

# China's Economy After the Currency Revaluation—Policy Management Implications and the Effect on Domestic and Foreign Economies

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## Introduction

On July 21, China announced that it would revalue the renminbi 2.1% over the dollar peg of 8.27–8.28 RMB in effect since 1994, and adopt a managed float currency system with reference to a currency basket. In this paper, we look at the backdrop to the policy decision, assess China's policy management outlook, and examine whether China can achieve monetary autonomy—a deficiency that plagued the previous currency regime—and alleviate the trade imbalance with the U.S.

## 1. Backdrop to Revaluation and Currency System Reform

In making the transition from a planned economy to a market economy, the successful shift to a flexible exchange rate regime has been China's ultimate challenge. China's authorities had been seeking the right timing for the shift.

The decision to revalue the renminbi and adopt a new exchange rate regime was motivated by growing constraints on monetary autonomy. Entering 2005, the bulging trade surplus aggravated trade tensions and putting upward pressure on the renminbi, while expectations of a revaluation attracted speculative capital from abroad.

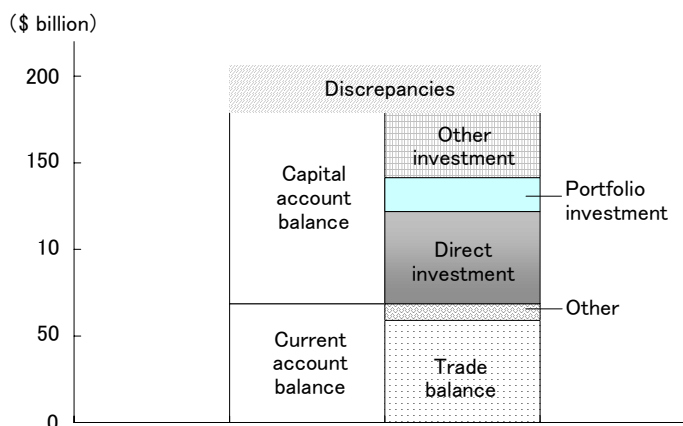
### 1. Lack of Monetary Autonomy

In 2004, China's trade surplus reached \$59.0 billion, while the broader current account surplus rose to US\$68.7 billion. Meanwhile, China's capital account surplus doubled from the previous year to \$110.7 billion, of which direct investment comprised \$53.1 billion (Figure 1).

The main growth component in the capital account surplus has been inward direct investment, which expanded as China met its WTO pledge to gradually open services and other markets. Relatively tight controls exist that limit capital outflows and ban most types of inward portfolio investment and short-term capital transactions (Figure 2). Nonetheless, as expectations mounted for renminbi revaluation, speculative capital managed to bypass controls and flow in. This inflow

is reflected in the huge \$27 billion BOP discrepancy.

**Figure 1 China's Balance of Payments (2004)**



Source: National Bureau of Statistics of China

Confronted with large foreign currency inflows through various routes, authorities intervened massively by buying dollars to sustain the renminbi peg. Official reserves grew to \$206.7 billion during 2004 and \$609.9 billion by yearend. In 2005, the trade surplus surged higher, while inward direct investment and speculative investment remained high. By June 2005, official reserves surged another \$100 billion, reaching a total of \$711.0 billion.

**Figure 2 Controls on Capital Transactions**

	Outward capital flows	Inward capital flows
<b>Direct investment</b>	< Outward investment > Approval needed	< Inward investment > Allowed (excluding banned industries)
<b>Shares</b>	< Issue locally by nonresidents > A shares (in renminbi): strict requirements B shares (in foreign currency): allowed < Purchase abroad by residents > Banned (except for QDII)	< Issue abroad by residents > Approval needed  < Purchase locally by nonresidents > A shares (in renminbi): limited to QFII B shares (in foreign currency): allowed
<b>Bonds</b>	< Issue locally by nonresidents > Banned < Purchase abroad by residents > Limited to authorized banks (conditional)	< Issue abroad by residents > Approval needed < Purchase locally by nonresidents > Banned
<b>Money market instruments</b>	< Issue locally by nonresidents > Banned < Purchase abroad by residents > Limited to authorized banks (conditional)	< Issue abroad by residents > Approval needed < Purchase locally by nonresidents > Banned
<b>Commercial credits</b>	< By residents to nonresidents > Limited to authorized financial institutions	< To residents from nonresidents > Approval needed

Notes: QDII is qualified domestic institutional investor; QFII is qualified foreign institutional investor.

