

"What's Ahead: Decade of the Dollar, the Euro, or the RMB?"

Jeffrey Frankel
Harpel Professor of Capital Formation and Growth
Kennedy School of Government
Harvard University, USA

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I would like to thank Eurobank for bringing me to Athens. Where better than this cradle of civilization to attempt to put current market developments in a longer term perspective?

I want to talk tonight about decades. Each new decade has its own theme, from the perspective of economics and geopolitics.

Consider as an example the 1980s. Japan was seen as an unstoppable juggernaut that was going to take over the world economy.¹ By 1988, the yen had climbed to record levels. Supposedly Asia was becoming a yen bloc. Supposedly economic Japan's success was due to certain features of the Japanese model: long-term investment horizons structurally high saving rates, firms working in groups called keiretsu, lifetime employment, strategic industrial policy, firms that sought to maximize size or market share rather than profitability or stock market value, a financial system built on main banks, and so on.

In the next decade, 1990s, all this turned out to be wrong. The proposition that there was such a thing as too much investment, which had seemed to be only a naïve claim of neoclassical economic theory, turned out to be true after all. Japan had overinvested in autos, steel, and other manufacturing industries, which turned out to have low returns. The same turned out to be true of Korea and some other Asian countries later in the decade. The United States, instead, emerged as the global leader, not just politically but economically as well. The US economic expansion of the Clinton years became the longest in our history. Interest rates and inflation remained low through the end of the decade. The "strong dollar" policy of the US Treasury was triumphant by the late 1990s.² Virtually all other real indicators in the US were also favorable. The explanation for this good performance seemed to be an American economic model, based on competition, innovation, and globalization. [Good macroeconomic policy also played a very major role.]

Forecasting decades is difficult. Most who do it extrapolate from the preceding decade. But this does not work. As in the example I have just given, the apparent

¹ The first was Ezra Vogel, *Japan as Number One* (1979).

² Indeed it contributed a bit to the crises that, beginning in 1997, hit emerging market countries such as Thailand, Korea, Russia and Argentina.

lessons and conventional wisdoms of one decade, which seem to be eternal truths, tend to be abruptly proven false at the beginning of the next decade. Consider the last five decades. The seemingly limitless growth of the 1960s came to an abrupt end with the collapse of the Bretton Woods monetary system in 1971 and the oil shock of 1973. Stagflation followed. By the late 1970s, the new assumption was that oil price increases would continue indefinitely, as would inflation more generally. This extrapolative view, in turn, came to an abrupt end with the recessions and disinflation of 1980-82. The transition from perceived Japanese dominance in the 1980s to US dominance in the 1990s came equally abruptly in 1990-1992. Here I see there as having been three salient events:

- (i) the bursting of the Japanese stock and land bubble in 1990 and the beginning of a decade of economic stagnation in that country
- (ii) the US military victory against Iraq in Kuwait in January 1991, which seemed to put to rest the syndrome of the defeat in Vietnam, and
- (iii) the fall of the Berlin Wall in November 1989 and the collapse of the Soviet Union in August 1991, which not only removed the other competing military superpower, but also completed the demonstration in the eyes of many around the world that the western market model worked better economically than central planning.

How will history regard the current decade? Even though we are halfway into the new decade chronologically, this does not make the task easy. Indeed, somewhat amazingly, we don't yet even have a name for the decade: "0s"? "00s"? "zeros"? "naughts"? At least we don't have a name in English, perhaps you have one in Greek.

It is not hard to list the shocks that abruptly ended the 1990s: The bursting of the high-tech stock market bubble in 2000; the terrorist attack on the World Trade Center on September 11, 2001; corporate scandals such as Enron and Parmalat; and, in the US, the recession of 2001. I personally would also add to the list of shocks the US Supreme Court awarding Florida's electoral votes to George Bush, who from the day he took office in January 2001 abruptly reversed every Clinton policy he could find.³

But I know I am getting too US-centric here, which is not my goal, and probably too partisan to boot. (I am a Clintonite Democrat.) I want to keep this lecture as a tour of the global horizon. So far I have said little about Europe. EMU should be added to the list of fundamental transformations that ended the 90s, and indeed the 2nd millennium. But I will come to the euro later.

