Economic Analysis

April, 2004

A Publication of the BEA Economic Research Department

Future Development of the RMB Exchange Rate

Overview

Renminbi (RMB) revaluation has been a hot topic for quite some time. The recent surge in China's foreign currency reserves and international political pressure have both conspired to keep the topic in the news. However, from China's policy interest point of view, the main priorities are (1) strengthening the capital control system to slow hot money inflows and (2) cooling the over-expanded asset market. For the time being at least, a significant change in the exchange rate level or regime is seen as counterproductive.

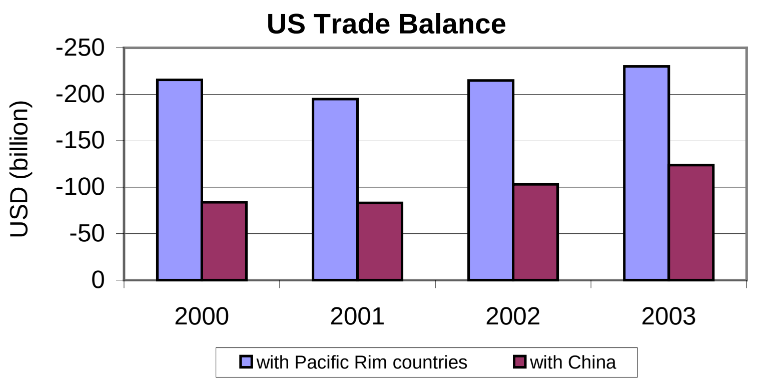
Nevertheless, in the long run, there is room for changes to the regime. The peg to the greenback exposes China to the exchange rate volatility of a single currency. It is also not the best arrangement as China's external trade relationship matures. As the domestic economy grows stronger, the benefits of a strong RMB on the import side of the equation will carry more weight in the country's future exchange rate policy.

Changes are Unlikely in the Near Term

The call for RMB revaluation first gained momentum in the first half of 2002, indicated by an increasing discount in the RMB forward market. As we move ever closer to the date of the US presidential election, voices calling for RMB appreciation are expected to become louder, as both US labour unions and the domestic US textiles industry exert pressure on the candidates to adopt hard-line trade policies on China.

However, there are good reasons for China to refuse to bow to such pressure.

Firstly, the surge in the Sino-US trade imbalance, which is often given as the key factor supporting RMB revaluation, is largely misunderstood. The US trade deficit with China grew by 48% over the period 2000-2003 to US$124 billion, or 25.3% of the country's total deficit. This creates an impression that China's exports are the major contributor to the growing US trade deficit and hence to the loss of US jobs.

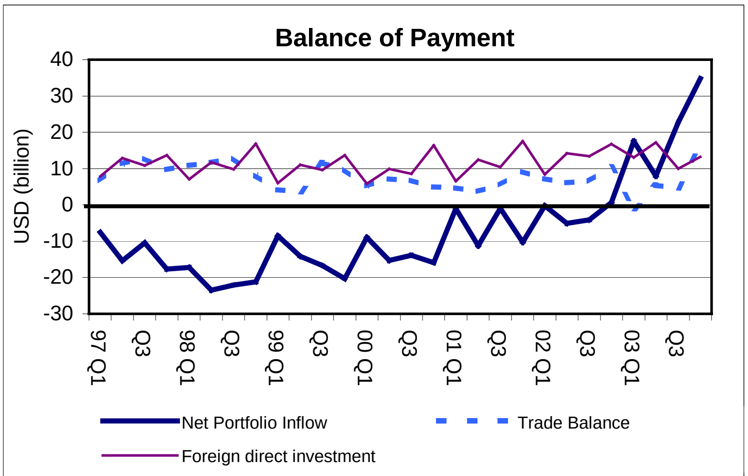


Source: Bloomberg
Note: Pacific Rim includes Australia, Brunei, China, Hong Kong, Indonesia, Japan, Korea, Macau, Malaysia, New Zealand, Papua New Guinea, Philippines, Singapore, Taiwan

However, our research results suggest that the widening trade imbalance is mainly the result of the restructuring of regional trade patterns. In recent years, many manufacturers have relocated low-end production facilities to the Mainland to take advantage of low production costs. China has increasingly served as the final link in a regional production chain. Under the new arrangement, Taiwanese, Japanese and Korean manufacturers supply semi-finished products to China for final assembly, while Southeast Asian economies provide the necessary resources. As a result, the Sino-US trade balance alone will be a misleading indicator of China's contribution to the US trade deficit. As a matter of fact, the US trade deficit with the Pacific Rim has hovered in a close range since 2000 (see chart above).

Secondly, changes in the RMB exchange rate regime could compromise China's efforts to deal with the problems associated with excess capital inflows. China's foreign exchange reserves have almost doubled in the past two years, despite the relatively stable level of its trade surplus and foreign direct investments. This is due to the change in magnitude and direction of other balance of payment components, often referred to as portfolio inflow/outflow. This includes illegal capital flows and overseas investment holdings by Mainland companies, etc.

