THE IMPACT OF THE U.S QE POLICY ON CHINA’S MACROECONOMY
AND THE RMB INTERNATIONALISATION STRATEGY

By

Dr. Tu Yonghong

Abstract

Four rounds of implementation of unconventional monetary policy called Quantitative Easing Policy flooded the world with USD, which not only somewhat stimulated the domestic market in the U.S., but also undoubtedly led to enormous spillover effect in other nations. As the biggest and second biggest economies, the United States and China have not only shared trade in goods but also capital flows on a large scale, and engaged in ever closer economic relations, it is hard for China’s economy to avoid any impact from QE. However, China’s economic growth model, economic cycle and economic management style has its own characteristics. Moreover, China uses the exchange rate regime reform, and encourages the cross-border use of RMB, to a large extent, to reduce the impact of the U.S. QE on China’s domestic economy. Nevertheless, China's monetary aggregates and price fluctuations are still significantly influenced by the U.S. QE, and this effect is getting stronger as time goes on. China's rapid development of the internationalization of the RMB allows the RMB to enter the ranks of the world's top ten trading currencies. Using RMB in foreign trade invoicing and settlement, increasing foreign loans (FDI) and the rising offshore market activities are the main driving forces to promote the internationalization of RMB. However, RMB's internationalization still has a long way to go, and China needs to strengthen financial cooperation with other countries and allow the market to play a greater role, on the basis of mutual benefit.

1. Recent Developments

The Subprime Crisis had a severe impact on the U.S. economy, causing a sharp decline in economic growth in its wake. In response to the economic downturn, the Fed announced on September 18, 2007 that it would cut the federal funds rate from 5.25% to 4.75%. This was the first Federal Reserve interest rate cut since June 2003, and from that time, the United States entered the loose monetary policy period. After eight consecutive times of lowering the federal funds rate, there was still little success in stimulating the economy. To suppress a further

21 Professor, School of Finance, Renmin University of China.
slowdown in economic growth, the Fed launched the unconventional “quantitative easing monetary policy”. On November 25, 2008, the Fed first announced the purchase of agency debt and MBS, marking the beginning of the first round of quantitative easing. And then, on November 4, 2010, September 14, 2012 and December 13, 2012, the Federal Reserve launched the second, third and fourth rounds of quantitative easing. In order to alleviate the recession and maintain coherence with the Fed’s monetary policy, Japan, the UK, the Euro Zone, Australia and many other countries and regions began implementing similar policies of quantitative easing.

Under the USD-centered international monetary system, the cumulative effects of U.S. quantitative easing policy are bound to have a decisive impact on the global economy. The United States is China’s largest trading partner, and the economic interdependence between two sides is relatively high; China’s huge foreign exchange reserves are mainly USD, and China is also the largest holder of U.S. Treasuries. Regardless of the domestic economy or the financial markets, China will inevitably be subject to the fallout of United States QE. As China’s current economic structure is undergoing restructuring, and the financial system needs to be strengthened further, facing the external spillover effects on China’s domestic economy from U.S. QE are necessary for China’s steady development while maintaining risk aversion.

2. The U.S. QE Policy’s Influence on the World Economy

As the world’s largest economy and the issuing country of international reserve currency, the United States and its QE policy will undoubtedly take advantage of the fluctuations of both, interest rates and exchange rates, which could have an impact on international capital flows and international trade, by transmitting the effects of its monetary policy to other countries, thus dealing a heavy blow to the global economy. The influence of the U.S QE policy operates as follows:

2.1 Promote world economic growth. Since a loose international monetary environment is conducive to the economic growth, the U.S. QE policy has increased the international supply (global liquidity) of its currency. According to McKinnon’s (1964) two-gap model, for those countries with low savings or capital constraints, the global liquidity inflow could improve their ability to pay for imports to purchase the machinery and equipment which are required for economic development, which then increases labor productivity as well as promotes the growth of output and income.