I will attempt in the remainder of my speech to say something about trends in six areas:

- (i) globalization of trade
- (ii) interest rates
- (iii) the dollar
- (iv) the euro
- (v) the renminbi
- (vi) emerging markets.

³ Such as dialog with North Korea, vigilance against Al Qaeda, support for multilateralism, attention to the environment, budget surpluses, slow growth in government spending, free trade in steel, etc.

1. Globalization

One of the leading conventional wisdoms with which we ended the last millennium was that globalization was an unprecedented, all-powerful, unstoppable, irreversible trend. The remaining trade barriers would be steadily negotiated away under the new World Trade Organization, and some groups of countries would experience even deeper integration, following the historic example of the European Union. Indeed, the main counter-argument to the proposition that the trend of economic integration would continue was the claim that it was already complete....that distance and borders no longer mattered for trade and finance....that a Greek company could already do business with a partner on the other side of the world as easily as a partner across town.

From the viewpoint of an economic historian or econometrician, it was always clear that some of these claims had been exaggerated. The globalization of the postwar period is not historically unprecedented: by many measures the economic integration of the late 19th century was been every bit as astonishing and consequential as the late 20th century. Some driving forces behind 19th-century globalization were technological: the invention of the steam engine, the railroad, steel-hulled ships, the screw propeller, and the telegraph. Other driving forces were geopolitical: the Pax Britannica and the gold standard.

So the postwar trend is not unprecedented. It is also not complete. It is clear statistically that most firms continue to trade with their neighboring citizens far more easily than across borders or distance, even in the absence of formal trade barriers, linguistic differences, political frictions, and so forth. The ratio of trade to GDP has tripled since the 1940s; but it would have to increase another six-fold before it would make sense to begin talking about perfect integration. Distance and borders still matter.

But these are academic quibbles. There is no question that the trends toward increased trade over the last 60 years, and toward financial integration over the last 30 years, have been strong and important. The interesting question is “will they continue unabated?”

Technological progress usually results—via reduced costs of transportation and communication -- in increased trade from one decade to the next. But this is not inevitable. Social and political forces can sometimes go the other way, and can sometimes be strong enough to dominate. This is what happened between 1914 and 1944, when the clock of economic integration was turned back by war, protectionism, isolationism, fascism and communism. There is no guarantee it couldn't happen again in the 21st century.

I will go out on a limb, and hazard the prediction that, although the globalization trend will continue, some new difficulties may slow it down a bit.

- To start with, progress in the current round of multilateral WTO trade negotiations has been slow and the prognosis is poor. When the Bush Administration began its trade policy by applying tariffs on imported steel that were illegal under the WTO, it sent a strong negative signal, undermining free traders and economic reformers everywhere. Applying the labels “Doha Round” and “development round” sent good signals. But like much of what the Bush Administration does, the actions differ

sharply from the rhetoric. Despite the phrase “development round,” so little attention has been given to the interests of developing countries, that they essentially walked out of the WTO Ministerial meeting in Cancun in September 2003. As we seek to put up barriers to the upsurge in imports of textiles and clothing from China, even though we had agreed through the WTO to end all such barriers from the beginning of 2005 and had ten years to get ready for it, we are sending a signal of hypocrisy to developing countries everywhere. We also should be letting in sugar, cotton, and other agricultural imports important to developing countries.

Europe as well bears a large share of the blame for holding up trade liberalization, particularly in agricultural policy. The next WTO Ministerial in December [meeting in Hong Kong, under new WTO Director Pascal Lamy] seems likely to fail, in part because of slow progress in agreeing to liberalize international trade in services. Relevant services include banking, stock brokerage, health care, transportation, and telecommunications. I hope they include ocean shipping, which is regulated and uncompetitive in the Western Hemisphere, but I am dubious. Liberalization in many of these areas would have a double pay-off economically: improved efficiency within the sector in question, as well as lower costs in other sectors that use, e.g., transportation, as an input into production and trade. Political resistance to liberalizing services appears to be strong in Europe, where even intra-EU integration has been slower than it was supposed to be. Admittedly, on both sides of the Atlantic, the leaders are merely responding to voter sentiment. Recent manifestations include the Schumer bill now in the US Congress and the motivations of some Frenchmen in their no vote on the new EU constitution two weeks ago. These are all reasons to be pessimistic about the pace of multilateral trade liberalization.