Source: IMF, "Annual Report on Exchange Arrangements and Exchange Restrictions 2004."

To prevent inflation, the central bank had to sterilize dollar purchases with open market sales of Treasury and PBC bonds to banks, thereby absorbing excess renminbi currency in circulation. The mounting cost of sterilization was an important domestic concern leading to the currency reform.

## 2. Growing Trade Imbalance

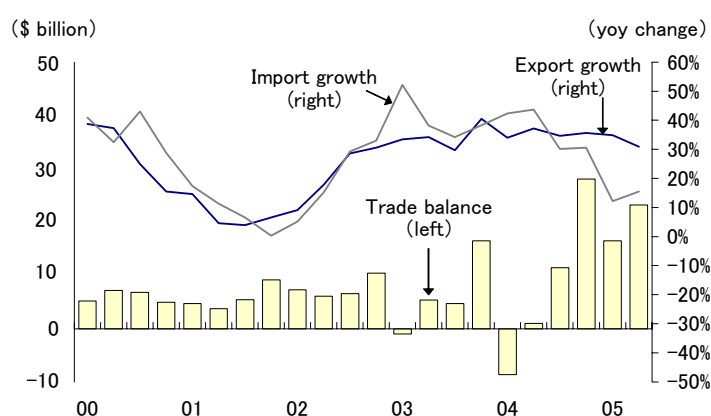
In June, China announced that future currency reform would follow the three principles of “independent initiative, controllability and gradual progress.”<sup>1</sup> The exact timing of reform was apparently influenced by growing trade frictions with the U.S. and Europe, and by pressure from other countries to revalue the renminbi.

### 1. Expanding trade imbalance and trade friction

In the first half of 2005, China’s trade surplus climbed to \$39.65 billion, mostly on trade with the U.S. and Europe. The full-year surplus is expected to reach \$70 billion, eclipsing the previous year’s \$59 billion surplus.

The surging trade surplus resulted from slower import growth of 14% year-on-year, combined with a steady 32.7% growth rate for exports (Figure 3). The import slowdown is attributed not only to the fading investment boom of the previous year, but to structural factors such as growth of domestic productive capacity and import substitution. Meanwhile, exports remain vigorous across all categories ranging from machinery, which comprises roughly half of exports, to labor-intensive textile and apparel goods, and materials such as chemicals and metals.

**Figure 3 Import & Export Growth, and the Trade Balance**



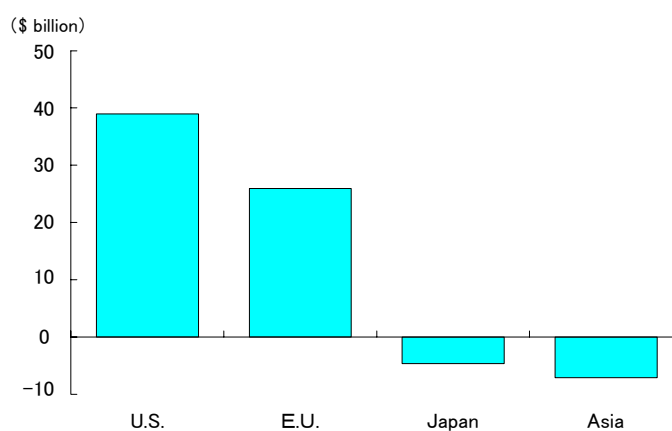
Source: China Customs Statistics

As we noted, China’s trade surplus is mainly generated with the U.S. and Europe, whose markets have been instrumental to China’s strong economic growth (Figure 4). After the Multi-Fiber Agreement (MFA) was phased out at the end of 2004, China flooded both markets with textile & apparel exports in 2005, pushing trade tensions to the edge. The U.S. imposed safeguard measures on seven textile goods in May, and is expected to do the same for other goods. In June, China agreed with the E.U. to limit exports of ten textile goods by the end of 2007, averting imminent safeguard actions. However, trade tensions linger in other goods and may spark protective

<sup>1</sup> Speech delivered by Chinese Premier Wen Jiabao at the opening ceremony of the Sixth Finance Ministers' Meeting (FMM) of the Asia-Europe Meeting (ASEM), June 26, 2005.

measures in the future.

