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Abstract
The surge in international capital inflows and the remarkable excess liquidity in China between 1997 and 2007 are examined in the present paper. It is shown that China's improved position in terms of foreign exchange purchases, ignited by huge foreign capital inflows, has effectively induced excess liquidity in China. More importantly, by developing an econometric model for inflation and excess liquidity, the present study demonstrates that excess liquidity has imposed significant pressure on inflation in China over the past 10 years. This finding suggests that excess liquidity in China has not only contributed to the rise in stock prices and the real estate market boom, but also affected the consumer goods market. The potential transmission mechanism of liquidity-driven inflation and policy implications of the findings of this study are discussed.

Key words: capital inflow, excess liquidity, inflation, monetary policy

JEL codes: E31, E52, E58

I. Introduction

Since the start of the century, China has witnessed a remarkable surge in international capital inflows through the so called “twin surpluses” embedded in its current account and capital account. In addition, the improved macroeconomic fundamentals in the Chinese economy in conjunction with financial innovations and liberalization of international capital markets have geared up the mobility of capital flows.

The huge capital inflows have resulted in massive accumulation of international

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reserves in China. In turn, China’s RMB position for foreign exchange purchase (PFEP) has risen rapidly as a result of the well known “exchange surrender system,” which has been in effect in China since 1994. The exchange surrender system, exercised by the State Administration of Foreign Exchange (SAFE), enforces sales of foreign exchange by domestic institutions to commercial banks of China. This enforcement ensures that foreign capital inflows to China are eventually added to the foreign exchange reserves through the mutual commitments between commercial banks and the People’s Bank of China (PBOC).

As such, several years’ accumulation has built up abundant liquidity for the domestic market. This excess liquidity has become a serious concern for monetary authorities in China. In particular, given the hike in food prices since early 2007, the authorities have expressed considerable concern about the potential pass-through of excess liquidity to more general consumer prices.

Interestingly, however, research by Yu (2002), Han et al. (2005), Li and He (2007) and Makin (2007) has found that excess liquidity, measured by the ratio of monetary aggregate to nominal GDP, has not resulted in a resurgence of consumer price inflation in China. These studies claim that excess liquidity in China, rather than affecting the consumer goods market, could have impacted on asset markets; that is, that excess liquidity has contributed to rises in stock prices and has driven the real estate market boom.

Unlike those existing studies, the present research indicates that excess liquidity can effectively help to form market expectations for future inflation and drive consumer price inflation in the short run. To validate this conjecture, the paper develops an econometric model capturing the dynamics between inflation and excess liquidity. Using quarterly data over 1997–2007, the paper shows that excess liquidity has had a statistically significant and sizable impact on consumer price inflation in China. This finding is robust whether we use model specifications that take into account the effect of real economic variables on inflation, or use different price indices to derive inflation.

Overall, our finding suggests that excess liquidity in China has systematically imposed pressure on inflation, which transmits an important signal that excess liquidity in China is soon to impact on the market of consumer goods. Therefore, the current exchange rate policy of rapidly appreciating RMB should be exercised cautiously because the appreciation could trigger more international capital inflows (speculative in nature) into the domestic market and, in turn, exacerbate the ongoing inflation in China.

To avoid inflation resurgence, we propose that the monetary authorities in China consider adding a random element to the daily movements in the RMB exchange rate, around the general appreciation trend, so as to thwart market speculation. For example, the central bank could deliberately devalue the RMB against the US dollar or reduce interest rates in an irregular manner. This, in conjunction with stabilizing interest rates in the domestic
market, could effectively discourage speculative capital inflows, alleviate the pressure of excess liquidity, and eventually tame the pressure on domestic inflation.

The rest of the paper is organized as follows. Section II discusses capital inflows and excess liquidity in China over the past decade, and details causes and consequences of the excess liquidity. Section III develops an econometric model to capture the dynamic interaction between excess liquidity and inflation. Section IV explains the dynamic transmission mechanism of excess liquidity to inflation in China. Section V concludes the paper and provides some policy implications based on the findings of the present study.

