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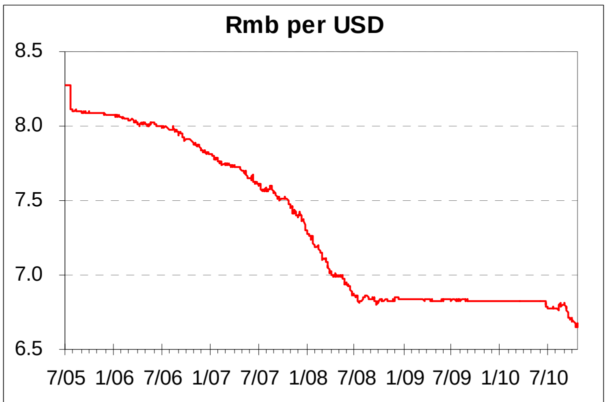
The Outlook of the Appreciation in Renminbi

After a period of relative calm, the Renminbi (Rmb) is once again in the spotlight. The charge of China keeping the value of its currency artificially low has returned with a vengeance. The period of calm since the outbreak of financial crisis in the late 2008 was broken in June 2010, when China announced the adoption of a more flexible exchange rate policy. The Rmb/USD rate has appreciated by some 2.3% since then. However, this movement has been too little for US politicians, while the pressure of election year further added to the political posturing. Recently politicians in other countries also joined the chorus in demanding China to step up the pace of Rmb appreciation.

Factors Underpinning the Appreciation Trend of the Rmb

China's 11th Five-Year Plan, introduced in 2006, was aimed at reducing the country's reliance on export-led growth in favour of domestic consumption, in order to create an environment conducive to a more balanced and sustainable growth. With the shift in economic strategy, input prices are no longer set at low levels to support exports. Stringent environmental regulations have been introduced, energy prices liberalised and export rebates substantially reduced. Further, China engineered a significant appreciation in the value of the Rmb between June 2005 and September 2008, forcing the Rmb up by 21.4% against the US dollar. These measures, combined with rising wages, led to great hardship within China's export sector.



Source: State Administration of Foreign Exchange

Despite rising production costs, recent studies[1] indicated that China's share of global exports of manufactured goods increased from 10.8% in 2006 to 12.7% in 2008. Further, competition from low-cost producers such as Vietnam, Cambodia and Bangladesh has done little to dent China's position. In fact, China's share of traditional light consumer goods in the US and EU markets has risen during this period. China has taken the lead in the quality-price ratio, delivery lead time and flexibility in meeting different order requirements far ahead to offset the adverse impact from the surge in production cost.

The above indicates that China's exporters have gradually adapted to a rising cost environment. Not only left unharmed despite rising costs, they have proven adept at moving up the value-added ladder. This experience should strengthen the confidence of the Chinese government in allowing the Rmb to appreciate over time.

Another factor underpinning the value of the Rmb is internationalization. In recent years, China has focused on promoting the Rmb as an international currency. The first step has been to encourage the use of the Rmb in bilateral trade. In order for the volume of trade conducted in Rmb to expand, the amount of Rmb funds held offshore must also expand, so that a wide range of Rmb denominated financial services could be effectively provided to support Rmb business activities. Appreciation of the Rmb is useful in this regard, as it encourages people to hold the currency for investment return. As offshore trade in Rmb gains momentum, the demand for Rmb will only accelerate.

The Case for a Gradual Pace of Appreciation

While the Rmb is firmly on an appreciation path, it is very unlikely that we will see a large move of the currency in the foreseeable future. One argument for the potential of a significant jump in Rmb exchange rate is the sizable Sino-US trade imbalance. The widening trade gap between the two countries reached a record high at 45.1% of the total US merchandise trade deficit in 2009.

[1] "Trade Watch –The Competitive Supply Chain: China v arising Asia", *HKTDC*, June 2010

However, this gap only reflects the fact that China is standing at the end of the regional manufacturing supply chain. Much of what China exports is assembled in China from raw materials imported from Southeast Asia and semi-finished products from countries such as Japan and South Korea. China then inherits the accumulated trade surplus against the US, which gives the illusion that it is the major contributor to the US trade imbalance.

As a matter of fact, there are signs that China's overall trade surplus is declining, with its merchandise trade surplus slumping by 34.2% in 2009 amid robust domestic consumption but weak external demand. During the first eight months of 2010, China's overall trade surplus shrank by a further 14.7%, while the total US trade deficit jumped by 33.9%. This runs counter to the claim that China is the major contributor to global imbalance. It also reminds us that when evaluating the need for rebalancing, China's overall trade picture is much more relevant than the bilateral trade relationship with the US. With China's strategy of shifting its growth engine from exports to domestic consumption, its trade surplus should continue to narrow in the future. A recent projection made by PBOC deputy governor Yi Gang was that China's current account surplus would fall below 4% of GDP in the next three to five years, from 6% in 2009.

Meanwhile, according to the 12th Five-Year Plan (2011-2015) proposed during the annual meeting of the Central Committee of the Communist Party of China, one of the targets is to raise the share of final consumption to GDP from 48.6% in 2009 to 55% in 2015. Two options would be beneficial in this regard. One option is a stronger Rmb would make imported goods cheaper for Chinese consumers. The other is a faster wage growth would encourage greater spending. Wage growth could be promoted through raising the minimum wage and stimulating job creation through policies such as industry deregulation. In recent months, Mainland regional governments have raised minimum wages by 10-30%, and there are individual reports of sizable wage increases in some coastal cities.

The downside to a rise in wages is that it could be inflationary, while currency appreciation would tend to reduce inflation. Currency appreciation also has a downside, however, as it lowers the cost of imported goods compared to local goods. As a wage increase would raise the demand for both goods and services, the impact on domestic employment would be more beneficial than a rise in the Rmb. Wage rise can also fasten the pace of narrowing the wealth gap.

An increase in China's labour costs will affect its cost competitiveness and increase import consumption; hence, the impact will be similar to currency appreciation in addressing the trade imbalance. From the overall interest of the state, a rise in wages is preferred over currency appreciation. In the same vein, the proposal of the 12th Five-Year Plan calls for raising the proportion of household income in national income. This implies future acceleration of wage growth, hence the magnitude of Rmb appreciation will be limited in the long term.

China's Effort to Maintain Independence in Currency Reform

Following the onset of the financial tsunami, China has recognized the importance of assuming a stronger role in international finance so as to safeguard its national interests. Since then, it has been promoting the use of the Rmb over the US dollar in bilateral trade settlement. In tandem with this effort, China has been at pains to highlight that its currency reform was directed against a basket of currencies rather than the dollar alone. Unfortunately, this is not well received by the US politicians, and we expect the Rmb/USD to remain as a bone of contention in the future.

Amid the prevailing ultra-low rate environment, appreciation of Rmb will attract capital inflow into China. The central government has to handle the issue of Rmb appreciation with great prudence in a bid to avoid heavy influx of hot money into its capital market. In conclusion, we are convinced that the Rmb will continue to appreciate over the long term. However, the path will be determined by domestic considerations, while the magnitude of adjustment will only be steady and moderate.