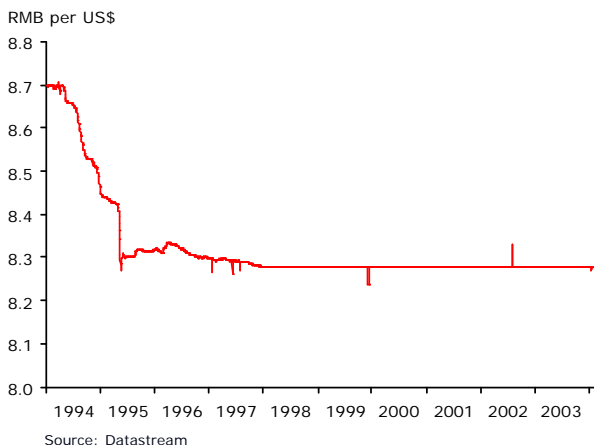


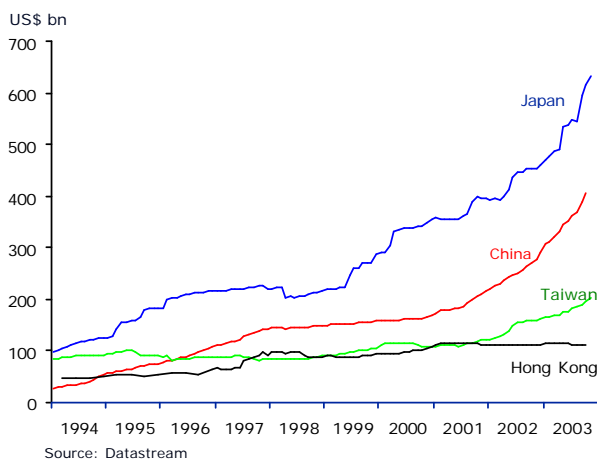
Will China float or revalue its currency?

There has been much discussion of the renminbi exchange rate recently, with many critics urging the Chinese authorities to float or revalue the currency. Some of these critics seem to have confused the textbook arguments for a floating currency with the pros and cons of a stronger currency. Others seem not to appreciate that China's unhealthy banks and poorly developed financial markets limit its options. Also, there is a lack of understanding that Chinese authorities will not be pushed into any policy change, and will do what they, rightly or wrongly, decide is in China's best interests – which simply put, means the promotion of economic growth with social stability. Some evolutionary change to the exchange rate regime, such as widening the trading bands or pegging to a basket would be consistent with this, but a significant upward movement in the exchange rate would not be.

The renminbi is a closely managed currency



China's reserves are second only to Japan's



Recently, there has been a lot of discussion in the media about the value of China's currency, the renminbi. Through close management by the Chinese authorities, the renminbi has remained at, or near to, 8.227 per US dollar since 1998. Many commentators regard it as undervalued at this level, and point to China's trade surplus and the

strong inflows of direct investment which have, in recent years, produced a sustained build-up of foreign exchange reserves. In the latter months of last year, the issue became a hot topic in the USA, where various politicians tended to link the decline in manufacturing employment with the large bilateral trade deficit with China, and urged that country to float or revalue the renminbi.

If China were to change its currency regime, there are essentially five options. It could: adopt a float, either with existing controls on capital transfers or without them; it could retain the existing arrangements, but widen the trading bands; it could simply revalue; or it could peg the renminbi to a basket of currencies.

1. A free float without restrictions on convertibility

This is the arrangement held out by Chinese officials as their eventual objective, but it is a long way off. There have been some moves to ease controls during 2003, such as allowing exporters more latitude to retain foreign currency earnings, but full opening of the capital account at this stage would be disastrous. Although at present the direction of capital flows is inwards, it can be argued that if controls were lifted there would be an exodus as Chinese depositors deserted Chinese banks and sent funds abroad. So, before lifting controls, China needs first to build the institutional pre-requisites, such as a sound banking system and effective financial markets. Even then, there would no doubt be significant outflows as Chinese investors sought international diversification.

2. A float subject to existing controls on capital transfers

This is an intermediate stage, a precursor to a free float. It is a stage which has been used by some countries to foster their foreign exchange markets,

both spot and forward, in preparation for the very much greater and more volatile flows that would accompany the removal of capital controls¹. India uses such a system at present, and it would be appropriate for China to do so before liberalising its capital account.

However, it needs to be asked whether China's financial sector is equipped to handle even a constrained float? Given its poor health and inexperience of real markets, a phased process, such as trading within widening bands (option 3, below) would be less risky. Nevertheless, there may be advantages in forcing the pace of change, and a case could be made for an early move to a float. This could bear fruit by hastening progress towards the goal of market-related pricing and allocation of resources, by soundly managed banks and other players. Also, there would be the textbook advantages of a float: In the present context of credit-driven overheating, floating would eliminate the impact on base money of foreign exchange intervention, and consequently remove the need for sterilisation, which inhibits the implementation of monetary policy.