II. Excess Liquidity: Facts, Causes and Consequences

1. Stylized Facts Regarding Excess Liquidity

Since early 2007, excessive accumulation of liquidity has received considerable attention from monetary authorities in China, especially in relation to its possible implications for price and financial stability at the national level. However, little research has been undertaken regarding excess liquidity in China, especially over the recent decade using quarterly data. Therefore, the present study investigates some stylized facts relating to excess liquidity in China.

As a starting point, we present evidence of high growth in money supply between 1997 and 2007. Data from the PBOC suggest that both narrow money (M1) and broad money (M2) grew at a fast rate in China between 1997 and 2007, with average growth rates of M1 and M2 of 16.9 and 16.7 percent, respectively (see Figure 1). Figure 1 reveals that the growth rates of monetary aggregates, in particular the growth rate of M1, have been spiraling upwards since early 2006.

The marked growth in monetary aggregates only partially reflects the expansion of liquidity in China. Whether the liquidity is excessive needs further investigation using

![Figure 1. Growth Rates of M1 and M2 in China: 1997 Quarter 1 to 2007 Quarter 3](image_url)

Source: The author’s calculation based on data from PBOC (2007).

Notes: The plot is based on the year-to-year growth rates of M1 and M2 in China.
quantitative measures of excess liquidity. A variety of methods can be used to measure excess liquidity. For instance, the European Central Bank (ECB, 2004) advocates the so-called “real money gap”, defined as the deviation of the actual stock of money from an estimated equilibrium level, to measure excess liquidity. Gerdesmeier and Polleit (2005) provide a comprehensive survey of methods used to measure excess liquidity.

Among the alternative measures of excess liquidity, the ratio of the broad monetary aggregate (M2) to nominal GDP remains an intuitive and useful indicator of excess liquidity in a country. Therefore, it is often proposed that broad money supply be compared with nominal spending to gauge the size of excess liquidity, as is suggested by Ruffer and Stracca (2006) in their study of global excess liquidity across G5 countries.

The measure of excess liquidity used here follows the conventional definition of the ratio of broad money to nominal GDP. The sample spans the first quarter of 1997 to the third quarter of 2007. Note that the calculation of M2/GDP using quarterly data is not straightforward. GDP is a flow variable, whereas money aggregate is a stock variable. Therefore, to construct the measure of M2/GDP using quarterly frequency data published by the International Financial Statistics (IFS), we derive the measure for nominal GDP (not seasonally adjusted) at quarterly frequency by computing the four quarter’s moving sum of the published data, whereas money aggregate is measured using the corresponding quarterly observations of M2. Denoting quarterly time by $t$, the measure of excess liquidity at quarterly frequency is then computed as:

$$\text{Excess liquidity}_t = \frac{M2_t}{GDP_t + GDP_{t-4} + GDP_{t-2} + GDP_{t-3}}.$$  

This calculation provides a measure of excess liquidity comparable to the one computed using annual data in Li and He (2007). The method proposed here also alleviates the potential influence of seasonality in the published quarterly data because each observation of the GDP constructed in this way spans four different quarters.

Figure 2 illustrates the ratio of M2/GDP in China from the first quarter of 1997 to the third quarter of 2007. For comparison purposes, Figure 2 also plots M2/GDP using annual data for 1997 to 2007. Not surprisingly, the measure of M2/GDP calculated using annual data is much smoother than that computed using quarterly data. Nonetheless, the general pattern of the measure of excess liquidity using the different frequency data is rather similar over the entire sample period of 1997–2007: M2/GDP kept increasing between 1997 and 2003, slightly declined between 2003 and 2005, and crept higher after mid-2005. The level of M2/GDP in China grew from approximately 1.2 in the late 1990s to above 1.7 in 2007, with a remarkable rise of 40 percent over 1997–2007.

Figure 2 indicates that excessive money has been used to pursue less economic output
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over the past 10 years as the level of M2/GDP is persistently above 1, which indicates that liquidity in China is indeed excessive. To gauge the excess liquidity in China, we also compare the measure of excess liquidity in China with major developed countries. Figure 3 plots the ratio of M2/GDP for China in conjunction with the same measure for the G5 countries (US, UK, EU, Japan and Canada) over 1997 to 2006.