But governments’ trade policy is only one factor that determines the pace about globalization. Let us consider some others

- What about the internet? It is unquestionably giving a huge boost to international trade in services. But face-to-face contact will always be important. Even when the cost of transporting the good or service is zero, as over the internet from India, managers, salespeople and technical people have to make the trip between Bangalore and the West. September 11 and the American “war on terrorism” have put up a number of barriers. National security concerns have made travel between the US and the rest of the world more difficult (I am thinking of airport security, visas, etc.). At schools like Harvard we have seen a drop in enrollment of students from overseas, especially in executive programs. For merchandise trade, which remains by far the largest component of trade, the US would like to impose high security standards to prevent the smuggling through container cargo of bombs or terrorists.
- High fuel prices currently are another factor raising the cost of shipping.
- Turning to the area of contagious disease, mad cow disease and the SARS epidemic a few years ago each produced quarantines – of cattle and people, respectively. This might be a small advanced taste of what lies in store from more serious epidemics.

I am not predicting an outright reversal of globalization. As bad as a single nuclear weapon in a cargo container would be, it would take more than that to return us to the

dire circumstances of the first half of the 20th century. Nevertheless, the first prediction I offer is contrarian enough for me: a possible slowdown in the rate of growth of trade relative to GDP.

Let us now turn from trade to finance. People can buy and sell securities across the globe even more easily than goods and services. Cross-border financial arbitrage is almost as powerful as its reputation [though, again, not quite].

2. Outlook for interest rates

I am one of those who view it as a puzzle that long-term interest rates are as low as they are currently, especially in the US. A conundrum. Because credit risk spreads are low, the puzzle applies even more to so-called “junk bonds” or “high-yield bonds.” [Today I would say that “high-yield” is the euphemism and “junk” is the more accurate description, rather than the other way around.]

To declare a “global savings glut” is not enough of an explanation for the low interest rates.⁴ Yes, the Chinese save a lot, and yes, the continued erosion of capital controls and other barriers to international flows mean that countries’ interest rates are determined jointly. But China has a *low* capital/labor ratio, not a high one. Net private capital flows are going *in* to China, not out. Meanwhile, where the Japanese people and government were legendary for high saving rates in the 1980s, that has disappeared. The demographic retirement boom has hit Japan before the rest of us, and so their saving rate is going down, not up. In any case, world interest rates are not primarily determined in Asia. In theory, financial conditions in Europe should count as much as those in the US, since the economic size is similar. But for some reason, the Federal Reserve apparently continues to exercise more influence over world interest rates than does the ECB.

The big mystery is in the U.S. We have a White House that has cut tax rates sharply, increased military spending rapidly, and – contrary to its rhetoric -- increased domestic spending as well. Much as in the first Reagan Administration. Also as in the 1980s, private saving in this decade has fallen alongside public saving. Given that national saving is so low, why are real interest rates not high like they were in the 1980s? Why has the bond market remained so strong? Some say that the world has changed, that globalization and broadening of financial markets mean that larger quantities of government debt can be absorbed at lower interest rates (Martin Feldstein, Alan Greenspan). I say that some special factors have kept US interest rates temporarily low over the last four years, and that they are soon coming to an end.

I have three factors in mind.

1. The Fed pursued unusually easy monetary policy during 2001-04. In this respect, the period has been more like the late 1960s and early 1970s, when the Fed under Chairman Arthur Burns accommodated the expansionary fiscal policy of the Vietnam War era [ultimately bringing down the Bretton Woods system] than it is like the 1980s

⁴ I am responding here to comments from, among others, Ben Bernanke; and Dooley, Michael, David Folkerts-Landau, and Peter Garber, 2003, “An Essay on the Revived Bretton Woods System,” NBER WP no 9971, Sept.

mix of loose Reagan fiscal policy combined with Paul Volcker's monetary discipline. To put it simply, the Fed bought a trillion dollars of US treasury securities during the George W. Bush's term, so their price has been kept high. But the Fed has been steadily removing this monetary ease over the last year, and plans to continue raising short term interest rates awhile.