It is perhaps more apposite to ask what China is *likely* to do. Would the authorities judge it to be in China's interests to move from a very stable exchange rate to a more volatile and probably significantly higher one? The answer, at this stage, is undoubtedly "No". The authorities place great store in currency stability, and cite a number of reasons why a stronger or more volatile currency is not in China's interest. (See Pros and Cons below.) Against this, the risks associated with retaining a fixed exchange rate combined with leaky capital controls, are probably not rated highly.

3. Retain existing arrangements, but widen the bands

The renminbi is widely regarded as a pegged currency, but strictly speaking it is a managed float, held within a narrow range, with the central bank ready to buy or sell foreign currency to maintain it within that range. This regime has been in place since the unification of the various official rates in 1994, but the permissible range has been narrowed over time, and since the onset of the Asian crisis in the latter half of 1997, the currency has been kept very close to RMB8.277 per US dollar, giving the appearance of a fixed exchange rate.

¹ In contrast to this, in the 1990s several Asian countries, having liberalised their capital accounts, still maintained closely managed exchange rate regimes. This was one of the pre-disposing factors to the Asian crisis, which broke in 1997.

There would be some advantages to widening the range within which the renminbi is allowed to trade. First, some modest fluctuation of the renminbi would become feasible, and this could help accelerate development of China's financial markets. It is one thing to trade a fixed currency, but if the currency fluctuates, then risk is present and adequate management systems need to be introduced. It would also encourage a role for the market in setting interest rates, as an effective interbank cash market and a vigorous market in instruments such as bank bills are essential complements to (if not pre-requisites for) spot and forward foreign exchange trading.

A second possible advantage of widening the renminbi bands is that it would permit a trend appreciation and this could help to alleviate foreign criticism of China's exchange rate policy. Technically, the trading range is set either side of the previous days close², so it is possible that the use of wider bands together with intervention could produce both fluctuation and trend appreciation. However, any appreciation is likely to be too gradual to appease those critics arguing for a significant revaluation.

4. Revalue the renminbi, to a new, fixed US\$ level

While a simple, significant revaluation might help ameliorate foreign criticism, it would bring all of the disadvantages of a stronger currency while doing nothing to promote the evolution of China's financial sector. Why would China do it?

5. Peg the renminbi to a basket of currencies

This could be quite an attractive option. It would generate some movement in bilateral exchange rates and so encourage development of financial markets and risk management systems as discussed under (option 3) above. Moreover, so long as the US dollar continues to decline against other major currencies, there would be scope for the renminbi to rise against the US dollar while depreciating against, for example, the yen and euro. If relative currency movements were large enough and sustained for long enough, such a system could, in principle, affect the pattern of China's bilateral trade balances – for example, shrinking both its surplus with the USA and its deficit with Japan.

² This arrangement is best described as a crawling peg.

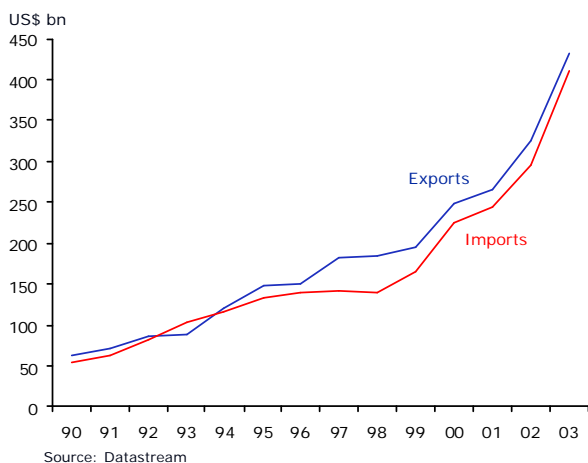
What is China likely to do about its currency?

Chinese authorities will seek to make progress towards their ultimate goal of full engagement with global currency and capital markets, while avoiding instability along the way. Maintaining the *status quo* does not represent progress, so some change seems probable. However, any change in the exchange rate regime is likely to be incremental, so as to avoid sudden or large shifts in the value of the renminbi.

Options 3 or 5 above would fit this requirement. If option 3 is selected, the currency is unlikely to be allowed to move as much as 1% initially. If an excess supply of dollars persisted, then continued appreciation would be allowed, but would be unlikely to exceed 5% in the first year.

If option 5 (pegged to a basket) is selected, then the movement of the renminbi against the US dollar would depend on the weights assigned to the currencies in the basket, and the movement of the US dollar itself against the other currencies. It is thus impossible to predict, but being dampened by the weighting would be less extreme than the changes in the components of the basket.

