THE HUFFINGTON POST

China has Chosen Instability

Steve H. Hanke

January 7, 2016

The plunging Shanghai Stock Exchange and the sudden reversal in the yuan's appreciation have caused fears to spread beyond China's borders. Is something wrong with the world's growth locomotive? In a word, yes.

Indeed, China's leadership has chosen instability. They have forgotten my golden rule: stability might not be everything, but everything is nothing without stability.

How did China arrive at this point -- a point of high uncertainty and potential economic instability? A look at China's exchange-rate regimes provides a window into these troubled waters. Since China embraced Deng Xiaoping's reforms on 22 December 1978, China has experimented with different exchange-rate regimes. Until 1994, the yuan was in an ever-depreciating phase against the U.S. dollar. Relative volatile readings for China's GDP growth and inflation rate were encountered during this phase.

After the maxi yuan depreciation of 1994 and until 2005, exchange-rate fixity was the order of the day, with little movement in the CNY/USD rate. In consequence, the volatility of China's GDP and inflation rate declined, and with the yuan firmly anchored to the U.S. dollar, China's inflation rates began to shadow those in America (see the accompanying exchange-rate table). Then, China entered a gradual yuan appreciation phase (when the CNY/ USD rate declined in the 2005-14 period). In 2015, the yuan began to experience weakness. In terms of volatility, economic growth and inflation rates, China's performance has deteriorated ever since it dropped exchange-rate fixity.

So, why did China drop exchange-rate fixity in 2005? After all, China's fixed-rate regime had performed very well. Pressure from the U.S. and many nonsensical mercantilist's arguments, emanating from Washington, D.C., caused China to abandon fixity. Little did Beijing realize that it had chosen instability.

Steve H. Hanke is a senior fellow and director of the Troubled Currencies Project at the Cato Institute and a professor of Applied Economics at The Johns Hopkins University in Baltimore