2. The second factor is that other central banks have likewise bought almost a trillion dollars of US securities during this period, in efforts to prevent or moderate the appreciation of their currencies. Especially in Asia, central bank reserves are now huge, and I believe that they will soon tire of continuing to add to their holdings of dollars.

3. Third is public perceptions regarding the US fiscal outlook. What is most objectionable about the Bush fiscal policies is not that they created record deficits in the early part of this decade. Keynesian theory says that we could have used some of the stimulus in 2001 and immediately thereafter. What is most objectionable, rather, is that Administration policies have all but locked in similarly huge deficits for the coming decade, and much larger ones subsequently if the programs associated with the retirement of the baby boomers are factored in. But official US government projections in 2001, and still today, pretend to believe that the budget deficit will gradually improve over the subsequent decade; they do not accurately reflect realistic paths for spending and tax revenue. Perhaps because they are still reading about the official projections in the newspapers, most citizens and most investors are not aware how bad the situation is. I believe that this misperception of the magnitude of the problem is another factor that has helped keep interest rates low, but is another factor that will gradually correct itself in the future as reality proves the forecasts false.

When will the day of reckoning come? I think the US Administration will try to continue its remarkable record of ignoring fiscal reality for another few years. Each of the last four US presidents has initially run for office on platforms that called for unrealistically low taxes. But the others adjusted course during their first few years in office, as reality was observed to deviate from the script that the presidential speechwriters had prepared. George W. Bush shows no sign of responding to incoming data [either on fiscal policy, Iraq, or anything else]. So I think the correction will have to come from investors, not from our government.

If I am right, as each of the three factors that have helped support the US bond market over the last four years – easy US monetary policy, support from Asian central banks, and unrealistic budget perceptions -- diminishes, the underlying weakness in the fundamentals will come to the surface. Long term interest rates will rise from their current vicinity of 4%, to 6% at least, and possibly substantially higher. Given financial integration and the asymmetric influence that US financial markets have on other countries, interest rates in the rest of the world will probably follow. After all, the outlooks for budget deficits and pension demographics in Europe and Japan are even worse than in the US anyway.

One of the vulnerabilities in the world economy is that the coming decline in the bond market might be sudden and disruptive. Real estate prices are very high in many

countries around the world.⁵ One reason is the relative ease of monetary policy over the last few years. Regardless whether one views the real estate appreciation as a bubble or as a rational response to low real interest rates and high availability of credit, a sharp increase in interest rates could bring an abrupt end to the housing boom. This in turn could contribute to economic recession, especially in light of high leverage of households in the US and high sensitivity of mortgage rates in the UK.

3. The dollar

Another difficult question is whether the coming rise in US interest rates will occur as part of a “hard landing” in which foreign investors pull out, and the dollar falls abruptly in tandem with US securities prices.

The US budget deficits that returned with this decade, and low national saving rates, have translated into record current account deficits. These twin deficits are similar to those of the 1980s, but bigger. I believe the current path of the US current account deficit – 6% of GDP, and perhaps continuing to climb on current policies – is not sustainable in the long run. For this reason, my position on the dollar for the decade as a whole has been bearish.

For 2005, the situation is temporarily different. US interest rates are going up, for the reasons I have said, and are now once again well above European interest rates. This attracts investors to the dollar. This is a reversal of the situation a year ago. Then we still had the famous “dollar carry trade,” when low US interest rates sent money into foreign currencies (along with real estate, commodities, emerging markets, and just about everything else). Meanwhile, growth in the main European economies has all but disappeared. As a result, the dollar may well be going up in the short term, before it goes down. But I think this reversal [which I had predicted] is temporary. Over a ten year horizon, I think the downward trend must resume. The current account must by definition be either adjusted or financed; either way, a dollar depreciation will almost certainly have to be major part of the process.