**Figure 4 China's Trade Balance by Trading Partner (Jan-May 2005)**



Source: China Customs Statistics

## 2. Stance of the U.S. and E.U.

The U.S., Europe and Japan have long agreed on China's need for currency system reform. However, their respective stances have varied based on the nature of their trade ties with China and standing in currency markets.

Prompted by mounting frustration in business circles and Congress, the U.S. was most ardent in pushing China to make substantial currency reforms without delay. In 2004, America's trade deficit with China reached \$162.0 billion, or roughly one-fourth of the total trade deficit. Chinese imports, thought to hold an unfair trade edge due to the undervalued currency, were devastating America's small business sector. For China's part, the currency reform appears synchronized to the political calendar, in particular President Hu Jintao's visit to the U.S. in September, and release of the Treasury Department's *Report to Congress on International Economic and Exchange Rate Policies* in October.<sup>2</sup>

Meanwhile, Europe and Japan took a milder stance that left the timing and scope of currency reform to China's discretion. Compared to the U.S., Europe was less sensitive to the trade imbalance with China for several reasons. First, as the euro weakened against the dollar and yen in 2005, Europe's frustration eased over the euro's burden in absorbing part of the U.S. trade imbalance. Second, E.U. members were not unified on the issue of China's currency. And third, Europe's growing trade deficit with China was offset by its trade surplus with the U.S.

The G7 immediately welcomed China's currency reform, and other countries responded favorably to the new flexibility. Many U.S. officials including Treasury Secretary John Snow, White House

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<sup>2</sup> In his statement on the May 2005 report, Treasury Secretary John Snow commented, "If current trends continue without substantial alteration, China's policies will likely meet the technical requirements of the statute for designation," referring to designation as a currency manipulator.

spokesperson Scott McClellan, and FRB Chairman Alan Greenspan praised the move toward flexibility, while emphasizing the need for additional steps. But several days later on July 27, the House of Representatives passed a compensatory tariff bill targeting Chinese products. The U.S. thus remains wary of future trade friction with China and of the renminbi's movement, and appears poised to apply further pressure as needed.

## 2. Policy Management

### 1. Economic Impact of Policy Management

While the currency reform marks an important first step toward a floating rate regime, the 2.1% revaluation against the dollar is quite small, and the 0.3% band remains unchanged (1.5% band for other currencies). However, the statement also prompts optimism in that the exchange rate “will be more flexible” in the future with reference to a basket of currencies, and that PBC “will make adjustment of the RMB exchange rate band when necessary” (Figure 5).

The currency weighting of the reference basket is assumed to be led by the U.S. dollar, which is most used in China's transactions with the U.S. and Asia, followed by the euro and yen. However, authorities have not disclosed the composition of the currency basket, nor the basket's importance in determining the exchange rate.

#### Figure 5 PBC Announcement on Reforming the Exchange Rate Regime

- 1 Starting from July 21, 2005, China will move into a managed floating exchange rate regime with reference to a basket of currencies.
- 2 PBC will make the closing price of a foreign currency in the inter-bank foreign exchange market the central parity for trading on the following working day.
- 3 The exchange rate of the U.S. dollar against the RMB will be adjusted to 8.11 yuan per U.S. dollar at 19:00 hours, July 21, 2005.
- 4 The daily trading price of the U.S. dollar against the RMB in the inter-bank foreign exchange market will continue to be allowed to float within a band of  $\pm 0.3\%$  around the central parity. Trading prices of non-U.S. dollar currencies will be allowed to move within a certain band announced by PBC.
- 5 The RMB exchange rate will be more flexible based on market condition with reference to a basket of currencies. PBC will make adjustment of the RMB exchange rate band when necessary according to market development as well as the economic and financial situation.

Source: People's Bank of China press release on July 21, 2005.