The research conducted by Eggertsson and Ostry (2005) indicates that Japan has had high levels of excess liquidity. However, China's excess liquidity surpassed that of Japan in 1998 (see Figure 3). Indeed, the level of M2/GDP in China has been above that in all other countries considered here. In addition, unlike China, which has experienced a continuous increase in M2/GDP, the ratios of M2 to GDP in other countries between 1997 and 2006 are relatively stable. For example, M2/GDP in the USA and Canada has remained around 0.50,
and 0.7 in the EU. The demonstrations in Figures 2 and 3 highlight China’s excess liquidity over the past recent decade.

2. Causes of Excess Liquidity

The fundamental cause of excess liquidity in China lies in the drastic international capital inflows. International capital favors China because of its remarkable high economic growth over the past decade, which has created terrific opportunities for business and investment. In addition, the rapidly-increasing returns in the capital and real estate markets in China also boosts international capital influx (Li and He, 2007). Moreover, market expectations of RMB appreciation since July 2005 have also helped to attract considerable amounts of international capital inflows, which are mostly short-term and speculative in nature.

The evidence of large capital inflows can be examined in a number of ways. We focus on two perspectives; namely, inward net capital inflows and the twin surplus of balance of payments. First, Figure 4 shows the inward net capital inflows from foreign direct investment (FDI), portfolio investment, and other investment in China over 1997–2007 based on the semi-annual data published by SAFE.

Among the three categories of net capital inflows, net FDI is predominant in most periods, except for 2004 and 2005, during which time the net other investment slightly surpasses the net FDI. The net portfolio investment, in contrast, rises steadily, particularly after the early 2000s. Overall, Figure 4 suggests that the total inward net capital inflows were relatively stable between 1997 and 2002 and have exhibited a continuously increasing

Figure 4. Net Capital Inflows to China: 1997–2007

Sources: SAFE (1997–2007) and the author’s calculation.
Notes: The plot is based on semi-annual data published by SAFE (1997–2007). Prior to 2001, annual data are used to represent semi-annual frequency because semi-annual data are not available before 2001. Net FDI, net foreign direct investment inflows; Net PI, net portfolio inflows; Net OI, net other investment inflows. Total capital inflows are the sum of the three inflows.

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trend since 2002, with a notable jump in 2004. By the first half of 2007, total capital inflows were registered at US$188bn, which is five times larger than that in 1997.

Second, China’s ballooning twin surpluses are indicative of large capital inflows. Figure 5 presents current account (CA) and capital account (KA) balances in China over 1997–2007 (semi-annual data). Figure 5 shows that the CA remains positive for the entire sample period, with a steady increase occurring since the early 2000s. For instance, the CA surplus was US$17bn in 2001, it grew to US$160bn in 2005, and reached US$325bn in the first half of 2007.

The persistent increases in the CA surplus partly reflect the huge trade surplus since China became a member of the WTO in 2001. The KA, in contrast, became positive in 1999 and has been in surplus from 1999. In addition, there was a sizable surge in the capital account surplus in 2007, although there was only a small increase in the second half of 2006. The total surplus (CA + KA), as shown in Figure 5, has been growing rapidly since 2000. The total twin surpluses of the first half of 2007 were US$500bn, which is equivalent to one-third of the nominal GDP in China over the same period.

The remarkable twin surpluses in China have been a direct cause of excess liquidity. Because the rapid expansion in the balance of payments in China causes the building up of massive foreign exchange reserves, which in turn contributes to the country’s money supply, the PBOC has to intervene in the market by issuing money aiming at RMB exchange rate stability. According to the data published by the IFS (2007), the foreign exchange reserves in China amounted to US$1430bn in the third quarter of 2007 (see Figure 6), far outpacing that in Japan (US$900bn) in the same period.

Therefore, the dramatic influx of foreign exchange greatly contributed to the large amount of monetary supply in China. Figure 7 illustrates the monetary aggregates in China.
during the first quarter of 1997 to the third quarter of 2007. It shows that both M1 and M2 have increased considerably over the past 10 years, with the growth in M2 being particularly striking. Not surprisingly, the ratio of M2 to nominal GDP (see Figure 2) in China has witnessed a remarkable increase, indicating expanding excess liquidity in the country.