If an Argentina or Turkey exhibited the same debt path numbers that the US is currently, investors would be thinking “crash,” if indeed a crisis had not already some time ago. The main thing that is different about the United States is that it is able to borrow large sums of money, denominated in its own currency, at low interest rates. This is the “exorbitant privilege” of having the dollar as the world’s premier international currency. An international currency is defined as one that is used outside its home country, for a variety of purposes. One of the most important aspects of an international currency, and one that is easily quantifiable, is its share in the holdings of reserves by central banks. The dollar lost some ground to the mark and yen in the 1970s and 1980s, and then recovered in the 1990s. Certainly central banks in Asia have been scooping up

⁵ From QIII of 2003 to QIII of 2004, average increases in housing prices were 13% in the US, 14% in Britain, 15% in France, 17% in Spain, 31% in Hong Kong, and 35% in South Africa. (Source: *Economist* in *NYT* 12 June, 2005, p. 4)

many billions of dollar reserves in this decade. The question is whether this will continue, or at some point they will diversify out of dollars into other currencies.

4. The euro

The question of whether the dollar would be challenged for its international currency leadership status has arisen before, in 1979, 1988, and 1995 [once a decade!]. Each time the journalistic speculation that the dollar might have to relinquish the number one spot was premature. But this time may be different.

The difference is that the euro now exists as a plausible rival. Notwithstanding the bumps in the road of European monetary integration and the doubts of many American economists, EMU became a reality in 1999, and the euro appeared in physical form four years later. The new currency passed the most fundamental tests: the transition was relatively smooth, 12 countries today use the euro, and the new currency has entered into international use as well. The dollar still dominates the reserve currency rankings easily, with 65% of the total, as compared to 15% for the euro. But the euro is clearly the leading rival.

In the first few years of its life, the euro did not receive much respect. This was largely related to its substantial weakness against the dollar. But subsequently this depreciation was fully reversed in the strong appreciation of 2003-04. Thus there now exists a potential serious rival to the dollar, where ten years ago there was none. Indeed, as the rise of the dollar/euro exchange rate reached its third year in late 2004, the newspapers began to report that central banks were on the verge of large-scale diversification out of dollars.

A recent paper I wrote with Menzie Chinn sought to ascertain the determinants of international reserve currency status, and to make some predictions as to whether the euro might under some conditions eventually overtake the dollar, and if so when.⁶ We looked at data on reserve currency holding since 1973 to ascertain the role of various determinants. [We found three kinds of variables to be statistically significant:

- Size of the home economy, as measured by GDP. Here the US is currently still slightly ahead of euroland.
- Depth of money markets in the financial center of the home country. Here New York remains far ahead of Frankfurt.
- Measures of rates of return on the various currencies, specifically the inflation rate, the trend of currency depreciation, and the variability of the exchange rate.
- Another strong finding is that currency shares evolve very slowly. Everyone wants to go on using the same currency that everyone else is using, which has been the dollar for at least sixty years. If there is a tipping to some new currency, it is not going to happen soon.]

⁶ Chinn, Menzie, and Jeffrey Frankel, 2005, "Will the Euro Eventually Surpass the Dollar, as Leading International Reserve Currency?" For *NBER conference on G7 Current Account Imbalances: Sustainability and Adjustment*, Newport, RI, June 1-2.

The major pay-off of the paper is predictions about scenarios under which the euro might in the future rival or surpass the dollar as the world's leading international reserve currency. That question appears to depend most importantly on two things: (1) whether enough other EU members join euroland so that it becomes larger than the US economy and, in particular, whether the UK comes in, with its large financial markets; and (2) whether US macroeconomic policies eventually undermine confidence in the value of the dollar through inflation and depreciation. We estimate, contingent on either of those two things happening, how quickly the euro might rise to challenge the dollar. We project that if all 13 EU members who are not currently in EMU join it by 2020, including the United Kingdom, then the euro overtakes the dollar in 2022. We also find that even if some of these countries do not join, a continuation of the recent trend depreciation of the dollar, were it to occur for whatever reason, could bring about the tipping point even sooner.

Euro enthusiasts have suffered serious setbacks so far in 2005: A slowdown of some major economies [Italy, France, Germany], the ever-clearer mockery of the Stability and Growth Pact, rejection of the new EU constitution in French and Dutch referenda, and a new depreciation of the euro, and the failure to agree an EU budget deal. I don't currently see the European economic model as likely to replace the American model anytime soon as a distinct variant of capitalism that is attractive to the rest of the world.⁷ To be sure, there is much to admire in Europe. In my view, the US model has been tarnished by corporate scandals and political incompetence. I personally favor a more generous social safety net than we have in the US [which does not mean, incidentally, subsidies for farmers and elderly who are richer than the average of the population]. Our abdication of leadership on global warming and a host of other issues is appalling.⁸ And I think it is quite possible that we Americans work too hard, and that Europeans are more advanced in their approach to leisure and the quality of life. But the European model is simply not delivering the rates of economic growth that people everywhere want. I think slow productivity growth can be attributed to the familiar rigidities in labor and goods markets that economists point to, and that are unlikely to be successfully reformed, in light of popular resistance.

