Economic Analysis

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Reform of RMB Exchange Rate Regime and its Implications

After much speculation, and considerable political wrangling, the day of Renminbi (Rmb) exchange rate reform has finally arrived.

While the market has been most interested in the near-term movement of the currency and the impact on other Asian currencies, the long-term implications of the reform are more significant. The decision effectively ends the Rmb peg to the USD, and is the first significant step on the road to gradual removal of capital controls. The change in the Rmb exchange rate will bring short-term adjustments, but the reform measure will have lasting impact on both the Mainland and Hong Kong economies.

The 2% Rmb revaluation will have limited impact

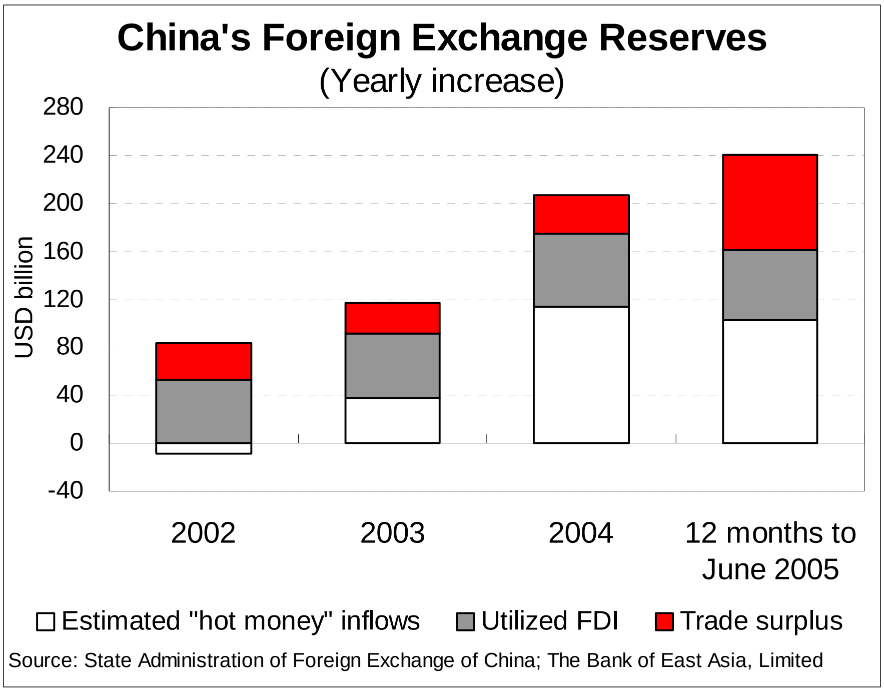
The biggest consideration of the currency revaluation is the possible erosion of China's cost advantage. But the magnitude of that erosion is likely to be considerably less than generally expected. Rmb revaluation immediately triggered appreciation of Asian currencies. Since Asian economies are both China's important overseas markets and export competitors, their currency appreciations will dilute any adverse impact on China's exports. After the revaluation move, the currencies of Taiwan, South Korea, Japan, Singapore and Thailand all appreciated by around 2% against the USD. Hence, exports to these markets, which account for 16% of China's total, will not feel the impact of the Rmb revaluation. Furthermore, China's coastal cities have developed into perhaps the most efficient manufacturing cluster in the world. The efficiency offered would also help to mitigate the effect of higher operating costs following the Rmb revaluation.

Relatively speaking, the impact of Rmb revaluation on the government's effort to develop the western part of China is of more concern. To achieve a more balanced growth profile, China has expended considerable effort to encourage greater economic activity in the inland regions, through policy assistance and investment in infrastructure. Since these inland areas do not possess the same level of economic efficiency as the coastal regions, cost competitiveness is vital. If currency revaluation raises the region's costs, the government's plans will suffer a setback. Furthermore, the move will also make agricultural imports cheaper and put pressure on farmers' incomes, which is the major source of income in western China. Hence, further appreciation will compromise the government's efforts to improve living standards in the western part of China.

Reform measures that bear true importance

While the market has focused on the currency revaluation angle, the switch to a managed floating exchange rate regime with reference to a basket of currencies and the liberalization of capital outflows are of greater importance to China's external financial balance. Since the start of 2002, the USD has depreciated by 33% and 18% against the Euro and the yen respectively, resulting in appreciation pressure on the Rmb. Switching from a USD peg to referencing a basket of currencies will rescue China from exposure to single currency exchange rate volatility. The question now is whether the government will actively manage the overall exchange rate mechanism over time. The advantage of such a flexible approach is that it would allow the authorities to respond more effectively to market demand, and avoid abrupt adjustments resulting from any build up in exchange rate pressures. The disadvantage is that it may encourage near-term market speculation, particularly at present when the market expects a fairly swift appreciation of at least 5% against the USD. Given that capital controls remain firmly in place, the government may experiment with small adjustments at the start to find the comfort zone.

