REVALUING THE RENMBI WILL NOT BE CATASTROPHIC FOR CHINA

But it will not be a cure-all, either

Some people were expecting it, others no longer believed it, and many people never thought it would happen. No matter: the probability that China will revalue its currency is no longer up for discussion. On July 21, the People’s Bank of China (PBoC) revalued the renminbi (RMB) by 2.1% against the American dollar—from 8.28 to 8.11 yuan/US$—and took a first step toward greater flexibility by pegging its exchange rate against a basket of currencies.

With China having very little inflationary pressure at the moment, in spite of its strong economy, the PBoC’s action appears to be aimed at easing some trade and political tension with western nations. However, the current account and capital account surpluses are still problematic, suggesting that we should expect subsequent revaluations in the next year or two. It is clear that China is reluctant about sharply revaluing the RMB, a situation that, in its opinion, would be disastrous for its export growth. How far can it go?

In this article, the last in our trilogy on China, we strive to explain the potential impact of revaluing the RMB on China’s economic growth. We also look at its ability to absorb some of the imbalances seen in the last few years, in particular the substantial deterioration in the U.S. current account balance and low interest rates on bonds.

China takes a first step toward greater flexibility for its exchange rate

Whether we look at the massive accumulation of currencies caused by simultaneous surpluses in the current and capital accounts, at the speed at which China has grabbed market share in global trade, or at its workforce’s increase in productivity or, more simply, at the strength of its economy, the arguments that the RMB is undervalued are many. With the current excitement about the currency’s revaluation, everything was suggesting that China would proceed to adjust the RMB sooner rather than later, but it was hard to know when, and by how much.

In mid-July, the Financial Times disclosed that John Snow, Secretary of the U.S. Treasury, had told Senators Shumer and Graham (the very ones who want to impose a 27.5% tariff on textile products from China) that China would revalue its currency in August. That’s all it took for China to put its reforms into motion and take everybody by surprise. Barely a week later, China revalued the RMB by about 2% and was taking its first steps toward greater currency flexibility (see the details in box 1).

For now, this revaluation will have very little if any impact on either China or the rest of the world. But, at 8.11 yuan/US$, the RMB is clearly undervalued, and everything suggests that further adjustments will be made in the next 24 months.

An Institute of International Economics study shows that a more substantial revaluation (about 25%) is required to control the imbalance in China’s balance of payments, but it appears unlikely that the Chinese government will make an adjustment of this size promptly. The result could be plants moving to other countries with low production costs, and foreign firms may not be as motivated to set up in China. A revaluation of this size could have a major impact on China’s agriculture sector (which
1) Starting July 21, 2005, China will reform the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The renminbi (RMB) will no longer be pegged to the U.S. dollar, and the RMB exchange rate regime will be improved with greater flexibility.

2) The PBoC will announce the closing price of a foreign currency such as the U.S. dollar traded against the RMB in the inter-bank foreign exchange market after the closing of the market on each working day and will make it central parity for trading against the RMB 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 the time of 19:00 hours of 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 ±0.3% around the central parity published by the PBoC, while the trading prices of non-U.S. dollar currencies against the RMB will be allowed to move within a certain band announced by the PBoC.

The PBoC will make adjustment of the RMB exchange rate band when necessary, according to market development as well as the economic and financial situation. The RMB exchange rate will be more flexible based on market conditions with reference to a basket of currencies. The PBoC is responsible for maintaining the RMB exchange rate basically stable at an adaptive and equilibrium level so as to promote the basic equilibrium of the balance of payments and safeguard macroeconomic and financial stability.

still has almost 60% of workers) and also endanger the financial health of the banking system. All in all, a major revaluation would substantially destabilize the country, which could then see social instability.

Moreover, the Chinese government’s desire to focus the growth of its economy on exports suggests that it is probably reluctant to allow its currency to appreciate sharply. It seems to be particularly concerned about the possible adverse impact on the country’s competitiveness, and, by implication, the potential impact on export growth (a major catalyst for employment) and its ability to attract foreign financing. According to Chinese authorities, a 5% increase in the RMB could slow export growth (now at 35%) to an annual pace of just 10%. An RMB revaluation of only 2.1% against the American dollar appears to bear out the government’s concerns. That said, it seems unlikely that a small increase in the RMB (from 5 to 10%) would be as catastrophic for China’s foreign trade sector as the government is claiming.

An RMB revaluation would have a limited impact on economic growth

It is difficult to quantify exactly what effect an RMB revaluation would have on China’s economy, but some points are worth mentioning. In general, history suggests that any economic slowdown will be limited. From 1994 to 1998, the real trade-weighted RMB appreciated by over 40%. Yet real GDP growth was never below 7.5% during this period (excluding the economic slowdown caused by the Asian crisis), i.e., the minimum growth rate needed to absorb the migration of rural workers to cities and ease social tensions. With current annual growth of over 9%, China’s economy seems to be fully able to absorb an RMB revaluation.