For countries with a fixed exchange rate system, the QE policy could affect output just as the one caused by the expansionary monetary policy, boosting these countries’ GDP growth or inflation. The mechanism operates as follows: growing supply of USD→dollar depreciation→boosts exports growth of the U.S.→higher import growth of the U.S.→exports growth in countries exporting to the U.S.→higher GDP growth in these countries; Meanwhile, export growth of any one country→increase of its national foreign
exchange reserves→ to maintain the national currency exchange rate the central bank may be forced to pump more money into the economy →further GDP growth and/or inflation.

For countries with a floating exchange rate regime, the U.S. QE policy is likely to have a negative effect, as "shifting the trouble upon them", results in the decrease of their GDP growth. The mechanism of the QE policy runs like this: growing supply of USD→export growth of these countries→currency appreciation→higher import growth of these countries→decline of their GDP growth. Due to price rigidity and the fact that international assets cannot be completely replaced, countries with a floating exchange rate regime could also benefit from the increase of GDP (Obstfeld and Rogoff, 2001).

2.2 Trigger cost-push inflation. QE policy has an external transfer effect, which could possibly lead to cost-push inflation in other countries. The mechanism of QE runs like this: growing supply of USDs→exports growth of other countries→currency appreciation in those countries→if the amount of appreciation is lower than that of rising import price→higher import costs or indirect wages of domestic enterprises→domestic inflation. After 9/11 the US reduced the interest rate seventeen times and implemented sustained loose monetary policy in order to stimulate the weak economy, which not only resulted in a significant rise in commodities prices of commodities like crude oil iron and others, but also in the inflation to a different extent all over the world. For example, 73% of the Euro zone’s inflation was due to this. There emerged rare inflation in China during this decade, when the CPI went up 6.5% year-on-year in August 2007, much higher than the 3% of the targeted policy goal. Dingzhiguo et al. studied the direct influence and indirect effects of the U.S. monetary policy on Chinese inflation based on a FAVAR model in 2012. The U.S. market liquidity, led by M2 had strong and continuous positive spillover effect onto Chinese inflation through the main channels of trade credit and, expectations.

2.3 Hot money impact and the rise of asset prices. The QE policy has raised the money supply, which inevitably caused declining interest rates, the depreciation of the USD, as well as an income reduction of holders of asset denominated in USD. In order to avoid this risk, the holders of USD usually took some actions, such as exchanging the USD into other currencies with an appreciation trend, such as JPY and RMB, then invested them in both, the foreign exchange market and the capital market by buying government loans, stocks, bonds and other financial instruments, or real estate. Since the USD is the main currency of international settlements and international reserves, there is a wide range of dollar-holding economic agents, such as the governments, enterprises, individuals and financial institutions. Their selling of USD would further increase the supply of USD in international markets, thus expanding the scale and intensity of the impact of hot money. It is likely to witness a price bubble in stocks and real estate fuelled by the hot money. Whether China would follow the U.S. monetary policy or not, the situation of abundant global liquidity can increase the occurrence of assets price bubbles. (Tan Xiaofen, 2010). The research of Ehrmann and Fratzscher (2006) indicated that as long as the U.S. implemented expansionary monetary policy, the other six nations of the G7 would experience a remarkable rise of stock market price;
the U.S. monetary policy was the important force leading to asset price fluctuations, between 11% and 17% in the stock market and real estate market of these countries.