3. Consequences of Excess Liquidity

In this subsection, we discuss two important consequences of excess liquidity in China; namely, the ineffectiveness of monetary policy and escalation of inflation. First, excess liquidity reduces the effectiveness of the country’s monetary policy and the central bank of China has limited capacity to adjust monetary supply as a result of ongoing excess liquidity. In particular, the increase in the RMB position for foreign exchange purchase has directly led to an involuntary increase in base money, which in turn substantively limits the degree of freedom for Chinese monetary authorities to adjust monetary supply to intervene

Figure 6. Foreign Exchange Reserves in China: 1997 Quarter 1 to 2007 Quarter 3


Figure 7. Monetary Aggregates in China: 1997 Quarter 1 to 2007 Quarter 3

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in domestic economic development.

Figure 8 compares the level of PFEP with M1 and illustrates dramatic year-to-year increases in PFEP relative to that in M1. The figure indicates that banks’ RMB equivalent for foreign exchange purchases went up to RMB12500bn in the third quarter of 2007, after an increase of RMB6000bn in the first two quarters of the year.

The rapid increase in the PFEP has led to high ratios of PFEP over M1. Figure 9 shows that the ratio of PFEP/M1 was around 30 percent in 2000, while it grew to above 85 percent in 2007. Such an extraordinary high ratio of PFEP/M1 has left policy-makers in China with the task of maintaining an effective monetary policy.

Another important consequence of excess liquidity relates to inflation in China. In retrospect, inflation in China has been remarkably low for nearly one decade since 1997. Nonetheless, after a few years (2004–2007) of positive shocks, inflation is now creeping...
higher, reflecting accumulative effects of abundant liquidity. By September 2007, the year-to-year consumer price index (CPI) inflation was consistently above 3 percent for 7 months, reaching 6.2 percent in the third quarter of 2007. With the rapid expansion in liquidity, there seems no clear signal of taming inflation in the short run.

However, is there any evidence showing the proposed correlation between excess liquidity and inflation in China? We will specify a dynamic model to formally verify this conjuncture in the following section and provide an intuitive illustration here. Figure 10 plots quarterly data for inflation measured by the CPI and retail price index (RPI) and M2/GDP in China over the first quarter of 1997 to the third quarter of 2007. Figure 10 shows a co-movement between inflation and excess liquidity during the underlying period. It also indicates that M2/GDP leads inflation at one to two quarters, indicating an increase in the level of excess liquidity will be followed by a rise in inflation.

From the above analysis it is evident that excess liquidity in China has gradually accumulated as a result of improvement in the foreign exchange purchasing position between 1997 and 2007. In turn, the accumulated liquidity begins to destabilize the monetary policy requiring that the PBOC clear the daily foreign exchange market at a pre-announced exchange rate. More importantly, the relevant time-series data reveal that excess liquidity contributed to inflation in China between 1997 and 2007. The positive relationship between money and prices is critical in this process, which is well acknowledged in the economic literature (Roffia and Zaghini, 2007). The following section endeavors to investigate the dynamic relationship between inflation and excess liquidity in China.

**Figure 10. Excess Liquidity and Inflation in China: 1997 Quarter 1 to 2007 Quarter 3**


Notes: CPI, consumer price index; RPI, retail price index.
III. Excess Liquidity and Inflation in China: An Econometric Model

The discussion above, in particular the demonstration in Figure 10, provides an intriguing scenario where excess liquidity may significantly drive consumer price inflation. A formal test of the relationship, however, is not yet common in the literature and that is the niche that this section tries to fill.