Specifically, the potential adverse impact on the foreign trade sector remains mitigated. It should be said that from 1999 to 2002, the effective RMB appreciated by 13%, which did not stop export growth from moving from negative (-5%) to positive (+13%) figures. Since then, the effective RMB has depreciated in tandem with the greenback, losing 13% of its value against the currencies of its main trading partners and almost 10% against Asian currencies. A revaluation of even 10% of the...
RMB would thus still leave China in a very advantageous position, particularly since it could trigger parallel appreciation by other Asian currencies against the U.S. dollar.

From 1999 to 2002, export growth has accelerated in spite of an RMB increase

But it is the structure of China’s foreign trade sector itself that would keep any damage limited. It should be said that Chinese exports have substantial imported content, that is, almost 40%. Given China’s comparative advantage in the area of labour costs, it would be hard for its competitiveness to be reduced sharply or eliminated by a small increase in the RMB. Also, a number of neighbouring countries are benefiting from exporting parts for assembly and packaging in China, which China then re-exports as finished products. The value added of China’s export products rarely exceeds 30%. Under these circumstances, the revaluation of the yuan will likely have a minimal impact on the total value of imports, particularly since any price increase will be in part offset by a decrease in the price of imported products. The increase in Chinese purchasing power would, at the outset, reduce the negative impact on the profits of export businesses.

An RMB revaluation cannot correct the American current account deficit on its own...

Since internal pressure on China to revalue its currency is relatively weak for now, everything suggests that the 2.1% revaluation has only served to ease trade and political tensions with western countries, particularly the United States. There is therefore reason to wonder about the potential impact of such an action on the American economy, particularly on absorbing the U.S. current account deficit and its financing. At the outset, it is not clear that a modest RMB revaluation will cure all ills.

The United States’ current account balance has deteriorated sharply in the last 15 years, going from a small surplus at the start of the 90s to a record US$780B deficit in the first quarter of 2005, that is, 6.4% of GDP. For many, correcting the deficit will require further depreciation in the American dollar. Yet, since China is experiencing phenomenal economic growth, and it alone represents one quarter of the deficit posted last year, China seems perfectly positioned to begin the correction.

In fact, China is not responsible for the escalating U.S. trade deficit. It should be understood that, for every Chinese export dollar, the United States has reduced their imports from other Asian countries by almost the same amount. That is not too surprising, since China is increasingly becoming established as the world’s manufacturer because of its low production costs. There has therefore been a transfer of labour intensive production and assembly activities from Asian countries to China over the last few years.

... but it’s a step in the right direction

It should also be said that, at less than 10%, the weight of China’s trade with the United States is only a small proportion of total U.S. imports. Under these circumstances, a 10% RMB revaluation would only bring the trade-weighted U.S. dollar down by 1%. And even supposing that the increase in the RMB would allow floating Asian currencies to appreciate proportionally, the trade-weighted American dollar would barely depreciate more than 3%, as Asia’s weight (excluding Japan) is 25% of the total index. This doesn’t seem like enough to correct the sizeable American deficit, but it is still a step in the right direction.

It should be noted that, while the American dollar weighted against the main U.S. trading partners depreciated 27% between February 2002 and December 2004, the trade-weighted index of the currencies of other important partners (OITP), with over 60% Asian currencies, is even higher than it was three and a half years ago. Yet, it is against these countries that the U.S. trade balance has deteriorated the most in recent years, down by close to 100 basis points, at -2.7% of GDP, from only 30 basis points, at -2.0% of GDP, for the United States’ main trading partners.
That said, it is unlikely that this will be enough to correct the imbalance of the American current account. With economic growth that is systematically higher than that of the main industrialized countries, and a marginal propensity to import that is higher for each dollar of additional income, the American trade deficit has deepened almost continually in the last decade\(^5\).

As we do not anticipate any net acceleration in demand growth in the euro zone and Japan in the next few years, we would have to see unprecedented structural change in American consumption habits (highly unlikely) or a recession in the United States (just as unlikely) to see the trade deficit eliminated. Also, if oil prices do not come down, the U.S. net import bill will remain inflated for several quarters to come.

\textbf{China: A big Treasuries buyer?\(^6\) Not really!}

It would therefore be good to ask some questions about the U.S. deficit’s financing. Clearly, with negative national net savings, Americans are increasingly dependent on the supply of foreign capital. Here, China, whose stable monetary policy means it must amass currencies, is often held responsible for the low interest rates in the United States. What would happen if China revalued the RMB more extensively? Would we see an increase in U.S. interest rates? Once again, the impact is likely to be quite small.

First, remember that American interest rates have continued to evolve downward, in spite of the fact that net purchases of Treasuries by most of the major Asian nations\(^7\) have slowed substantially in the last few quarters. Thus, even if an RMB revaluation caused the PBoC to reduce purchases of U.S. debt securities, it is not clear that this would have any major impact on U.S. rates. On July 21, interest rates on 10-year bonds increased by about ten basis points in response to the PBoC announcement.

