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China's Monetary Dilemma
The Case for Revaluation of the Renminbi

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Increasingly, the Chinese are realising that keeping their currency undervalued is not a viable option. The end game as far as the exchange rate management in China is concerned should look towards establishing a less controlled and more market oriented exchange rate—one that is determined by actual demand and supply factors.

Introduction

China's role in the existing financial architecture of the world can hardly be understated. Currently, the Chinese markets are the primary driving force for global commodity prices. The huge investment demand in China is only going to grow larger in the coming years, even if there is a deliberately engineered "soft landing" to prevent overheating of the economy by the Communist government. This demand for raw materials and manufactured goods alike is going to be vital in order to mitigate chances of another global recession; a veritable "double dip".

Consequent to China's rise in the new economic world order, its currency, the Renminbi, has attracted a lot of criticism for being undervalued relative to other currencies, especially the US Dollar. This undervaluation equates to more competitive exports for the Chinese. A bulk of the criticism has come from Western nations, struggling to keep pace with the close to double digit growth rates in the emerging world. Opinion is divided amongst economists and commentators on whether the criticism is wholly valid or only partially so. There is no doubt that China is not playing according to the rules of the free market, but in the context of the recent global financial crisis, few are[1].

Increasingly, the Chinese are realising that keeping their currency undervalued is not a viable option. However, this is because of different reasons than the ones stated above. It is worthwhile examining the current context with a background history of the control over the Renminbi's exchange rate.

Background

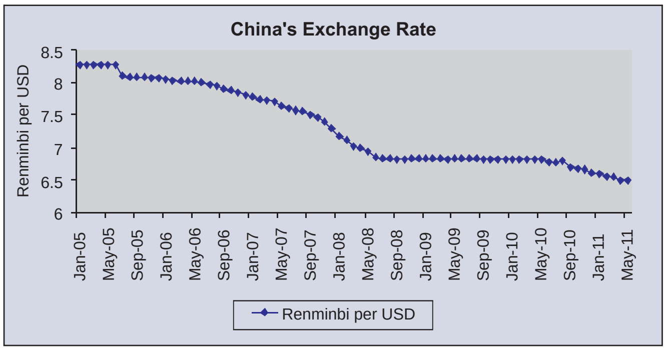
Meticulous planning and control have been pivotal in the way the Chinese have managed their economic trajectory since Mao Zedong proclaimed the founding of the People's Republic of China in 1949. The new government formed after the defeat of the Chinese Nationalist Party, tried to curb the existing inflationary pressures in the economy by centralizing the foreign exchange management. China opened its economy in 1978 and has since tried to combine market reforms and central planning to achieve economic growth and stability.

The Renminbi has seen many sweeping reforms in its history, and there have been three distinct phases. The first phase of the existence of the currency, between 1948 and 1978, was also the phase when China was looking inwards, and not really bothered about monetary transactions with the outside world. Following the economic reforms in 1978, the second phase started, which lasted till 1993. In this phase, a dual track system was adopted, whereby there were two exchange rates; one was the official exchange rate, and the other was the foreign trade related internal settlement rate (later evolved into the foreign exchange swap rate). During this period the Renminbi depreciated steadily against the Dollar, from 1.58 to 5.8 per Dollar. This steady depreciation was warranted as the exchange rate had been set at an unreasonable–almost parity level against the Dollar to begin with.

In 1994, the third phase for the Renminbi began, when the two exchange rates, the official exchange rate and the foreign exchange swap rate were merged. Thus evolved the managed exchange rate peg and the Renminbi was devalued further in January 1994 from 5.82 to 8.72 to the Dollar.

The Renminbi exchange rate against the Dollar remained almost static till 2005, when a major revaluation (from China's perspective) was announced. In the month of July, China revalued its currency higher against the Dollar by over 2%. This revaluation was largely the result of stiff pressure from the United States Congress, which had been threatening to impose trade sanctions for some time, along with simultaneous growing pressure from Europe. The Renminbi has been appreciating against the US Dollar slowly since 2005, and with the backdrop of the financial crisis and threat of a continued global recessionary environment in the existing highly integrated global economy, Chinese policy makers have been cooperating with the developed world's demands[2].

