

**How will the New Exchange Rate Regime Affect the Chinese Economy?**  
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China's announcement on June 19<sup>th</sup> that it will abandon its currency peg to the dollar and henceforth manage the renminbi more flexibly against a basket of currencies will have implications for the world economy, but most of all it will have implications for China. Assume that Beijing now allows the renminbi to appreciate. How will this affect the Chinese economy?

Some warn that there could be a sharp slowdown in Chinese growth, with adverse effects on the export sector and financial markets. They point to the appreciation of the yen in the 1970s and again in the 1980s, followed first by a sharp slowdown in Japanese growth and then a lost decade. Others say that these fears are overblown. They note that the renminbi's appreciation in 2005-8 had little visible impact on Chinese exports and economic growth. The rebuttal here is that the currency's appreciation was so limited in duration and magnitude – the renminbi rose against the dollar by only 7 per cent a year and even that was halted after 12 quarters – that it is not possible to draw general conclusions from this experience. Moreover, the backdrop to the 2005 episode was special: the world economy was booming, and the Chinese economy itself was in an exceptionally strong position. This episode, it is objected, was *sui generis*.

It would be nice if we had a larger sample of analogous episodes from which to draw inferences. In this paper we therefore ask what can be learned from other times and places about the likely effects of China now exiting its de facto pegged exchange rate regime in favor of renewed currency appreciation. It turns out that it is possible to construct a sample of other “exits up,” although the resulting data set is relatively small. We have identified 27 instances where a fixed peg was abandoned and the currency appreciated over the subsequent year either against the dollar or the SDR. Many of these are clustered around the end of the Bretton Woods

System in the early 1970s, although there are also a number of other episodes ranging from Equatorial Guinea in 1979 to Mozambique in 2004 and Malaysia in 2005. The average rate of appreciation in the first year is not too different from China's 2005-8 average of 7 per cent.<sup>1</sup>

What do we find? The average annual rate of GDP growth slows by 1 percentage point between the five years preceding the exit and the five years following. Because countries that exit up were growing faster than other countries in the five years preceding the policy change – by 1 ½ percentage points per annum on average – it is hard to say whether the slowdown is a healthy correction that avoids overheating or something more. One bit of evidence is that countries that exit up were also running higher inflation than other countries in that preceding period, consistent with the overheating view. Their inflation rate is about 5 percentage points higher, too big a difference to be explained away on Balassa-Samuelson grounds.

Importantly, however, there is no growth collapse. Exiting up does not doom the economy to a Japanese-style lost decade. More generally, we find little evidence of economic and financial damage as a result of exits up. There is no increase in the incidence of banking and financial crises. There is no evidence of significant stock market declines. There is no evidence of a significant deterioration in the current account. There is no evidence of a significant fall in the investment rate. A variety of other economic and financial variables are similarly unaffected. While the rate of export growth slows from 9 ½ per cent to 5 ½ per cent per annum, the rate of import growth slows by nearly the same amount.

So what accounts for the growth slowdown in a proximate sense? Since the rates of growth of exports and imports slow by the same amount, the answer is not the contribution of net exports. Nor are there significant changes in the rate of growth of investment and government

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<sup>1</sup> For details, see our paper "27 Up: The Implications for China of Abandoning its Dollar Peg," at <http://www.econ.berkeley.edu/~eichengr/> and <http://faculty.haas.berkeley.edu/arose/>.

spending. Rather, there is a significant slowdown in the growth of household consumption. With the country now exporting less, there is a decline in consumption of both imports and domestically-produced goods (all relative to their prior rates of growth). Again, this could be a healthy adjustment to more sustainable growth rates that avoids overheating. Or it could be that the slowdown could have been avoided entirely had the government boosted public consumption and taken measures, such as liberalizing financial markets and developing the social safety net, to encourage household consumption.

What are the implications for China? The experience of other countries gives little reason to think that an exit up will have seriously adverse consequences for the economy. But it points to the possibility of economic growth slowing. If the authorities wish to limit the risk of an excessive slowdown, they can maintain the level of public spending and redouble their efforts to foster the growth of private consumption. If more domestic spending means more spending on, among other things, imported goods, this will represent a Chinese contribution to global rebalancing.