Moreover, by leaving in place capital controls and limiting access to foreign currency markets, authorities retain great discretion in managing the new exchange rate system.<sup>3</sup> Considering the large economic impact of policy decisions, the government's policy management stance warrants close attention.

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<sup>3</sup> The main participants are the four state owned banks and the People's Bank of China.

## 2. Factors Affecting Policy Management

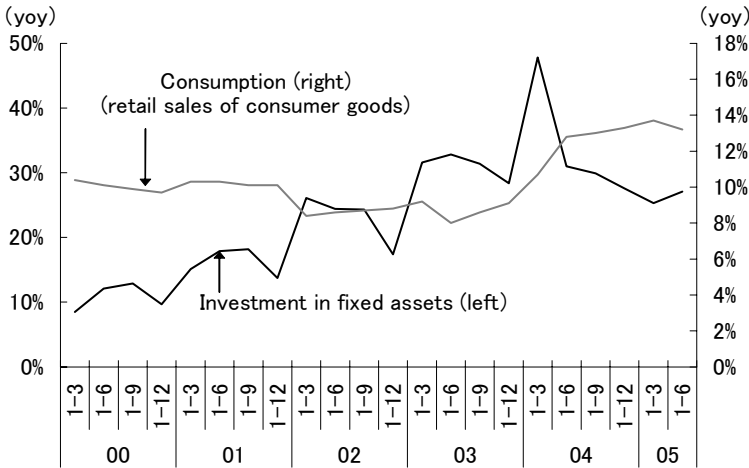
We can infer a few things about near-term policy management from the July 21 announcement, particularly where the PBC says it “will make adjustment of the RMB exchange rate bank when necessary according to market development as well as the economic and financial situation.”

### 1. Economic situation

In the first half of 2005, the economy maintained the 9.5% growth pace from the second half of 2004, exceeding the government’s target of 8%. The largest contributor to growth was net exports. Fixed investment slowed to 27.1% (yoy) from 31.0% one year ago, while consumption growth rose to 13.2% from 12.8% (Figure 6). Although growth patterns reflect macroeconomic policies to cool down the investment boom from last year and stimulate consumption in rural areas, exports and investment remain the pillars of growth.

Despite its growing presence abroad, China faces serious domestic issues—growing disparities between state-owned enterprises and non-state-owned enterprises, urban and rural areas, and coastal and inland areas. Sustained growth in exports and direct investment is vital to address these issues without triggering latent unemployment. Currency revaluation, by decreasing competitiveness and increasing flexibility of the currency system, has the negative effect of heightening uncertainties in cross-border economic activity.

**Figure 6 Growth of Fixed Investment and Consumption**



Source: National Bureau of Statistics of China

In the second half of 2005, net exports will contribute less to economic growth than in the first half as safeguards curb textile and apparel exports to the U.S. and Europe, while imports recover partially. And while signed agreements for direct foreign investment capital grew 19.0% (yoy) to \$86.2 billion in the first half, investment actually utilized fell 3.2% to \$28.6 billion. Moreover, as a result of excess investment and rising corporate goods prices, corporate profits deteriorated in the first half, while non-competitive state-owned enterprises, small local businesses, and the

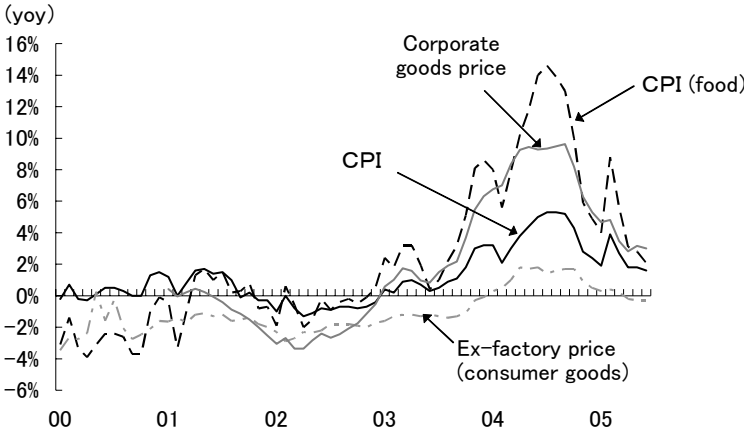
agricultural sector remain sensitive to currency revaluation. These factors act as incentives for a policy that limits the currency adjustment band.