All that aside, most assessments of the sustainability and adjustment of the US current account see a role for substantial depreciation of the dollar in the future.⁹ Our results suggest that such dollar depreciation would be no free lunch, and could have profound consequences for the functioning of the international monetary system. It is for those reasons, and at a 20-year horizon, that I dare to suggest the euro could eventually overtake the dollar.

5. The renminbi

⁷ In other words, I can't sign on with such Euro-philes as Jeremy Rifkin, *The European Dream: How Europe's Vision of the Future is Quietly Eclipsing The American Dream*, Penguin: NY, 2004.

⁸ "How the US Government Flubbed Its Opportunity to Exercise Global Economic Leadership," published as "Bush's Spectacular Failure," *The International Economy*, Spring 2004, pp. 22-27, 71.

⁹ whether operating via expenditure-switching or a valuation effect.

Now back to Asia. If Japan was considered the new Number One economic model in the 1980s, and the United States model reigned supreme in the 1990s, it seems that this is going to be the decade of China. China's growth has been miraculous, and it will indeed become increasingly influential in international trade and finance.

Just as Europe's economic weakness need not prevent the euro from rising internationally, so China's economic accomplishments need not mean that its currency, the yuan or renminbi, will rise in value or expand in role anytime soon. As regards international currency status, China is still far behind the dollar and euro, or even the yen, pound and Swiss franc, in the attributes that suit a currency to international status, particularly financial markets that are deep, liquid and open. Indeed, China will probably have to pass through the rite of passage of a speculative bubble and financial collapse [as did the Netherlands in 1635, Britain in 1711-1722, US in the 1920s, and Japan in the 1980s], before it moves on to the phase in which the RMB is ready to take its place on the stage of international currencies.

But the "hot" issue currently concerns not eventual international currency status for the renminbi, but rather whether China should abandon its eight-year peg to the US dollar.¹⁰ The logic of many Americans starts with the proposition that a general depreciation of the dollar is necessary to gain competitiveness, reduce the US trade deficit, and thereby reduce unemployment. It then notes that the dollar already depreciated against the euro and other currencies in 2002-04; so that leaves the renminbi and some other Asian currencies. It concludes with accusations that China is unfairly manipulating its currency, thereby violating some law or other. The Democrats are even worse than the Treasury on this one.

My view is that any country is free to choose to peg its currency if it wishes. Thus allegations of "illegal exchange rate manipulation" are probably inappropriate. It is not even true that an appreciation of the renminbi against the dollar would have an immediately noticeable effect on the overall US trade deficit, and still less on employment, though the effect on the US trade balance would eventually be moderate if other Asian countries were to respond by letting their currencies appreciate against the dollar as well. But in any case, the first order of business for China should be to determine what policy is in its own interest.

American politics aside, I can think of a number of good reasons suggesting that the de facto dollar peg may now have outlived its usefulness for China.¹¹ (1) China's economy in 2003 crossed over to the threshold of overheating, and appreciation would help ease inflationary pressure. (True, inflation is not especially high. But real estate prices are very high, and vulnerable.) (2) Although foreign exchange reserves are a useful shield against currency crises, by now China's current level is fully adequate, and US treasury securities do not pay a high return. (3) It becomes increasingly difficult to

¹⁰ To be sure, some policymakers in the US, and China as well, use phrases like "internationalization" or "liberalization" to confound the two issues of allowing the exchange rate to be more flexibly determined and removing controls on international capital flows. But the two issues are in fact distinct. This is one of several respects in which US Treasury pressure on China to appreciate the RMB today echoes pressure on Korea to appreciate the won in the late 1980s and on Japan to appreciate the yen in 1984.

