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Quantitative Easing and the Renminbi
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CAMBRIDGE – The United States Federal Reserve’s policy of “quantitative easing” is reducing the value of the dollar relative to other currencies that have floating exchange rates. But what does the new Fed policy mean for one of the most important exchange rates of all – that of the renminbi relative to the dollar and to other currencies?

The effect of quantitative easing on exchange rates between the dollar and the floating-rate currencies is a predictable result of the Fed’s plan to increase the supply of dollars. The rise in the volume of dollars is causing the value of each dollar to fall relative to these currencies, whose volume has remained constant or risen more slowly.

The Fed’s goal may be to stimulate domestic activity in the US and to reduce the risk of deflation. But, intended or not, the increased supply of dollars also affects the international value of the dollar. American investors who sell bonds to the Fed will want to diversify the dollars that they receive from it. One form of that diversification is to buy foreign bonds and stocks, driving up the value of those currencies.

The Fed’s policy of increasing the supply of dollars also increases investors’ concern about the future rate of inflation in the US. That provides a further reason for American investors to shift part of their portfolios from dollars to other currencies that are not likely to experience rising inflation.

In particular, since the European Central Bank has clearly rejected quantitative easing, investors will want to buy euro bonds issued by Germany and other European countries that are not in danger of default. Likewise, outside the eurozone, Sweden’s clear inflation target makes its currency attractive. South Korea, Brazil, and other emerging-market countries are also attractive diversification investments, causing their currencies to appreciate.

But the market forces that cause those currencies to appreciate do not work on the renminbi, because China has only very limited capital-account convertibility. Investors in the US and other countries cannot buy either renminbi or renminbi-denominated bonds in the way that they can buy other currencies. The Chinese government, acting through the People’s Bank of China, determines the renminbi’s exchange rate.

So the relevant question is how the Chinese government will choose to respond to the Fed’s quantitative easing and the impact of the Fed’s policy on other currencies. Between 2008 and June of this year, the Chinese held the renminbi at a fixed rate of 6.8 to the dollar. In June of this year, the Chinese authorities decided to allow the renminbi to appreciate at a moderate pace, as it had done between 2006 and 2008.

Indeed, in the five months since that announcement, the Chinese government has allowed the renminbi to appreciate by 3.1% – not much less than the average rate of appreciation that it allowed between 2006 and 2008. It is significant that this policy was adopted before Fed Chairman Ben Bernanke’s speech in August, in which he announced his tentative plans for quantitative easing.

While the renminbi has appreciated slightly relative to the dollar since June, the greater fall of the dollar

relative to many other currencies means that the renminbi has generally also fallen relative to those currencies. The overall trade-weighted value of the renminbi has thus declined significantly, particularly relative to the currencies of the emerging-market countries with which Chinese producers compete.

Chinese Prime Minister Wen Jiabao has stressed that China does not want more rapid appreciation of the renminbi, because of the potential adverse impact on Chinese exporters. Rising Chinese exports between 2006 and 2008, despite renminbi appreciation, suggests that this worry is misplaced or at least exaggerated. But it is clear that the fall of the renminbi against other currencies that has resulted from the Fed's policy of quantitative easing now gives the Chinese scope for more rapid appreciation of the renminbi relative to the dollar.

Greater scope for renminbi appreciation comes at a good time for China. A stronger renminbi would help to reduce rising inflationary pressure in China by reducing the cost of imports, which would also increase Chinese households' real incomes – a key goal of China's new five-year plan. Even those Chinese households that do not buy imported goods would benefit, because the lower cost of imported raw materials would reduce the cost of goods produced in China.

In short, the Fed's policy of quantitative easing is likely to accelerate the rise of the renminbi – an outcome that is in China's interest no less than it is in America's. But don't expect US officials to proclaim that goal openly, or Chinese officials to express their gratitude.

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