the Chinese RMB has been one dollar to 3.7 yuan in 1950, followed by one dollar to 3.4 yuan in 1960, 2.5 yuan in 1970, and 1.7 yuan in 1980, respectively. It seemed that the yuan has been going up in a 30-year time span hereby. However, after it reached the highest point of the exchange rate in 1980, the yuan began to step into the process of depreciation: one dollar to 4.8 yuan in 1990, 8.3 yuan in 2000, and 8.1 yuan since July 21 of 2005. Of course, the RMB is a younger currency and its fifty-year history could not be viewed as very long in comparison with the Dollar and the Yen. But the long-term trend of depreciation of the yuan is obvious; and although the appreciation of the yuan in the future could be possibly predicted, it is very hard to say that the value of the yuan, measured by the U.S. dollar or the gold, could bounce once more to its highest record of the year of 1980.

If we had paid even little attention to the above facts of the fluctuations of currencies, instead of following the so-called mainstream theories, during the period of the Asian financial crisis, the arguments of the RMB might have been much more practical and beneficial. If we had done so, the RMB would have had more room for the adjustment in the following years.

We would like to point out again: the changes in the exchange rate or in the value of a currency are basically an economic phenomenon. Their political and moral meanings, which should be kept in mind, though, are actually incidental and derivative that, in most cases, were exaggerated by scholars or politicians. In other words, if we had recognized this historic trend behind the currency changes during the period of the Asian financial crisis, the 'correct' or 'feasible' policy for the RMB would have been depreciation.

### **The future of the RMB**

Suppose the RMB had depreciated modestly, say by 10-20 per cent, which was nearly the lowest degree of the depreciation of the Southeast Asian currencies during the period of 1997-1999, as the non-mainstream scholars suggested in those days, and when the regional economy recovered the RMB appreciated again later. Then, the RMB would have become neither a target of international criticisms nor the receiver of the huge pressure from the trade protectionism.

One may reasonably doubt this suggestion made by the minority of Chinese economists. However, compared with the theories of Chinese mainstream economists, the proposition of depreciation is much better. In fact, some mainstream economists have conceded privately that they could have never understood why some international political events happened during the Asian financial crisis showed that the RMB's relative appreciation did not bring economic benefits and spiritual or moral comforts they had originally expected to China. After observing some unpleasant political events, the mainstream scholars became silent, angry, and disappointed. Since the year of 2000 there have been no mainstream scholars who still willingly claim that the appreciation of the RMB in the Asian financial crisis was an admirable choice.

Not only for China, but also for the Asian region the mainstream suggestion was an inferior alternative. When such unprecedented crises as the Asian financial crisis occurred in 1997-1999, the most urgent policy for the region should be one that aimed to reform or to overthrow the fragile financial system and structure of the region, instead of a negative and conservative remedy of maintaining the existing currency institutions. The creation of the Asian Monetary Union or a new regional currency, as some economists within and outside the region suggested at that time, might be one of the policy alternatives. If we had done so, the situation of the region might have become much better. In this sense, the suggestion of the RMB's depreciation by the non-mainstream economists was much more positive and aggressive.

At present, the future of the RMB is still uncertain. The exchange rate of RMB with other currencies such as the U.S. dollar, the Japanese yen and the Euro would become more flexible and the further appreciation of the yuan, say one dollar equals seven yuan or much less, would not be unthinkable in the future. But it seems that the highest point of one dollar to 1.7 yuan in 1980 would not be possible any more. Of course, the dream of the new Asian currency or closer monetary cooperation across the region seems to become even much remoter.

### **Lessons for the economists in other countries**

We think that some lessons, which will benefit not only the Chinese economists but also our colleagues in the other countries, could be drawn from the debate on the RMB's

exchange rate in the Asian financial crisis of 1997-1999.

First, the issue of the currency is basically one of economics, but not one of politics or morality; therefore, the economists, when questioned by the governments and the mass media on the subject, should contribute their advice mainly based on the general economic principles.

Second, the simplified political-moralization of an economic issue, especially the trade deficit or the exchange rate, will inevitably result in the complication of the issue itself. Even high-sounding words like the national responsibility or the manner of a big country, which we often heard in the debate on economic and trade issues in many countries, could become a heavy and invisible burden for the government policy-makers.

Finally, it is very difficult for a single country, no matter how wise or powerful it is, to make a proper economic decision, which can satisfy all its neighbors. Therefore, when economic problems are involved with other countries, the best way of discussions is to put all main parties in a regional or international framework. In this sense, Asia needs a higher advanced organization like the European Union (EU) or the North American Free Trade Agreement (NAFTA) in the future, which is the most difficult work for the regional political leaders.

We want to end our paper with these final words:

The existence of different theories and groups in scholars is a very normal situation and a prerequisite for academic freedom and progress in any country. We need the mainstream group and its theory, of course. Otherwise, the government and the public will become confused, or lose confidence and direction when they face a difficult task in an urgent moment. But meanwhile, there is one danger that should not be ignored: the mainstream could become an obstacle of reforms and progress in some cases, because it puts too much emphasis on maintaining the present institutions and orders to lose the chances of transformation.

In this sense, a society needs a non-mainstream group in order to gain refreshments and inspirations, as well. But on the other hand, the weakness of the non-mainstream is that sometimes it may cause social-economic disorders and this is why it is not so popular. Therefore, the two groups would have more effective discussions. The best economic decision may be somewhere in the middle of the two opposite opinions. This is the final important lesson we could draw from the debate on the RMB exchange rate during the 1997-1999 Asian financial crisis.

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