2.4 Conducive to the economic growth of developed countries and inimical to that of developing countries. In order to ensure the smooth realization of monetary policy goals, a country's central bank would often intervene in the exchange rate and neutralize policy measures to offset the impact of the changes in global liquidity, moreover, it would also set a “firewall” for the country’s GDP and prices to insulate them from the adverse effect of external shocks. On account of the differences among countries' level of openness, economic structure and macroeconomic management, the spillover effect of the global liquidity through the exchange rate and interest rates is really uncertain in many countries. (Betts and Devereux, 2001; Schmidt, 2006). Over the past 20 years, scholars have conducted extensive research on the spillover effects of the U.S. monetary policy. The research showed that developed countries have gained relatively significant benefits from the spillover of U.S. monetary policy. As long as the United States loosened (or tightened) its monetary policy, the quantity of money in the other six developed countries would increase (or decrease); their GDP would rise (or fall) as well. Borja and Goyeau (2010) found that there was a significant spillover effect between the U.S. and the Euro countries. When the United States implemented a loose monetary policy and increased the quantity of money, Japan’s GDP and prices changed very little; however, the GDP and prices in the Euro Zone showed greater fluctuations of growth. Because of exchange controls, financial markets in developing countries have faced a lower degree of contagion; the GDP in those countries was hardly favorably affected (Mishkin, 2005). However, the expansionary monetary policy of the U.S. impacted the externalities gained by Latin American countries and the other six G7 nations differently. A negative correlation occurred between the GDP of Latin American countries and the U.S. monetary policy, : the expansion of the U.S. currency→decrease in Latin American countries' interest rates→capital outflow→reduction in demand→decrease in GDP (Canova, 2005).

Economic situations still remained unstable in many countries even after the recovery, which could not loosen monetary policy and were caught in a dilemma due to excess global liquidity and transmitted inflation. Therefore, other nations of the G20 expressed strong dissatisfaction with Quantitative Easing Policy in the U.S. The then President of Brazil, Lula, claimed that the U.S. intended to transmit hot money to the emerging market economies and made them pay the bill for the U.S. at the cost of inflation; the Chancellor of Germany criticized directly as well that the U.S. weakened the USD factually, which possibly leads to competition by currency manipulation. The then President of France, Sarkozy, condemned that the U.S. debauched the currency, taking advantage of the central role of the USD in the world financial system, thus influencing the financial stability in other countries. He appealed for the reform of the international monetary system. The Chinese government demanded that the U.S. not abandon its responsibility as asupplier of the international reserve currency because of its own interests.
3. The QE Policy's Impact on China's Macro Economy

According to China's national conditions, China has its own characteristics, which are different from the ones in the Western countries in terms of economic growth, macroeconomic management and exchange rate system. Why did QE have such a huge influence on China? It is because that there is a strategic economic partnership between China and the U.S., which forms a pattern of "Made in China, for the U.S. consumer". QE cannot be ignored. Through profound research, it is found that QE has a positive impact on China's economic growth, the producer price index, M2 growth rate, stock index, and has a negative impact on the growth of trade balance and the real effective exchange rate. It is the monetary aggregates and inflation which are affected most strongly by QE. Some 20% of China's price fluctuations are caused by QE of the United States.

In the study of the monetary policy transmission process and its impact, the Vector Auto Regression model (VAR) is the most commonly used empirical method, which has also been applied in this paper to do the empirical research. We take the fact into account that, on the 25 November 2008, the Fed started the first round of QE; therefore, the monthly data from December 2008 to December 2013 are selected for research. Since QE is an unconventional monetary policy to increase the quantity of money in case the interest rate close to the zero bound, we choose the U.S. M2 growth (um2g) as a measure of monetary policy, testing its impact on China's industrial value added growth (cgdg), producer price index (cppi), M2 growth (cm2g), the trade balance growth (ceig), stock price index (csti) and the real effective exchange rate (cexr). Data come from the IMF IFS and the Chinese National Bureau of Statistics.

Since the quarterly GDP data released by China's National Bureau of Statistics provide only a relatively small amount of statistics, and the industrial value added has is closely related, we use the industrial added value growth (cgdg) as a proxy for GDP variables for the empirical process.

Because of the direct or indirect complex interaction effects among economic variables, this paper will only reflect the impact of QE on China's macroeconomic and monetary policies by analyzing the VAR Model Impulse response and variance decomposition. The two results of the Impulse Response and Variance Decomposition are shown in Figure 1 and Table 1.