To test whether excess liquidity has significant pressure on inflation, a simple model is set up defining inflation as a linear function of excess liquidity. Although straightforward, such a model cannot reflect the dynamic interactions between inflation and excess liquidity, as indicated by Figure 10. Moreover, a model without inflation dynamics is not able to capture the nature of inflation persistence, as documented by Zhang (2007, 2008). Therefore, we set up the following model with lagged inflation characterizing inflation dynamics:

\[ \pi_t = c + \alpha (L) \pi_{t-1} + \beta \text{excess}_t + u_t, \]

(2)

where \( \pi_t \) denotes inflation, \( c \) denotes a constant, \( \text{excess}_t \) refers to the measure of excess liquidity, \( u_t \) is an error term, and \( \alpha \) and \( \beta \) are coefficients on lagged inflation and excess liquidity, respectively. Note that \( \alpha (L) = \alpha_0 + \alpha_1 L + \alpha_2 L^2 + \cdots + \alpha_p L^p \) is a polynomial in lag operator with \( \alpha(i) = \alpha_0 + \alpha_1 + \cdots + \alpha_p \) capturing inflation persistence.

Equation (2) not only specifies current inflation as a function of excess liquidity in the current period, but it also captures the dynamic interactions between inflation and excess liquidity, per se. To make this more clear, Equation (2) can be rewritten as:

\[ \pi_t = (1 - \alpha(L))^{-1} (c + \beta \text{excess}_t + u_t), \]

(3)

where \( (1 - \alpha(L))^{-1} = (1 - \alpha_0 L + \alpha_1 L^2 + \cdots + \alpha_p L^p) \) and \( \alpha(i) (i=1, 2, \ldots) \) are functions of \( \alpha, (j=1, 2, \cdots) \). As such, it is straightforward to observe that the baseline model indicates that inflation at time \( t \) is driven by excess liquidity not only in the current period, but also at lagged periods, which in turn reflects the lagged effect of excess liquidity on inflation.

Based on the above derivation, we report the OLS estimation results for model (2), using quarterly data for inflation and the measure of excess liquidity (M2/GDP) defined in the previous section. In all regressions, the optimal lag order in the model is chosen by the Akaike Information Criterion. The estimation results are summarized in Table 1.

First and foremost, the results in Table 1 show that M2/GDP significantly drives inflation, with a 1-percent change in excess liquidity leading to a 3.23 and 4.80 percent rise in the CPI
and RPI inflation, respectively, *ceteris paribus*. In addition, the persistence parameter estimate on lagged inflation (i.e. $\alpha(1)$) is above 0.60, which indicates that inflation in China exhibits considerable persistence. The diagnostic statistics listed in the last three columns in Table 1 also suggest that the model has reasonable goodness of fit (adjusted $R^2$ is above 0.80) and the estimated residuals of the model are free of serial correlation ($p$-value of the serial correlation test is insignificant at the 1-percent level).

Furthermore, to assess the stability of the model, in particular the stability of the parameter on excess liquidity (i.e. $\beta$), we examine recursive (OLS) estimates for $\beta$ in Equation (2). By construction of the model, one would expect a series of point estimates without substantive changes if the underlying model is stable. The results shown in Figure 11 indicate that the model indeed gives rise to reasonably stable estimates of the parameter.

Although plausibly specified, Equation (2) might still have the problem of omitting the real driving variable on inflation, as indicated by the conventional Phillips Curve theory. In practice, we also estimate alternative models by adding the growth rate of real GDP or the output gap (e.g. Hodrick–Prescott filtered output gap) to capture the possible feedback of real economic activity on inflation, and varying estimation samples to examine the robustness of our finding. These augmentations do not improve the fit of the model and substantially change the fundamental finding in Table 1. An interesting finding in these exercises is that neither the real economic growth nor the real GDP gap has exerted statistically significant pressure on consumer price inflation in China during the past decade. The real variables maintain intuitive (positive) signs in the pertaining estimations.

Overall, the empirical results in this section show that excess liquidity in China has played a significant role in driving general price inflation over the past 10 years. The transmission mechanism of excess liquidity to price inflation will be discussed in the following section.

