Economic Analysis

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# RMB Revaluation is Not a Panacea for External Imbalances

The Renminbi (Rmb) exchange rate policy has become a focal point in the relationships between China and its major trading partners over the past few years. Since the government in Beijing unpegged its currency last July, the Rmb has strengthened by nearly 5% against the US dollar. After much heated debate, western experts have tempered their criticism regarding the pace of Beijing's Rmb reform. The successful visit to China by the US Treasury Secretary, Henry Paulson, in September this year has suggested that the differing view between the two countries on the Rmb issue has narrowed.

## Pressure remains on Rmb reform

However, China's exchange rate policy could be high on the agenda again with the possible slowdown of the US economy. Following the anticipated rise in the US unemployment rate next year amid a softening property market, calls from Washington for faster Rmb appreciation will intensify. American critics have been claiming that an artificially undervalued Rmb has reduced their competitiveness, which in turn resulted in the mounting US trade deficit with China of an all-time record of US$202 billion in 2005. Given the loss of manufacturing jobs in the country to date, it will become more difficult to mollify frustrated Americans during a period of economic slowdown.

On the other hand, international pressure is unlikely to force Beijing to deviate from its progressive but gradual approach to currency reform. With the implementation of the 11th Five-Year Plan, China aims to tighten regulation to lower pollution and enhance the country's efficiency in resource utilisation. Mainland exporters are already too pre-occupied to adjust to these policy changes. High commodity and energy prices also add extra burden. The wafer-thin profit margins of exporters will be further sliced if the Rmb rises at a faster pace. A resulting surge in unemployment is the last thing that Beijing wants to see. Hence, it is expected that future appreciation of the Rmb will continue in a step-by-step manner, which will place greater strain on Sino-US trade relations early next year.

## Expansion of imports is the key

Setting aside the political wrangle, it should now be clear that China's external trade imbalance is mainly due to structural issues. In addition to its nearly 5% appreciation of the Rmb since last July, China has taken steps to slow export growth over the past few years, including the removal of export subsidies and the slashing of tax rebates on exports. However, for the first nine months of 2006, the country still posted a record trade surplus of US$109.85 billion, greater than the total of 2005.

As China-made products are cost competitive in the global market, a revaluation of the Rmb may slightly diminish but not eliminate this advantage. As long as US consumers maintain their current spending pattern, the bilateral trade imbalance will not be significantly reduced. Furthermore, as half of the mainland's exports are produced by foreign-owned manufacturers, further debate in this direction will result in a lose-lose standoff.

A more effective way to curb the soaring trade surplus is by expanding China's imports through market opening. For example, the US should encourage the export of high-tech products, one area in which the country has a competitive advantage. However, US trade barriers have been imposed on China under its export control policy. The US export of products in over 2,000 high-tech categories is currently restricted, and the US government's import licence application procedure is lengthy. For these reasons, technology exports from the US to China have been growing only half as fast as those from the European Union, and markedly slower than those from Japan. Enabling US companies to capture growing opportunities in China's service sector is another important area that will boost US export income.

These approaches address the challenges by exploring the comparative trade advantages of both countries. However, it will take time before such efforts can help achieve a significant rise in US export income on the mainland.

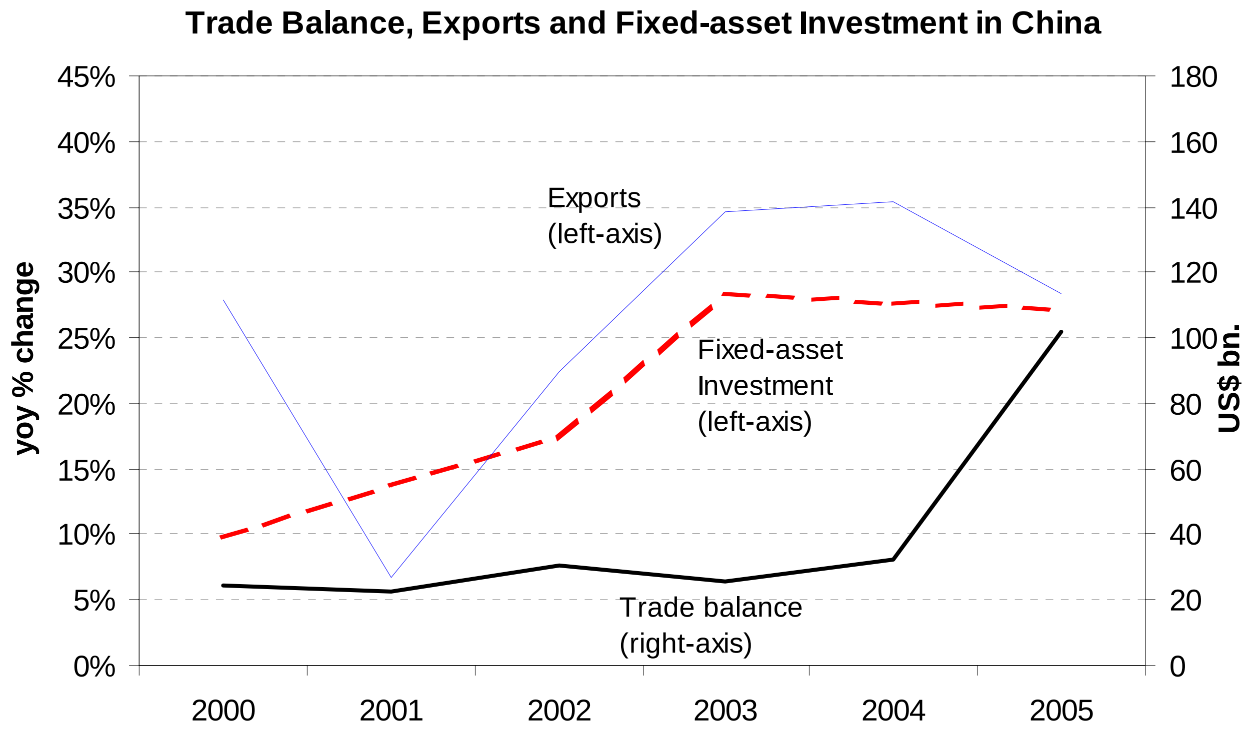
**Outward investment helps reduce foreign exchange reserves**