Figure-i



Data: People's Bank of China

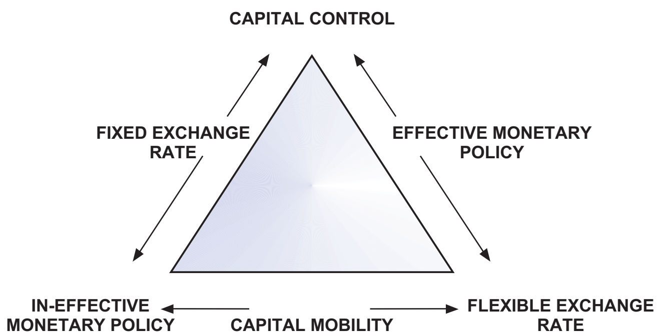
Given the current economic forces prevailing within China, it is not a given that the pace of its currency's appreciation is ideal. There are in fact numerous factors why China should want it to happen faster, as will be discussed in the following paragraphs. Till recently, China seemed to be stuck in a reactionary mode, a consequence of its increased bargaining power due to its strong economic standing in the world. This mindset is rapidly changing, since Chinese policy makers realise that exchange rate appreciation is wholly compatible with the nation's existing economic environment.

The Open Economy Trilemma

In international finance theory, there is a policy trade-off between three different goals of economic governance, which is known as the open economy trilemma[3]. This trade-off exists between open international flows of capital, effective monetary policy and stable exchange rates. According to theory, only two policy alternatives from the aforementioned three are available to a nation's government at any point in its economic trajectory. Therefore, if say country A were to choose open international flows of capital and stable exchange rates, then it will give up control over its monetary policy, in the sense that it will cease to have any effect on money supply.

To elucidate further, the US has open international flows of capital and effective monetary policy, and in the process, has little control of the Dollar's exchange rate. This is evident in the way the exchange rate fluctuates on a daily basis relative to currencies like the Euro and the Yen, and the effectiveness with which the Federal Reserve's monetary policy has controlled inflation over the last few decades. The Chinese have decided to make a different policy choice by keeping the exchange rate stable and their monetary policy effective, and have thus had to control their international flows of capital.

Figure-ii



The deliberate policy choice of controlling foreign flows is rather evident in the way China's capital control system has been biased towards encouraging capital inflow rather than outflow. There is an inherent economic contradiction in this policy. China is a net exporter—it sells more goods and services to foreign nations, than it is buys from them. This leads to influx of foreign currency from sales of goods and services abroad, and this currency should theoretically be used to buy foreign assets, and thus net capital flows[4] should be positive. Economic theory suggests that not doing this puts upward pressure on the exchange rate of a nation and policymakers have started to acknowledge this fact by making changes in the way capital outflow is regulated. Chinese regulatory agencies have introduced the 'Qualified Domestic Institutional Investor' (QDII) programmes in 2006. This change has allowed Chinese commercial banks, investment managers, brokers and insurance companies to invest in foreign markets for the first time. There is strong demand for overseas portfolio funds within China, both from retail investors and institutional investors including the Chinese government itself. The Chinese government has been able to start the process of diversifying its foreign exchange reserve investments, from dull, low return securities, which carried huge opportunity costs to more efficient allocations overseas.

This move towards a more open system of capital flows is a positive step for China in the context of the global economy, but it does produce certain unanswered policy questions. The trilemma dictates that as the capital controls are eased over time, exchange rates must be allowed to move according to market forces. There is no doubt that without this, monetary policy is going to be rendered ineffective, as recent CPI data has indicated. Despite China's attempts to squeeze money supply by raising reserve requirements five times this year, and repeated interest rate hikes, inflation has remained at a high of over 5% in the last few months[5].