Strong import growth has narrowed China's trade surplus in recent years



Pros and cons of a higher value for the renminbi

At the risk of some repetition, here is a list of the various arguments for and against a significantly stronger level of the renminbi. These are not necessarily consistent with one another. They are simply arguments that have been aired in the media and may reflect particular viewpoints or agendas. Some are easy to rebut, but generally I have resisted the temptation. (For convenience, the word "revaluation" as used below includes "appreciation".)

Arguments against a revaluation of the renminbi:

- Revaluation would place pressure on exporters' already thin margins, which in turn would place downward pressure on wages³.
- Revaluation would make China less attractive as an investment destination.
- Revaluation would increase the pressure on Chinese businesses selling into the domestic market. These businesses are already facing import competition due to China's WTO-entry commitments. Job losses in the state-owned enterprises and in agriculture are likely to accelerate.
- The trade surplus is not persistent and is in fact shrinking, and so does not need to be corrected by currency revaluation. A second line of defence here is that revaluation would not necessarily reduce the surplus anyway⁴.
- The view that the currency needs to be revalued is a recent, and possibly temporary, phenomenon. Support for this argument comes from the offshore non-deliverable forward (NDF) market, which normally has dollars at a premium, and only since late-2002 has traded dollars at a discount.

Arguments in favour of a revaluation of the renminbi:

- Currency appreciation is necessary to placate China's critics, particularly the USA, which may seek to apply measures to restrict imports from China. (However the risk of trade sanctions against China is perhaps overstated. The situation is not as antagonistic as the anti-Japanese pressure in 1980s. Moreover, China, with its large and rising foreign exchange reserves is a major buyer of US Treasuries and could retaliate!)
- A stronger currency would be useful in helping to slow an overheating economy. The case is strengthened by fact that monetary policy is hindered by poorly developed financial markets and excessive liquidity in the banking sector.

³ Rich-country consumers, not Chinese workers, are getting the benefit of the latter's productivity. China's manufactured exports are assuming "commodity" characteristics, and sell at market-clearing prices in US dollars. Manufacturing wages are a function of these prices. This line of thinking implies that a stronger currency would ultimately mean lower renminbi wages.

⁴ This embodies a similar line of thinking to that in the previous footnote. If exporters are price takers, then a higher exchange rate would place pressure on profits and wages, but not, unless factories are closed, reduce the volume of exports.

- A more abstract argument is that persistent external surpluses imply lost opportunities in terms of growth and living standards. From an *ex post* perspective, consumption and/or investment could have been higher, and the incremental demand could have been met by imports without any external financing difficulties. This reasoning would suggest that a higher exchange rate, that might have brought the current account, averaged over several years, into balance or even moderate deficit, would have been appropriate⁵. (However, this *ex post* analysis does not make a good case to revalue the currency now. To do so would be to miss the point that while a higher level for the currency would have permitted stronger demand growth, and a different pattern of production, the process of getting there is a lot more complicated than simply revaluing the currency.)

The bottom line

Strong growth is what China wants, and it is also in the interests of its trading partners, as an expanding economy pulls in imports. China is unlikely to jeopardise growth by adventurous policy shifts. Any changes to the exchange rate regime would have to be consistent with evolutionary development of China's financial sector, and this rules out any significant upward movement in the value of the renminbi. Over the long run, China will be well served by a freely floating exchange rate and integration with global capital markets. However, the development of properly functioning financial markets and a sound banking system are, in themselves, higher priorities, and also pre-requisites, for a float free of capital controls.

Bernie Shuttleworth
Economics@anz
Email: shuttleb@anz.com

⁵ This argument may seem unfamiliar, because it reflects the very opposite situation to most developing countries, which run persistent external deficits and whose growth is constrained by the difficulty in financing such deficits.

Australia and New Zealand Banking Group Limited is represented in:

AUSTRALIA by:

Australia and New Zealand Banking Group Limited ABN 11 005 357 522
10th Floor 100 Queen Street, Melbourne 3000, Australia
Telephone +61 3 9273 6224 Fax +61 3 9273 5711

UNITED KINGDOM by:

Australia and New Zealand Banking Group Limited
ABN 11 005 357 522
Minerva House, PO Box 7, Montague Close, London, SE1 9DH, United Kingdom
Telephone +44 171 378 2121 Fax +44 171 378 2378

UNITED STATES OF AMERICA by:

ANZ Securities, Inc. (Member of NASD and SIPC)
6th Floor 1177 Avenue of the Americas
New York, NY 10036, United States of America
Tel: +1 212-801-9160 Fax: +1 212-801-9163

NEW ZEALAND by:

ANZ Banking Group (New Zealand) Limited.
Level 10 215-229 Lambton Quay Wellington, New Zealand
Telephone +64 4 496 7000, Fax +64 4 496 7360

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