The positive effect of currency revaluation is to curb inflation by enhancing purchasing power and reducing import prices. Greater purchasing power helps address the immediate issue of revising the structural dependence on exports and investment. But since a large and sudden revaluation will hurt exports and direct investment more than help consumption, revaluation needs to be done at a moderate pace.

Consumer price inflation, which accelerated to 5.8% (yoy) in July and August of last year, has stabilized at 1.6% as of this June. During this period, the main cause of consumer price inflation was rising food prices. Even when rising materials prices increased corporate goods prices, intense competition and excess supply forced downstream companies to compress margins rather than to pass along price increases. As a result, ex-factory prices of consumer goods have been held down (Figure 7). In steel products and other overheated investment areas, excess production has even driven down prices, taming inflationary concerns and even arousing concerns of deflation.

Due to these economic conditions, along with the need to ascertain the initial impact of revaluation, we predict that the pace of revaluation will be restrained in the near term.

**Figure 7 Price Trends**



Source: National Bureau of Statistics of China

*2. Financial situation*

Some market reforms were effected ahead of the currency revaluation. On May 18, the Shanghai-based China Foreign Exchange Swap Center allowed trading between foreign currencies, for which two domestic banks and seven foreign banks were designated as market makers, and liberalized foreign currency trading rates. On June 15, trading of bond futures was started. Still, with the foreign exchange market, money market, and derivative market under construction, companies remain exposed to currency risk because forex risk hedging is not yet possible.

Financial system reform is now at a critical phase. By the end of 2006, China must fulfill WTO pledges to lift business, customer, and geographic restrictions on foreign banks and ensure fair competition with domestic banks. Ahead of this, state-owned commercial banks must dispose of nonperforming loans, strengthen their capital base, and prepare for stock exchange listing. But in doing so, they also need to avoid the negative impact of a strong renminbi on their main customers, who are state-owned enterprises. Thus the financial system is also highly averse to a volatile exchange rate.

### *3. Near-term forecast*

Entering 2005, Hong Kong's 1-year RMB non-deliverable forward (NDF) rate—an indicator of market expectations for the currency rate—stood at 7.88 RMB to the dollar, reflecting expectations of a 5% revaluation to the pegged rate. When the actual revaluation proved to be only 2.1%, the NDF rate priced in an additional expected revaluation of under 5%, and rose to 7.74 RMB.

After the revaluation, PBC Governor Zhou Xiaochuan reaffirmed that China would maintain the three currency reform principles of “independent initiative, controllability and gradual progress,” while striving for basic exchange rate stability and promoting gradualist reform toward a market economy. He denied the possibility of additional revaluations.

Based on these statements, we predict that authorities will limit currency adjustments in the near term. Then while keeping a keen eye on certain factors—economic and financial conditions, market development, the gradual trend toward capital liberalization and international pressure for capital transfers—they will allow “controllable” exchange rate movements and “gradually” accommodate market forces.

## **3. Domestic and Foreign Economic Impact of Currency Reform**

Assuming that only minor currency adjustments occur in the near term, we predict that the currency reform will have the following impact on China's monetary autonomy and trade imbalance with the U.S.

### **1. Monetary Autonomy**

According to international monetary theory, an open economy cannot simultaneously achieve the three objectives of capital market openness, monetary autonomy, and exchange rate stability because these objectives are contradictory. One of the objectives must be abandoned (macroeconomic trilemma of open economies).

Under the previous currency regime, China tried to impose capital controls while maintaining monetary autonomy and exchange rate stability. However, due to relatively weak capital controls



on direct investment and other capital transactions, and the growing amount of inward capital flows that completely bypassed capital controls, authorities had to relinquish monetary autonomy to maintain the exchange rate peg.

As a large economy, China is expected to shift to a floating rate regime and seek the objectives of capital mobility and monetary independence, while abandoning exchange rate stability. But in doing so, the important point is the sequence of priorities that China chooses to adopt.