While outflows ranging anywhere from US$8 billion to US$84 billion have been registered every year since 1991, the first ever inflow – amounting to US$83 billion – was registered in 2003. This indicates a sudden and strong preference to hold RMB denominated assets. Under the global low interest rate environment, the booming commodity and property markets in China have enticed Mainland companies to convert their foreign currency holdings into RMB investments. The weak US dollar and the subsequent international call for RMB revaluation have accelerated the pace of capital immigration.



Sources: China Monthly Statistics; National Bureau of Statistics; Bloomberg and State Administration of Foreign Exchange of China

The surge in capital inflows is hardly welcome news for the Chinese economy. China has been troubled by rising commodity and property prices. The extra liquidity created by the capital inflows will further stimulate the asset markets, threatening to push inflation higher. The government has responded with measures to cool off the overheated asset market and strengthen the capital control system to improve the situation. It has also eased restrictions on holding foreign currencies for both companies and individuals. Any change in the exchange rate level or the regime at this time will only reinforce appreciation expectations for the RMB. This would likely attract further capital inflows, compromising government efforts to tackle the problem.

Future Developments

While the Chinese government's immediate concern is to slow the rush of capital inflow, it needs to address two policy issues related to the RMB exchange rate in the long run. Firstly, China may wish to switch the peg from the US dollar alone to a basket of foreign currencies. The current US dollar peg does not accurately reflect China's current external trade relationship. The US accounted for 19.4% of China's trade volume in 2003. Even if countries that link their currencies with US dollar are included, the percentage share is only 37.6%. Meanwhile, Euroland and Japan together account for some 32.7% of China's total trade volume. Hence, a link to basket of currencies will offer greater stability in China's external trade relationship.

Moreover, a link to the US dollar exposes China to single currency exchange rate volatility. Due to the slide of the US dollar in the past two years, the RMB has depreciated by 44% and 22% against the Euro and Yen, respectively. The link also neutralizes US efforts to weaken its currency to boost exports. This triggers external political pressures, calling for RMB revaluation. A link with a basket of currencies will avoid this problem.

The timing of the switch is a more delicate matter. Firstly, major changes in the exchange rate regime at this time will elevate expectations for RMB revaluation, and attract capital inflows. As mentioned above, this will undermine government efforts to slow hot money inflow. Secondly, with the current weak US dollar exchange rate level, a switch at this moment may not be acceptable to China's trading partners. A less extreme valuation for the US dollar would be seen as better timing for exercise to proceed.

A second issue is the rethinking of China's exchange rate policy. Like all other countries, China tries to adopt an exchange rate policy that best suits its long-term economic interest. For the time being, nurturing an environment that attract foreign direct investment is the priority. China's political and economic reforms and its rich labour pool have succeeded in transforming the country into a global manufacturing power house. This has made China the number one attraction for foreign direct investments(FDI) in the world in the past few years.

Unlike hot money inflow, FDI plays a crucial role to China's economic development. It not only brings in jobs and capital, but also management and technical expertise. It helps to train the local labour force and impose international best practice on the market. This provides vital ingredients for China's effort to reform its domestic economy, which will be the major source of economic and employment growth in the long run. From this perspective, it is understandable that the Mainland government is averse to the risk of a currency revaluation that will dilute China's cost advantage and undermine China's attractiveness for FDI.

While we believe that a stronger RMB has more downside than merit at the current stage of economic development, the situation could change as the reform effort produces significant progress in coming years. Despite China's growing role in the global external trade arena, developing a strong and mature domestic economy is the country's true destiny. With a population of close to 1.3 billion, the potential of the domestic economy is tremendous. Although a strong currency hurts the country's cost competitiveness, it benefits the domestic economy with cheaper imports. This is relevant to China. It imports half of the steel and one third of the crude oil it consumes every year. A stronger domestic economy in future will lead to strong appetite for imports, and a firmer RMB will then find a much more appreciative audience.

Conclusion

China achieved 9.1% economic growth in 2003, despite being hit by SARS. However, government officials describe the growth pace as too fast and have designated 2004 as a year of consolidation. Cooling off the over investment and slowing hot money inflows top the agenda. Any significant changes in the exchange rate regime in the near-term will fuel currency revaluation expectations and hot money inflows, and hence will conflict with the country's policy direction. Significant changes in exchange rate policy will therefore likely have to wait until after 2004.

China has maintained its currency exchange rate largely unchanged since 1994. The current call for revaluation stems from the cost competitiveness of China's rich labour pool. The flip side of this strength is the severe unemployment problem facing China. 80% of the population lives in the rural areas, and the unemployment rate averages at 15%. Hence, it is important for China to maintain its cost competitiveness for the time being to attract FDI and keep the market reforms on course. This is crucial to efforts to solve the country's unemployment problem. However, as a more mature domestic economy take shape, it will become the key driver of growth in future. Policy makers will wish to see more affordable imports to nurture the development of the domestic economy. The balance between export cost competitiveness and the cost of imports will determine exchange rate policy in the long run.