Inflation and the Dragon

Inflation has not really been a big concern for Chinese central bankers since it spiked in 1994, and CPI figures reached 24%. The monetary tightening that ensued after this managed to bring down the inflation to single digits, without compromising the economic growth until the Asian Financial Crisis in 1997[6]. Inflation has once again become a problem for the Chinese (Figure iii), and recently Premier Wen Jiabao called it the government's top priority.

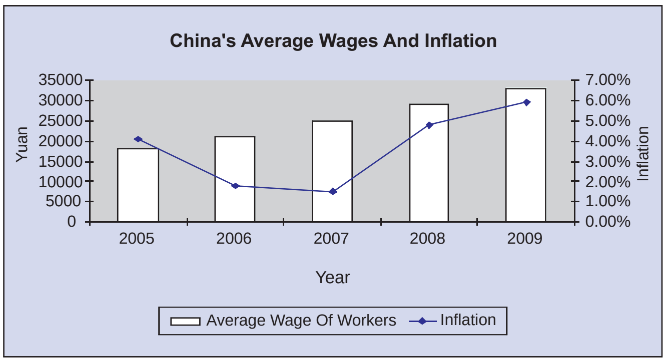
With the backdrop of the recent financial crisis, and increasing commodity prices, there is great concern in the government, amongst the officials at the People's Bank of China (PBOC), that inflation could undermine the economic growth that has been the marvel of many in the Western world. This concern is certainly not misplaced, especially on account of the sustained increases in energy and food prices over the past year.

Figure-iii

Data: CIA world fact book

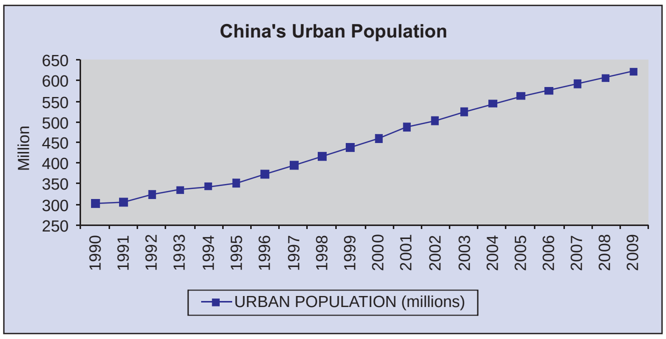
With rising incomes, burgeoning populations and structural supply problems, it is only natural for food to cost more in Asian countries in this new decade. The United Nation's Food and Agriculture Office's index of global prices indicates that prices have surged upwards of 37% in the first three months for meats, cereals and dairy products. With upward pressures on wages as a result of inflation, this self fulfilling spiral has consequently fed into more inflation. The nominal wage in China is in fact very closely correlated to the inflation over the past few decades (Figure iv). In China, more and more people are moving to cities (Figure v), and the food inflation is particularly severe on the lower-middle income groups that live in urban centres.

Figure-iv



Data: National Bureau of Statistics China (Average Wage of Employed Persons in Urban Units and Related Indices)

Figure-v



Data: National Bureau of Statistics China

The rise in commodity prices such as crude oil and metals is also the result of increasing global demand and limited supplies. The rise is further propelled by massive injections of liquidity in the form of the 'quantitative easing' programmes carried out by economies around the world to artificially stimulate sagging demand. The ongoing 'bull-run' in commodities is not likely to slow down until investment and structural demand slows in countries like India and China. Moreover, it is unlikely that we are going to see oil prices at what they were even five years back in our lifetime due to limited supply of fossil fuels on this planet. The rapid pace of Chinese urbanization and infrastructure build-ups are likely to ensure that demand for metals and other raw materials also remains strong in the coming decade.

There seem to be few options in the face of this 'multi-faceted' inflation that is causing trouble in China, except the appreciation of the currency. Monetary tightening has reached a plateau, whereby any further tightening could severely undermine the growth trajectory that is absolutely essential for China. Moreover, Chinese policymakers are reluctant to raise domestic interest rates because this will attract speculative capital inflows.

