

Interview with Menzie Chinn

Menzie Chinn is Professor of Public Affairs and Economics at the University of Wisconsin. His research on international finance and macroeconomics has covered topics including exchange rates, financial linkages and crises. In 2000-2001, he served as Senior Staff Economist for International Finance on the President's Council of Economic Advisers. He is currently a Research Fellow at the National Bureau of Economic Research, and has been a visiting scholar at the International Monetary Fund, the Congressional Budget Office, the Federal Reserve Board and the European Central Bank. Below, he argues that a sharp RMB depreciation—while unlikely given the PBOC's desire for stability—should not be cause for market panic.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.



Allison Nathan: What level does the PBOC think is the right level for the RMB?

Menzie Chinn: In the very short term, I think the PBOC is comfortable with the current trade-weighted value of the RMB, which has stabilized in the past four or five months. The PBOC seems to have a clear desire to

stimulate the economy through domestic monetary expansion without further depreciation, so I don't believe a meaningful near-term depreciation is in the cards. But as we look ahead, policies will depend on how economic growth evolves. If the economic slowdown intensifies, my guess is they would probably lean towards letting the currency depreciate further.

Allison Nathan: Chinese authorities have been criticized for what observers view as flawed communication and/or a lack of transparency in their intentions regarding the RMB. But is transparency always helpful in managing a currency?

Menzie Chinn: It is hard to say whether more transparency is unequivocally better. Transparency might be better but only if the stated intentions are credible. For example, authorities could say they will do everything they need to in order to keep the exchange rate stable against the trade-weighted basket, but if they are subsequently unable to follow through on that commitment, then all bets are off. They have to be transparent about a commitment to credible targets and they need to caveat appropriately, e.g., that they will defend the currency at a particular level at all costs as long as economic growth continues as anticipated. Otherwise, the commitment will not be credible, and the currency will remain vulnerable to attack.

Allison Nathan: What options does the PBOC have for managing the RMB in the face of ongoing capital outflows?

Menzie Chinn: The standard rules of international finance apply: they have the options of further devaluation, FX intervention, or interest rate defense. For now, I'm going to eliminate one other option—substantial and persistent tightening of capital controls—because that would run counter to their longer-term program of capital account liberalization. Of the three more likely choices, an interest rate defense is least likely because it would conflict with their goal of stimulating growth, which I believe trumps all else. Even if the PBOC tried to raise interest rates, the fact that such a move would likely

depress the economy means it would be difficult to persuade the markets that higher rates would remain in place for an extended period. In the end, outflows would not be staunched, and policymakers would be forced to relent, thereby damaging policy credibility. That means the authorities are almost certain to pursue a combination of further intervention in the currency markets and some exchange rate depreciation if need be. They have plenty of ammunition to continue to do the former given their still-massive holdings of foreign exchange.

Allison Nathan: What lessons can we draw from past currency attacks and defenses—successful or not—in other countries when thinking about the PBOC's policy choices?

Menzie Chinn: Let me first say that I am reluctant to call China's current situation an attack on the RMB; the currency has weakened because of capital outflows and the deteriorating economic outlook, not because of fear of an impending large and discrete devaluation. It is unfortunately difficult to draw lessons from other countries that have experienced attacks on their currencies because China's circumstances differ in many respects from these historical precedents. First, China has a current account surplus, which is not typical for a country facing a run on its currency. This means that even if China has capital outflows, there will still be some offsetting inflow of foreign currency just by virtue of the fact that they export more than they import. This is a critical difference from countries that rely on capital inflows to offset the deficit in their current account balance. For these countries, if capital inflows cease or reverse and access to borrowing disappears, policymakers end up in a bind—they have no choice but to curtail imports until they match exports.

Second, China has an incredibly large stockpile of foreign exchange reserves, which means that even if the current account-related foreign currency inflows are not sufficient to offset outflows, they can use their reserves to offset depreciation pressures.

Third, they have a vast arsenal of capital controls that they could quickly tighten if need be. These three factors suggest that the market should not be particularly anxious about the potential for a sudden devaluation.

Allison Nathan: Why do many market observers seem to believe that China will have no choice but to devalue sharply, potentially in the near term?