¹¹ Frankel, Jeffrey, "On the Renminbi: The choice between adjustment under a fixed exchange rate and adjustment under a flexible rate," *High-Level Seminar on Foreign Exchange System*; Dalian, China, May 26-27, 2004. KSG Working Paper RWP04-037, Aug. 2004. NBER Working Paper, 2005.

“sterilize” the inflow of money over time, which means exacerbating inflation. (4) Although external balance could be achieved by expenditure reduction, e.g., by raising interest rates, the existence of two policy goals (external balance and internal balance) in general requires the use of two independent policy instruments (e.g., the real exchange rate and the interest rate). (5) A large economy like China can achieve adjustment in the real exchange rate via flexibility in the nominal exchange rate more easily than via price flexibility. (6) The experience of other medium-sized emerging markets points toward exiting from a peg when times are good and the currency is strong, rather than waiting until times are bad and the currency is under attack. (7) From a longer-run perspective, prices of goods and services in China are low -- not just low relative to the United States (.23), but also low by the standards of statistical relationship based on productivity estimated across countries (which predicts .36).¹² In this specific sense, the yuan was undervalued by approximately 35% in 2000, and is by at least as much today. The paper finds that, typically across countries, such gaps are corrected halfway, on average, over the subsequent decade.

[These seven arguments for increased exchange rate flexibility need not imply a free float. China is a good counter-example to the popular “corners hypothesis,” which is a recommendation against intermediate exchange rate regimes like basket pegs or target zones.]

So much for what the Chinese authorities should do. To predict what they will actually do is more difficult. Last year I attended a conference in China to discuss the pros and cons. At the end, a senior Chinese official summed up his reaction roughly as follows, “I have listened to both sides of this debate. Here is what I think. I think those such as Robert Mundell who have called for a fixed exchange rate are right in the short run. And I think those who call for a more flexible exchange rate are right in the long run. How long is the short run, you ask? You must understand. China is 8000 years old. So when I say, short run, it could be 100 years.”¹³ My guess is that they will do something within a year or two, but it will fall far short of satisfying either the expectations of speculators or the complaints of Americans. Thus the situation will continue much as before.

The flow of capital to China in recent years might be seen as just another instance of the flow of capital into most emerging markets, which leads to my sixth and final area for prediction.

6. Emerging Markets

Emerging market interest rates are doubly low: once because the US Treasury bill or LIBOR benchmarks are low and again because the spreads are low (much like corporate interest rates). It is clear that easy monetary policy, in the form of low real interest rates, especially in the United States, helped fuel the flow of capital into emerging markets during 2001-04, much as they had in the late 1970s and the early 1990s. It is also clear

¹² In the academic literature, this relationship is known as the Balassa-Samuelson effect.

¹³ Dalian, China, May 2004, as paraphrased by author.

that tightening of monetary policy during 1980-82 helped precipitate the international debt crisis, and the same in 1994 for the Mexican peso crisis. The question is, with interest rates now again on the rise, will international investors this year pull out of emerging markets and precipitate a new round of crises? Other markets now look vulnerable to a reversal of the 2001-04 “dollar carry trade” – real estate, bonds, commodities... Why not emerging markets too?

Interest rates are of course not the only determinant of the demand for emerging market securities. As with stock markets, prospects for growth are as relevant as the discount rate. These look good for many developing countries.

As important as growth fundamentals is investor sentiment. The waves of sentiment for emerging markets seem to follow the biblical pattern: 7 fat years followed by 7 lean years. Consider the last 30 years:

- Strong capital inflows during the seven years 1975-1982,
- Net outflows during the “lost decade” that followed the 1982 international debt crisis 1983-1989.
- Strong inflows again 1990-96.
- And outflows during the East Asian and subsequent crises 1997-2002.

If this pattern holds true, we are still at a relatively early stage of the boom cycle, and not particularly vulnerable to interest rates or other shocks.

Is the biblical cycle to be taken seriously? What is the mechanism? 7 years may be how long it takes for a given class of investors to forget about the risk of a crash, to decide that they are living in a new world, and to overextend themselves. Perhaps the mechanism is job turnover in banks and other institutional investors. In any case, it seems too soon to worry. Today’s investors are aware of the risks, and not overextended.

***For references cited and further development of these ideas, go to
<http://ksghome.harvard.edu/~jfrankel/currentpubsspeeches.htm>.***