Foreign Exchange Reserves

The emerging world has seen massive foreign exchange reserve build-ups over the last decade. The scale of the reserve accumulation in China remains unmatched. There are two basic reasons why emerging countries, especially those in Asia, would want to build up foreign exchange reserves—hedging and export competitiveness.

The Asian Financial Crisis in 1997 served as a timely reminder to developing countries in Asia that foreign inflows from the developed world can be easily reversed. When this reversal takes place, and speculative money flows out, without some sort of hedging mechanism in place, there are severe effects on a nation's balance sheets. As an insurance against this, China has been extremely cautious, and had built up reserves of close to three trillion dollars by 2010 (Figure vi). On comparison with other developing Asian countries, the quantity of accumulation by China is unprecedented. Apart from wanting a solid insurance policy, the Chinese want their exports to remain competitive in order to keep their factories running and create jobs for workers. By building up reserves, they fight the upward market pressures on the Renminbi - which are exerted by foreign inflows, and hence keep their exchange rate undervalued (compared to where the free market would dictate it should be).

Figure-vi

Data: National Bureau of Statistics China

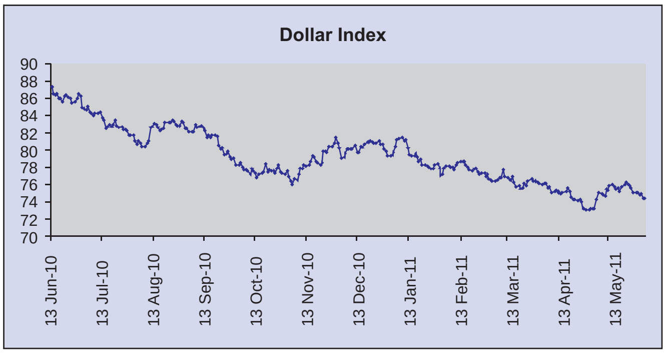
As is the case with most insurance policies, the build up of reserves comes at a cost. The most obvious cost is the opportunity cost of the interest forgone on the reserves. Central banks invest reserves in low yielding debt with short term maturities. They do this primarily to have sufficient liquidity in order to provide an effective and timely insurance in case a liquidity squeeze arises. PBOC officials of course realise that close to three trillion dollars, if invested in high yielding securities can result in significant returns, and hence have introduced the discussed QDII programme.

Secondly, excessive build ups of reserves, as has become evident to Chinese policymakers, can be detrimental if an inflationary environment becomes fertile, which clearly has happened. The relative unwillingness of the Chinese to control foreign inflows (even if they may primarily be of a speculative nature), is clearly importing inflation from the West in the current global economic scenario. Although China had a significant financial stimulus programme of its own after the financial crisis, it pales in comparison with the size of the many stimulus programmes carried out in the West and by the US in particular[7]. It is questionable whether the proportion of the money from the stimulus programmes in the West that flows into the developing markets is large or small, but there is no doubt that it has been happening, and consequently adding to the existing inflation woes in Asia[8].

No commentary about the reserve accumulation and the problems associated with it would be complete without mentioning the effects of the ongoing fall in the value of the dollar relative to other currencies (Figure vii). The ongoing drop in the value of the Dollar is causing a great deal of concern to the Chinese because a large part of their foreign exchange holdings are Dollar denominated[9]. The fall in the value of the Dollar, directly translates to a fall in the value of their reserves. The Chinese are no doubt acutely aware of this fact. There has been a lot of talk from Chinese policymakers, including from the Governor of the PBOC, about the need for "diversifying foreign exchange portfolios".

A caveat here about the influence of exchange rate appreciation on the Dollar would be appropriate: an increase in the value of the Renminbi relative to the US Dollar would add to Dollar weakness since it is pitted against a basket of global currencies in which the Renminbi is increasingly gaining significance. However considering that this appreciation is likely to be gradual rather than sudden, the effect on the Dollar will not be pronounced, and will certainly not outweigh the benefits of steady appreciation over the medium run.