Massive capital inflow is another factor contributing to the external imbalance. China now holds the largest reserves in the world. Commonly described as a savings glut, which has been created by the country's sizable trade surplus, China's foreign exchange reserves have grown annually by over US$200 billion since 2004. However, we believe that the accumulating reserves are mainly the by-product of China's capital account reform strategy. In the process of liberalising its capital account, China is experiencing a capital flow imbalance: the pace of easing restrictions on capital inflow is ahead of that of capital outflow. The rationale for adopting this approach is most likely to avoid a situation similar to the Asian Financial Crisis of 1997, involving a sudden outpour of capital. Few anticipate that this strategy will backfire, leading to the surge of capital inflow that China must now contend with.

In the past few years, China has established itself as the world's factory, while the potential of its huge domestic consumer market has attracted just as much attention. China has thus become a magnet of foreign investment, and now ranks as the largest recipient of foreign direct investment among developing countries. With the emergence of the mainland's housing market, there is now another source of attraction for foreign capital.

The surge of capital inflow may have also led to an exaggeration of China's merchandise trade surplus. China's exports surged in 2003 and 2004, but its trade surplus was initially maintained in the US$20-30 billion range. This was because faster import growth, driven by fixed-asset investment, had kept the size of the country's trade surplus in check. However, China's total trade surplus soared to US$102 billion in 2005, despite a less rapid growth in exports and strong increase in investment. Since China did not significantly alter its export structure during that period, the sudden jump in the export business margin does not add up.

One possible factor that may have contributed to this phenomenon is the massive capital inflow disguised as trade. China's tightening on capital inflow to cool overinvestment since 2004 may have caused many companies and individuals to channel funds into China by overestimating export values, which exaggerates the size of the trade surplus.




*Source: National Bureau of Statistics of China*

In order to correct the capital account imbalance and relieve pressure on Rmb appreciation, China has doubled its efforts to liberalise restrictions on capital outflow in recent years. Under the "going-out" policy, mainland companies are encouraged to expand their operations abroad through mergers and acquisitions. China's overseas investments jumped 123% to USD 12.3 billion in 2005, bringing the total investment outstanding to USD 57.2 billion. Furthermore, under the Qualified Domestic Institutional Investors scheme, Chinese banks, insurers, and other financial institutions are allowed to exchange Rmb for foreign currencies to buy overseas financial assets within a specified investment quota. Through different channels, individuals are now enjoying a wider selection of overseas investment opportunities. These measures should be able to digest the accumulated excess reserves over time.

**Conclusion**

Reforms introduced since last July have created a more market-based exchange rate regime. China's top priority in running the new system is to maintain a credible and consistent exchange rate policy. Following Premier Wen Jiabao's comment earlier this year which ruled out the possibility of any "surprise adjustments" to the Rmb's value, forecasts on the magnitude of further Rmb increases have been lowered. Beijing has also repeatedly stated that currency appreciation will follow a gradual and steady path. Therefore, little change is expected for China's current stance on its exchange rate policy, despite increasing political pressure on the country to quicken the pace of currency appreciation early next year. The Rmb exchange rate against the USD is forecast to appreciate at a moderate pace of 3-5% per year.

In China's 11th Five-Year Plan, the policy focus has shifted from growth in export volume to export quality. The country also aims to scale down capital inflow and reserve accumulation to cool growth in the supply of money. Based on the common interest to reduce the trade imbalance, efforts of the international community should focus on the roots of the problem, which are market and capital account liberalisation of China. Nonetheless, it will take time for these measures to show notable results, and continuing efforts and patience will be required before the balance could be regained.