Table 1. OLS Estimation Results for Model (2):
1997 Quarter 1 to 2007 Quarter 3

<table>
<thead>
<tr>
<th></th>
<th>$\hat{c}$</th>
<th>$\hat{\alpha}(1)$</th>
<th>$\hat{\beta}$</th>
<th>Adjusted $R^2$</th>
<th>Standard error of regressions</th>
<th>$p$-auto</th>
<th>Lag order</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI</td>
<td>−4.37***</td>
<td>0.67***</td>
<td>3.23*</td>
<td>0.81</td>
<td>0.88</td>
<td>0.76</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>(1.94)</td>
<td>(0.15)</td>
<td>(1.33)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RPI</td>
<td>−7.14***</td>
<td>0.64***</td>
<td>4.80***</td>
<td>0.83</td>
<td>0.92</td>
<td>0.02</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>(2.65)</td>
<td>(0.15)</td>
<td>(1.73)</td>
<td></td>
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</tbody>
</table>

Notes: $p$-auto denotes Breusch–Godfrey Lagrange multiplier test for serial correlation up to four lags; heteroskedasticity-robust standard errors are reported in parentheses; *** and ** indicate that the estimates are statistically significant at 1 and 5 percent levels, respectively. CPI, consumer price index; RPI, retail price index.
IV. Transmission Mechanism of Excess Liquidity to Inflation

The empirical results in the foregoing section show that large increases in liquidity are likely to lead to inflationary pressure on general prices. This indicates that excess liquidity in China not only concentrates on the capital and real estate markets, but also on the consumer goods market. However, this finding does not mean that excess liquidity must cause inflation directly. In effect, the transmission of excess liquidity to consumer price inflation can be achieved through its compelling impact on the asset market and the real estate market.

For instance, a stock market boom boosted by excess liquidity might cause the public to panic and pursue irrational investments. As such, perceptions of high inflation in the following periods prevail and the market will eventually form strong expectations regarding future inflation. The market expectation about future inflation will then influence consumers’ consumption and their investment behavior and firms’ pricing strategies, and in turn, further affects future inflation. Consequently, inflation will spiral upwards and prevail for a considerably protracted period. Indeed, Zhang et al. (2008) show that inflationary expectations play a predominant role among the factors that drive inflation. Figure 12 shows the dynamic transmission mechanism of excess liquidity to inflation.

The rationale calls for serious attention from the Chinese monetary authorities to control and manage the excess liquidity. As discussed above, the liquidity-driven inflation can have sizable adverse impacts on consumers’ confidence in the future economy; in particular, on the public perception of how fast prices are rising. A recent survey of 20,000

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**Figure 11. Recursive Estimates of $\beta$: (a) recursive $\beta$ (CPI) and (b) recursive $\beta$ (RPI)**

*Source:* The author’s calculation.

*Notes:* CPI, consumer price index; RPI, retail price index.
households in China conducted by the PBOC (2007) shows that more than 60 percent of those surveyed expect that inflation in China will continue to rise in 2008, and over 45 percent of them regard present consumer price inflation as “too high to be acceptable.” These will reinforce the PBOC to raise interest rates to provide a disinflationary offset and ensure that the economy is not overheating with the upshot of excess liquidity.

V. Conclusions and Policy Implications

International capital inflows, excess liquidity and inflation are intimately related with each other in China. This paper summarizes the stylized facts of capital influx and excess liquidity in China over 1997–2007. In addition, the empirical results of the econometric model of inflation and excess liquidity suggest that the excess liquidity places overriding pressure on China’s price inflation. This important finding indicates that policy-makers in China need to pay more attention to the liquidity-driven inflation phenomenon and prudently design interest rate and exchange rate policy to curb excessive capital inflows and to tame inflation resurgence.

To achieve this objective, it is not advisable to appreciate the RMB at a faster pace because rapid appreciation of the RMB can effectively provoke speculative capital inflows. Although strictly monitored, this sort of capital can often find illegal channels to flow in and it can be very difficult for the authorities to pin down the amount of such capital inflows. Therefore, allowing the RMB to quickly appreciate is not a sensible option, at least from the perspective of restraining speculative capital inflows.

Instead of appreciating the RMB at a faster pace, we suggest that the Chinese monetary authorities deliberately make unexpected changes in the RMB/US$ exchange rate, with the magnitudes and intervals being unpredictable. In particular, the durations of ups and downs in the exchange rate movements should be made irregular, which will effectively increase the marginal cost of speculation. By doing so, the authorities can make the RMB’s long-term trends less predictable so as to curtail speculations and prevent the economy from the
ups and downs that threaten long-run sustainable economic growth.

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