Liberalization of capital outflows is another key component of the reform. One of the biggest headaches facing the administration is the influx of capital. After growing USD200bn in 2004, China's foreign currency reserves are now on pace for an over- USD200bn increase this year. Even after subtracting the trade balance, the size of investment inflows is still huge, making it increasingly difficult for the government to conduct the sterilization operations necessary to digest the excess inflows. The resulting overheating of the economy has been a threat to China's economic health.



We believe that the current revaluation will not be enough to solve the problem of excess capital inflows. On the contrary, we believe it will accelerate capital inflows in anticipation of further revaluation, intensifying the harmful stimulus to the economy. On the other hand, the government will not allow sizable revaluation, which would further disadvantage the interior and could even pose a threat to China's export competitiveness.

Revaluation is not an effective solution to excess capital inflows, because export competitiveness is not the only driver of such inflows. China's current account surplus accounted for 4.5% of GDP in 2004, which is in line with levels in other Asian economies.

What makes China different is that it is an attractive destination for foreign direct investment (FDI). China is the largest recipient of FDI in Asia, due to its huge domestic market and growing dynamic economy. On the other hand, rising incomes and economic growth have also created demand for Chinese investments overseas. However, investing abroad is still tightly restricted, and this blocks the legitimate outflows that would help to neutralize the capital influx. Hence, easing restrictions on Mainland companies and individuals investing overseas goes to the root of the problem.

Implications for the Hong Kong Economy

As around 10% of Hong Kong's retained imports come from the Mainland and 40% from other Asia economies, the current 2% revaluation of Rmb and the subsequent appreciation of other Asian currencies will only give a modest push to Hong Kong's inflation rate. Hong Kong is a service-based economy, and rent and wages account for a significant share of its cost structure. Hence, even if the Rmb further appreciates, the effect on the economy should be muted.

The major adverse impact will be on Hong Kong's re-export trade. 60% of Hong Kong's re-exports originate from the Mainland. The total value of these re-exports was HKD1.14 trillion in 2004.

Excluding the re-export margin and imported components, a conservative estimate places the "made in China" component at HKD400-500 billion. If the re-exporters absorb the entire cost increase of the 2% revaluation of the Rmb, this will put the maximum cost at HKD8-10 billion. In reality, the cost increase is likely to be split between Mainland manufacturers and overseas buyers. How the cost is divided will be determined largely by the extent that overseas buyers switch their sourcing to other low cost economies. Movements in Asian currency exchange rates will be crucial. Since many Asian countries are China's export competitors, appreciation in other Asian economies will mitigate the loss of export orders.

Rmb revaluation is also expected to bring benefits to the Hong Kong economy. The expectation of further Rmb appreciation will attract capital inflows. This will lower HKD interest rates and give a boost to the asset market. Furthermore, 30% or HKD38 bn in Hong Kong's domestic exports are destined for the Mainland, and the lion's share of service exports, such as tourism, targets the Mainland market. They will be more price-competitive in Rmb term following the revaluation. However, the biggest boost will come from Hong Kong's investments and operations in the Mainland, including banks, property investments and developments, hotels, retail, etc. Hong Kong's accumulated utilized investment in China amounted to HKD1,884 bn, or 43% of the national total in 2004. A 2% appreciation of Rmb will translate into a HKD 37 bn gain in valuation, and will inflate their derived income in HKD terms. Overall speaking, the economic impact is likely to be positive.

Also interesting are the implications of the removal of the Rmb's long-standing peg to the USD. Currently, 43% of Hong Kong's external trade is carried out in Rmb, compared with 16% in USD. As the Rmb had been pegged to the USD, as much as 59% of Hong Kong's external trade had enjoyed exchange rate stability in the past. This has now changed, as the Rmb is no longer pegged to the USD. Hong Kong traders, businessmen and the economy as a whole will have to adapt to a new era of a floating Rmb exchange rate environment.

Conclusion

China's emergence as an economic power has become increasingly visible, so the country needs a more flexible and sophisticated exchange rate regime. It also must gradually liberalize its capital account. Otherwise, external financial imbalances will build up and damage the long-term health of the economy.

For Hong Kong, a more market-driven Rmb exchange rate regime has mixed implications. While the switch to referencing a currency basket will expose Hong Kong businesses and the economy to Rmb exchange rate volatility, it creates opportunities for exchange rate hedging activities for the financial markets. The effect will intensify with Mainland's gradual opening of the capital account. As Hong Kong further integrates with the Mainland economy, Hong Kong's continuing currency peg to the USD will pose great challenges to the Hong Kong economy and financial systems in future.