Lifting capital controls will help alleviate the present problems of an expanding BOP surplus and growing foreign reserves. But due to the dearth of asset management options—domestic savings are concentrated in the ailing banking system, while the bond market is underdeveloped and the stock market is stagnant—easing capital controls could trigger a massive capital outflow.

The government's top priority should be to restore the health of financial institutions and set up a market environment. To avert disturbances caused by massive capital flows, exchange rate flexibility should be emphasized over capital liberalization.

Although the small initial currency revaluation leaves room to expect additional actions, the basic BOP structure will persist because capital controls are likely to remain fixed in the near term. If the government wants to prevent large exchange rate fluctuations for economic and financial reasons, monetary autonomy will remain unattainable. In addition, to alleviate pressure from foreign currency inflows, a certain amount of exchange rate volatility must be tolerated.

## **2. Trade Imbalance with the U.S.**

In the near term, the currency reform will have only a limited effect on the trade imbalance with the U.S. for three reasons: the small size of revaluation, the investment-saving balance of both countries, and the structure of trade.

According to estimates we made in 2003, to reduce the U.S. current account deficit to 2% of nominal GDP by 2008, the renminbi would have to double in value from 8.3 RMB per dollar to approximately 4.4 RMB.<sup>4</sup> In June 2005, the Asian Development Bank estimated that if the renminbi were revalued 10% in the second half of 2005, the U.S. trade deficit would decrease by \$3.6 billion in 2006.<sup>5</sup> Since the initial revaluation was only 2.1% and future revaluations are expected to be limited, the effect of currency revaluation on the trade imbalance will be extremely small.

The fundamental solution to the U.S. current account deficit is for America to improve its investment-saving balance by cutting the fiscal deficit and increasing private savings. On the

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<sup>4</sup> Kumagai, Yajima and Ito (2003).

<sup>5</sup> Park (2005).

other hand, China's foreign reserves are growing not so much from its current account surplus, but from its large capital account surplus. In one sense, the overall surplus (current account and capital account) attests to China's success in securing investment funds to build the economy, which was the initial goal of the economic reform and market opening policy. However, the surplus has generated trade friction externally, while spurring excess investment and reducing investment returns domestically due to the nascent market mechanism's inability to efficiently allocate funds. China needs to advance currency reform, monetary reform, and capital liberalization in the appropriate sequence so that it can ease trade friction, correct structural and fund-flow distortions caused by unbalanced investment, and build a stable platform for growth.

The structure of trade between China and the U.S. also casts doubt on the currency revaluation's effectiveness to correct the trade imbalance.<sup>6</sup> The source of China's trade surplus with the U.S. lies in exports of labor-intensive products, IT equipment, and consumer electrical appliances. To manufacture these products, China participates in Asia's division of labor by buying materials and parts from Japan, South Korea and Taiwan.

Due partly to the phasing out of MFA quotas, China's textile and apparel products have grown phenomenally in U.S. markets for labor-intensive products. Since intense competition forces Chinese exporters to absorb cost increases from small currency rate adjustments, we expect little to change in China's market share in the U.S.

In machinery and equipment, since China imports materials and components from Asia to build and export finished products to the U.S., higher export prices from a renminbi revaluation would be partially offset by lower purchasing costs in the region.

However, for both product categories, rising production costs in China are prompting a shift in Asia's division of labor. As a result, it is possible that the U.S. trade imbalance with Asia as a whole may not improve.

Correcting the trade imbalance will require not only additional currency rate adjustments, but efforts by both the U.S. and China to improve their respective investment-saving balance, as well as a widespread appreciation of Asian currencies against the dollar.

## **Conclusion**

While the "gradual" currency reform will have a limited impact on domestic and foreign economies in the near term, it marks a major step toward an exchange rate system that supports China's market economy. The shift to a floating rate system and capital liberalization could even happen

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<sup>6</sup> The structure of China's exports to the U.S. and division of labor in Asia are analyzed in Ito (2004).

faster than expected if pressures to reduce trade friction and improve capital mobility become catalysts.

China's currency reform warrants ongoing attention as a factor that will affect Asian monetary policies forming the intricate network of division of labor, and global capital movements.

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