Menzie Chinn: I am not sure, and I don't see why they would need a big devaluation. I do think some depreciation against the

US dollar is probable for the simple reason that if authorities want the RMB to stay roughly constant in trade-weighted terms, and the dollar continues to appreciate as is widely expected, then the RMB will of course depreciate against the dollar. However, I don't think that the Chinese want a big deprecation at this point for at least four reasons. First, it would likely irritate other countries that are concerned about the potential loss of their own competitiveness. Second, it isn't clear how much they would even gain in terms of competitiveness because Chinese exports incorporate substantial quantities of imported inputs. Third, many Chinese corporates have taken on dollar debt, and this debt burden would rise at a time when presumably at least some of them are already struggling because of the slowdown in the economy. Fourth, the Chinese authorities don't like uncertainty and a big deprecation would engender substantial uncertainty on many dimensions.

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Allison Nathan: But will there be a point at which capital outflows become too large to control without a more extreme policy response such as a sharp depreciation?

Menzie Chinn: I don't think so. For now, they will continue to expend foreign exchange reserves to manage the situation. Outflows should also slow for a couple of reasons. First, the rise in outflows related to debt repayment as debtors presumably attempted to get ahead of any further depreciation should taper as debts are of course only repaid once. Second, by keeping the currency stable against the trade-weighted basket, the authorities will hopefully regain credibility in their aim of currency stability, as well as make progress in stimulating growth. Although stimulative monetary policy would tend to weaken the currency, there are also credit channels that can be tapped to spark economic activity and spur additional lending, which can help convince market participants of a more stable path for the RMB and better growth ahead. That would improve perceptions of the returns to capital in China and reduce outflows.

But if push comes to shove and outflows don't subside, authorities could further retrench on capital control liberalization, as evidenced by events in recent days. While they likely can't reinstate all the controls they had before they embarked on liberalization, I think they have a lot of room to tighten controls from here. I think the technocrats at the PBOC would be reluctant to do that, but it is important to note that the PBOC is just one actor and not the final arbiter in monetary and exchange rate policy decisions. So even if the PBOC attempted to preserve the liberalization programs, they would

likely be overruled, especially if the political authorities believed growth was being threatened.

At the end of the day, I strongly believe that everything revolves around growth; if all else fails, Chinese authorities will move on whatever dimensions they need to in order to sustain growth, including a much sharper devaluation.

Allison Nathan: Would a larger RMB devaluation be such a bad thing?

Menzie Chinn: I don't understand the fear of a big RMB devaluation. A sharp slowdown in Chinese economic growth would be bad for the global economy primarily because it would create even more downward pressure on commodity prices, and in turn, stress on commodity exporters and commodity-related sectors. To the extent that a large devaluation reflects such a slowdown, then it is something to be concerned about. That being said, if the growth situation in China is really that bad, a devaluation that will help stabilize growth should actually be welcomed globally.

Beyond what it might be telling us about Chinese growth, a large RMB devaluation doesn't strike me as a terrible thing in and of itself. It would change the relative price of Chinese goods, so that a little bit more aggregate demand would go towards China and away from other countries, unless those other countries tried to depreciate their currencies. And if they did try to match China's currency depreciation, then in essence you would have several players increasing their money supply and re-flating—which might be a worry if the global economy were at the brink of fast inflation, but that is generally not the case today. In fact, many developed economies in particular would likely welcome an inflationary impulse amid concerns about the lack of inflation. So I just don't think the biggest worry today is a short-term collapse in the world economy because China devalued.

Allison Nathan: How significant could spillovers be through the financial markets? Could China be the epicenter of the next global financial crisis?

Menzie Chinn: I don't think so. The first time you saw a US banking crisis turn into a world financial crisis was around 1857. So one way to answer this is to ask whether China has reached a point where we can expect it to be as influential as the US became in the 1800s. And the answer on many dimensions is no. In 1857, US GDP had actually exceeded that of the United Kingdom, which was still considered to be the global financial center. Today, China's economy is still only 64 percent of the size of the US economy. In addition, China is segmented from the rest of the world's economy in many ways, including in terms of capital controls, restrictions on the ownership of stocks and bonds, and a highly regulated—and largely state-owned—banking sector. The only real direct link China has to the global financial markets is through the purchases of foreign assets. So many of the linkages that allow propagation of a financial crisis from one country to another just don't exist. I therefore think there is a chance that China becomes the cause of an economic recession in 2016, but I don't think it will become the epicenter of a financial crisis in 2016.