After the implementation of the QE policy, the U.S. M2 growth has changed by 1 percentage point. In the long run, China's economic growth, producer price index, M2 growth rate and stock price index were strongly positive, while the growth of the trade balance and the real effective exchange rate were negative.
Figure 1: The U.S. M2 Growth's Impact on China's Macroeconomic Indicators

The U.S M2 Growth's Impact on China's Economic Growth (lh)
The U.S M2 Growth’s Impact on China's Producer Price Index (rh)

The U.S M2 Growth’s Impact on China’s M2 Growth (lh)
The U.S M2 Growth’s Impact on China’s Trade Balance Growth (rh)

The U.S M2 Growth’s Impact on China’s Stock Price Index (lh)
The U.S M2 Growth’s Impact on China’s Real Effective Exchange Rate (rh)
The results of the variance decomposition further revealed the extent of the long-term effects of foreign and domestic major factors on China’s macroeconomic variables; those results are listed in Table 1.

As can be seen from Table 1, in period 36, which corresponds to the end of the third year, domestic factors had greater explanatory power on the changes in various economic indicators of China. In the meantime, the U.S. QE policy also had an impact on the same indicators of China, but its contribution was merely a relatively small part.

Table 1: The Results of Variance Decomposition on the Fluctuation of China’s Economic Indicators

<table>
<thead>
<tr>
<th>Period</th>
<th>Index</th>
<th>Economic Growth</th>
<th>Producer Price Index</th>
<th>M2 Growth</th>
<th>Trade Balance Growth</th>
<th>Stock Price Index</th>
<th>Real Effective Exchange Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>the U.S. M2 Growth</td>
<td>5.39</td>
<td>19.78</td>
<td>3.83</td>
<td>4.24</td>
<td>2.11</td>
<td>0.87</td>
</tr>
<tr>
<td></td>
<td>Domestic Factors</td>
<td>94.61</td>
<td>80.22</td>
<td>96.17</td>
<td>95.76</td>
<td>97.89</td>
<td>99.13</td>
</tr>
<tr>
<td>24</td>
<td>the U.S. M2 Growth</td>
<td>5.25</td>
<td>16.53</td>
<td>15.39</td>
<td>4.49</td>
<td>6.78</td>
<td>4.71</td>
</tr>
<tr>
<td></td>
<td>Domestic Factors</td>
<td>94.75</td>
<td>83.47</td>
<td>84.61</td>
<td>95.51</td>
<td>93.22</td>
<td>95.29</td>
</tr>
<tr>
<td></td>
<td>Domestic Factors</td>
<td>91.86</td>
<td>80.71</td>
<td>85.78</td>
<td>95.48</td>
<td>90.49</td>
<td>91.91</td>
</tr>
</tbody>
</table>

From what has been discussed before, we can reach the following conclusion:

Firstly, the QE in U.S. is positively affecting the growth of China’s GPD and this impact will gradually increase over time. However, China’s economy largely depends on its periodic variance and development locus. Due to the high unemployment rate, the household consumption in the U.S. has not fully recovered after the financial crisis, China’s export volume decreased sharply and the trade surplus narrowed, thereby weakening the effect of QE in U.S. on Chinese economic power through trade channels.
Secondly, the QE in U.S. also had a reverse impact on the China’s trade balance and the exchange rate of its currency (RMB). Generally, the depreciation of USD stems from the U.S. QE policy. There was more than 30% appreciation of the RMB to USD, which simultaneously lowered its real effective exchange rate. The appreciation of RMB has brought about severe damage to China’s exports, especially in 2012, the first trade deficit occurred since 1993, the growth rate of trade surplus decreased continuously but China’s trade balance is gradually recovering.