In fact, the Middle Kingdom does not have as much influence as we think. It is true that, at US$243.5B, China is the second largest foreign holder of U.S. Treasuries, but it is well behind Japan, which has almost triple that amount, at US$685.7B. Its marginal influence is still weaker. China’s net purchases of Treasuries peaked at US$30.4B in 2003 before slowing to
US$18.9B in 2004. Conversely, Japan’s net purchases, which are a reflection of an interventionist policy designed to keep the yen weak against the U.S. dollar, were US$146.5B in 2003, picking up to US$166.4B in 2004. Japan thus represents a much greater potential impact on American interest rates than China.

China has no real interest in supporting the dollar

Yet, due to its stable money policy, China’s currency reserves have exploded in the last few years, going from US$168B in 2001 to US$711B last June. How can China have so little influence? The answer to that question lies in the RMB’s non-convertibility. Popular belief (false) has it that, to keep the RMB pegged to the greenback, China is obliged to buy U.S. dollars. In fact, pegging the RMB to the greenback is a Chinese government decree. All it means is that the PBoC must modify its currency reserves to rebalance its balance of payments. Since China currently has a surplus in its current and capital accounts, it is amassing currencies—dollars, euros, yen and other currencies. If, conversely, it was posting a deficit, it would be forced to get rid of some of its reserves.

China’s influence on American rates is even more diluted when we break down its currency purchases. It then becomes clear that a large proportion of purchases of U.S. securities have almost no effect on the dollar and American interest rates. It should be said that almost one quarter of the 2004 US$207B increase in China’s currency reserves is due to the influx of hot money. However, this phenomenon, associated with RMB speculation, is literally made in China. It primarily involves commercial banks and Chinese companies that have gotten rid of positions they held outside of China or have borrowed in foreign currency in the hope of an RMB revaluation. These funds are traded at the PBoC, which first compiles, then in part puts them back on the American market by buying U.S. debt securities. The PBoC’s purchases of U.S. securities simply counterbalance sales by private agents: there is almost no net effect. Thus, in spite of a massive accumulation of currencies, the impact on the American dollar and interest rates is much smaller than it seems.

A simple comparison of China’s currency accumulation and purchases of U.S. debt securities clearly shows that China has no real interest in supporting the American dollar. With the greenback’s depreciation between February 2002 and December 2004, which made Chinese exports even cheaper in the rest of the world, we can even wonder why China would support the American dollar. The graph below shows that the accumulation of reserves has picked up speed substantially starting at the end of 2002, but that purchases of U.S. debt securities did not keep pace. In fact, of the US$209B in currency accumulated in 2004, only US$44B represented U.S. debt securities (government, agencies and business combined). We can assume that the PBoC is keeping part of its cash reserves in U.S. dollars, but it isn’t in its interest. This means it therefore already has a well-diversified portfolio. It is thus unlikely that an RMB revaluation will cause China’s central bank to rush to get rid of the American securities that make up its portfolio. In any case, with over US$4000B in Treasuries in circulation, China would have to get rid of a substantial proportion of its US$243.5B in American securities.
to create any excitement whatsoever on financial markets. But why would it want to destabilize the economies of its main trading partners?

![The central Chinese bank's portfolio seems increasingly diversified since 2002](chart)

**Conclusion**

All in all, the potential adverse impacts of an RMB revaluation in the short term are largely offset in the long-term by the benefits of an appreciation. In the absence of an effective monetary policy, the RMB’s increase would put the brakes on the economy and force the government to transfer investment and export growth toward consumption. If there were a reduction in the current account surplus, this would also help partially reduce the burden associated with currency accumulation and sterilization. Inflation would be easier to control, and growth would likely be more sustainable.

The global economy would also benefit. With several years of urbanization ahead, China’s integration would be a major source of growth for the global economy. It is likely that China is revaluing its currency for political reasons only. This will not help correct the imbalances seen for the last few years, but it is a step in the right direction.

That said, it is still surprising to see all the brouhaha caused by pegging the RMB to the greenback when, on one hand, we realize that the deterioration in the U.S. trade deficit stems primarily from American companies based in China (thus American products that are made in China) and, on the other hand, lower-cost imports are to the advantage of Americans and help raise their standard of living (at this point, it is interesting to note the degree to which U.S. lobbyists defend the interests of small groups at the expense of the nation as a whole). Finally, real American wages would be lower still if not for the low inflation caused by trade with China.

---

1. Recently, investment in overheating sectors such as cement and coal has slowed sharply, and steel imports are down. Growth in the monetary base is also below the maximum objective of 15% a year, and inflation in consumer prices remains contained below the target of less than 3.0%, according to the latest five-year plan.


4. From 7 to 8% according to the International Monetary Fund (IMF).

5. See the Economic Viewpoint for June 18, 2004, “Will the U.S. Dollar Continue to Plunge” for further explanation of the US current account deficit.

6. Treasuries are U.S. federal government debt securities, and include Treasury bills, and medium- and long-term bonds.

7. Japan, China and South Korea.

8. This point is demonstrated in “How I learned to stop worrying and forget about the yuan” by Jonathan Anderson, Far Eastern Economic Review, December 2004.

---

Martin Lefebvre
Economist
(514) 281-2317