Thirdly, the QE in U.S. had a significant impact on China’s money supply and price level. The producer prices of industrial products fluctuated by 20% and 16% of the increased fluctuation of the money supply is caused by the QE policy in U.S. One possible explanation is that, when the U.S. implements QE, the interest rate becomes very low and has a 3% differential with China., Also due to the significant deprecation of the USD, a large amounts were invested to arbitrage China’s market, and China had to purchase large amounts of USD in order to avoid the excessive appreciation of RMB and supply of RMB, therefore the money supply as well as the price level fluctuated sharply.

Fourthly, the QE in U.S. positively affected the growth of Chinese stock prices; however, this subtle influence was negligible. The Chinese stock market has been protected by foreign exchange control restricting short-term capital flows, and only a small amount of foreign capital is allowed by QFII to enter the Chinese stock market. As a result, external shocks had less of an impact on the stock price.

It is worth mentioning that China has advanced the reform of its financial system in recent years. On the one hand, this reform has enhanced the ability to defend China against external shocks; on the other hand, it also bestowed more autonomy in its exchange rate policy. On 21th, July 2005, China reformed its exchange rate mechanism. The exchange rate of RMB would be defined by multi-currencies rather than solely influenced by the USD; the fluctuation range would increase accordingly. The change of exchange rate policy reduced the impact of USD fluctuations on Chinese import and export trade. Further, it has partly released the Chinese currency from the constraint of maintaining a nominal link. Therefore, the exchange rate policy of China can enjoy more independence. At the same time, the internationalization of RMB has to some extent reduced the impact of USD fluctuations on Chinese import and export trade as well as the financial market.
4. **RMB Internationalization Strategy**

There has been a consensus of international policy makers to promote the diversification of the international monetary system and to strengthen financial macro-prudential regulation, given the inherent vulnerabilities as a result of international monetary system’s overreliance on the USD. In the midst of the complex and turbulent international economic environment, the internationalization of RMB is by all means a vital institutional guarantee for the stable growth of the Chinese economy and maintenance of its core interests.

4.1 **The Present State of the Internationalization of RMB**

Since the launch of the pilot scheme for cross-border trade settlement in RMB in July 2009 to the national expansion of pilot regions in August 2011, the cross-border RMB settlement business has progressed smoothly. By the end of 2013, the cross border trade settlement volume has amounted to RMB 4.63 trillion, with a year-on-year increase of 57.5% (as shown in Figure 2), accounting for 24.5% of Chinese trade settlement. Among them, trade in goods was RMB 3.02 trillion, accounting for 65.2%; RMB settlement for trade of services and other current account items was RMB 1.61 billion, accounting for 34.8%. According to the statistics of the Society for Worldwide Interbank Financial Telecommunication (SWIFT), up till the end of 2013, RMB has become the world’s 8th payment currency, with a market share of 1.12% and a year-on-year growth of 15%.

**Figure 2: Cross-Border Trade Settlement in RMB from 2010-2013**

![Cross-Border Trade Settlement in RMB from 2010-2013](image)

Source: Bank of China.
With the implementation of QE in developed countries, the expectations of a RMB appreciation led to a gradual expansion of offshore RMB market and a rapid growth of the volume of international financial trading in RMB. RMB Overseas Direct Investment amounted to RMB 85.61 billion in 2013 and RMB foreign direct investment reached RMB 448.13 billion, with a year-on-year increase of 76.7%. According to a survey by the Bank for International Settlements, RMB global bonds outstanding exceeded 70 billion Yuan, with a market share of 9%. RMB global foreign exchange turnover has tripled from 2010 to 2013 and its ranking jumped to 9th from 17th, making it enter the list of the top ten most-actively traded currencies for the first time.

**Figure 3: Issuance and Stock Volume of RMB International Bonds and Bills**

![Chart showing issuance and stock volume of RMB international bonds and bills.](image)

Source: BIS.

By 2013, the People’s Bank of China signed currency swap agreements with 23 countries and regions and the swap lines amounted to 2.48 trillion Yuan, with the purpose of increasing liquidity and facilitating the use of RMB globally. An increasing number of countries are inclined to hold RMB as official reserves, with Malaysia, South Korea, Cambodia, Belarus, Russia, Philippines, Bolivia, Australia, Taiwan, South Africa announcing to include RMB in their foreign reserves.

Theoretically, a currency is defined in terms of the three functions. It serves as a unit of account, as a medium of exchange, and as a store of value. Compiling of RMB internationalization index (RII) based on these functions can act as an indicator measuring and reflecting the degree of the internationalization of RMB.
Table 2: Indicator System of RMB Internationalization Index

<table>
<thead>
<tr>
<th>First-class indicators</th>
<th>Second-class indicators</th>
<th>Third-class indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>International pricing and payment function</td>
<td>Trade</td>
<td>Proportion of RMB settlement in world trade</td>
</tr>
<tr>
<td>Capital and finance</td>
<td></td>
<td>Proportion of RMB credit in global foreign credit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Proportion of RMB securities in global issuance of international bonds and bills</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Proportion of RMB securities in global sum of outstanding international bonds and bills</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Proportion of RMB direct investment in global foreign direct investment</td>
</tr>
<tr>
<td>International Reserve function</td>
<td>Official foreign exchange reserves</td>
<td>Proportion of RMB foreign exchange reserves in total global foreign exchange reserves</td>
</tr>
</tbody>
</table>

The economic implications of RII can be interpreted as follows: if RMB is the only global currency, the value of every index of RII indicator shall be 100%, whilst RII equals 100. On the contrary, if there is no use of RMB in cross-border transaction, every index of the indicator is 0, with RII dropping to 0. If the value of RII is increasing, this indicates an increase in the degree of the internationalization of RMB.

Although the level of RMB internationalization is relatively low in the early stage, the RII has surged from 0.55 in the early 2012 to 1.20 in the 3rd quarter of 2013, with a year-on-year growth of 52.64%.

**Figure 4: RMB Internationalization Index**
5. **Analysis of the Forces Driving RMB Internationalization**

The transition of trade pattern offers a unique opportunity for RMB internationalization. Based on the theory of international trade, the currency of an emerging market with major trade volume has an advantage of becoming an invoicing currency; trade regionalization and structural adjustment will result in a new regional invoicing currency. The year 2013 saw China overtaking the US as the world’s largest trading nation with the total import and export volume amounting to US 4160.3 billion, resulting in a further increase of China’s international trading status and bargaining power. Driven by economic benefits and market mechanism, the motivation for RMB settlement and holding RMB-denominated assets are greatly enhanced.

Foreign direct investment facilitates RMB internationalization. Steady growth of RMB direct investment facilitates the increase of the global market share of RMB direct investment, through the linkage effects of overseas investment with import and export trade. Diversification of overseas investments and investment markets could also benefit the expansion of RMB direct investment. China has become the world's 6th largest investing nation and market power of Chinese companies in the global market is on the increase.

The RMB offshore markets are booming. In recent years, offshore RMB trading is developing rapidly in Hong Kong, Singapore, Taiwan and London. Diversified RMB financial products and derivatives are gradually provided, thus increasing liquidity of RMB in the international financial market and enhancing convenience and efficiency of use of RMB, as well as consolidating the foundation for the attractiveness of RMB-denominated financial products.

6. **Three-step Strategy of RMB Internationalization**

Based on the historical experiences, the RMB internationalization process still has a long way to go. In the long run, China will have to implement two strategies in "three-steps" in the next 30 years to achieve RMB internationalization. In regard to the scale of use of RMB, the first 10 years can be called "neighborization", which is the use of RMB in neighboring countries and regions; the second 10 years is "regionalization", which is the use of RMB in all the Asian countries; the last 10 years is "internationalization", which enables the use of RMB as a world's key currency. In terms of the functions of RMB as a world currency, the first step is “trade settlement", which is the use of RMB as international settlement currency in cross-border trade settlements; the second is "financial investment", which enables RMB to be used as investment currency in the international investment sector; the last is “international reserve”, which will make RMB one of the most important reserve currencies in the world.
7. **Policy Recommendations**

Firstly, the transformation and upgrade of the domestic economy and the breakthrough of key regions must be implemented. The realization of the steady transformation of the Chinese economy, the transition from extensive growth to intensive growth and internal and external balance are indispensable parts of the RMB internationalization strategy. China needs to optimize its trade structure, gain more trade rule setting power through the China (Shanghai) Pilot Free Trade Zone, promote economic and financial cooperation in the economic belt of the maritime and land silk roads, with the purpose of lowering obstacles to the replacement of the trading currency.

Secondly, implement the policy of “walking on two legs” and let international finance play the role of an accelerator. Banks have an important role in China's financial system, they expand cross-border loans and facilitate trade development through export credit. Trade and investment cooperation with other countries needs to be strengthened. The opening of the capital account is the prerequisite of RMB internationalization, and the establishment of the RMB offshore market before the full opening of the capital account meets the RMB liquidity and asset management needs of international partners.

Lastly, culture internationalization and RMB internationalization strategies shall be advanced in tandem. The international cultural acceptance of a country plays a vital role in the international use of its currency. Hence, carrying forward and promoting the Chinese traditional culture such as the harmonious thought in traditional Chinese culture will facilitate RMB internationalization with mutual benefits.

To conclude, the use of a currency as a trading currency in international economic activities is a matter of microeconomic decisions. With the Chinese government's strengthening of the domestic economy, stabilizing economic development, and undertaking more responsibilities in global affairs, it is my belief that RMB will ultimately have a bright future in the global market.

8. **China's Policy Response to Tapering**

The termination of the U.S. QE policy will have little effect on China's economy, with no large capital outflows occurring. As a matter of fact, while countries like India, South Africa, Brazil were facing the portent of an emerging market crises in 2013, China’s net capital inflows exceeded USD 300 billion.
The main risk of the QE policy tapering for China is rising long-term interest rates caused by capital outflows, which might threaten to burst the real estate bubble. In that case, shadow banks and local debtors will face more defaults, and RMB will devalue or become more volatile. In response to the tapering of U.S. QE, China does adjust macro-economic policies to maintain a sustainable growth:

First, improve exchange rate policy by reforming the exchange rate mechanism, expanding the exchange rate floating range. The RMB exchange rate is mainly determined by market supply and demand. When the floating range of RMB is widened from 1% to 3% or even 5%, that raises the cost of hot money arbitrage, and saps the motivation for arbitrage.

Second, focus on solving domestic problems; promote the healthy development of the financial markets. The present emphasis lies on interest rate liberalization, shrinking the real estate bubble, regulating shadow banks, opening local bond markets to solve the local debt problem. As long as China’s financial market is large and healthy enough, even if facing capital outflows, systemic risk and financial crisis should not happen.

Third, strengthen short-term capital controls. Since the U.S. tapering caused massive speculative capital flows and the attack on capital markets seems plausible, increased controls on hot money such as the implementation of a Tobin tax become necessary.

In conclusion, adoption of the QE policy by the United States was a wise decision in view of a high fiscal deficit, which has played an important role in accelerating the economic recovery. The withdrawal of the U.S. QE policy and the return to a normal monetary policy at the moment would benefit the stability of the world economy. Each country will be subject to different degrees of external shocks, but governments must face the reality and take positive policy responses, in order to seek benefits while avoiding disadvantages based on the local conditions.

China is on the way to deepen reforms completely and make full use of the market mechanism. Economic results brought about by the system reform have appeared, for instance, as industrial growth jumped by over 10% in the first quarter of this year. In consideration of China’s strong economic fundamentals and relatively small potential risks, as well as the full preparation that the government has made against the tapering of the U.S. QE, China will follow its own track to achieve a sustainable development.
References