Figure-vii



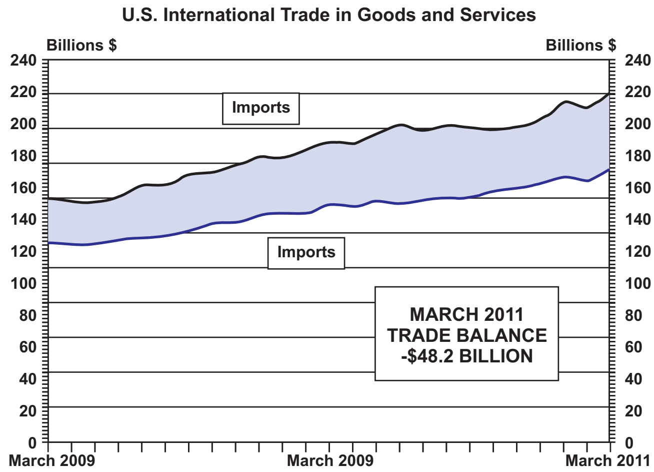
Data: http://www.census.gov

Trade (Im) balances

The single biggest factor for the hue and cry in the West about China's exchange rate management is the existing state of US trade balances. In March 2011, the trade balance with other countries stood at -$48.2 billion (Figure viii). This is largely a result of the heavily negative trade balance with China, estimated at—$18,082.6 million in March 2011 alone[10]. Although negative trade balances have been largely ignored by US investors, the sordid macroeconomic picture in the country is starting to drive home the fact that this has to change. Repeatedly, President Obama has said in his recent speeches that innovation in sciences and manufacturing is the only long term solution to cutting soaring deficits[11].

The US federal debt ceiling (a cap set by Congress on the amount of debt the federal government can legally borrow) has already been hit on May 16th this year. A lot of this debt is owed to foreigners, especially the PBOC. Most of the borrowing that has caused this debt to soar has resulted from financing of the trade deficit by foreign countries.

Figure-viii



Data: http://www.forexpros.com (Measure of the value of USD relative to a basket of foreign currencies—Euro, Yen, Pound Sterling, Canadian Dollar, Swedish Krona, Swiss Franc).

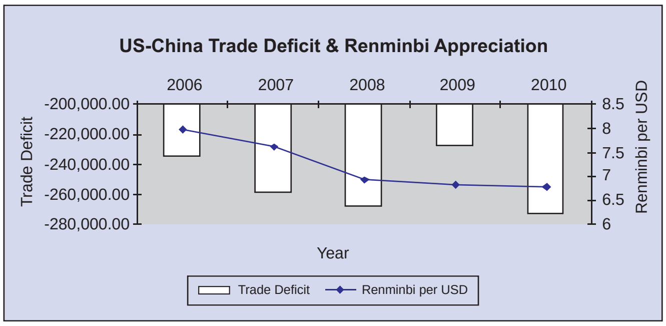
Given that China's top exports both to the US and to the world are electrical machinery and equipment[12] and power generation equipment, the appreciation of the Renminbi might lead the US to search for more competitive bargains from other countries (since a stronger Renminbi would equal expensive exports), especially the export-oriented ASEAN nations.

However, it is unlikely that the Americans will get a better bargain since there has been a structural shift in the manufacturing sector base from countries like Japan and Taiwan to China in recent years[13]. At the very least, in the short to medium run, the US would find that substituting the cheaply manufactured goods from China might not be as easy as it sounds. And, indeed, given the current uncertainties about an actual recovery in the US housing and jobs market and consequently, the economy as a whole, it cannot afford to pay more for imports even in the short run. Furthermore, this is a catch 22 situation for China, as it cannot afford to price exports at levels which are not affordable to the US and other OECD countries due to its dependence on the export demand from the West.

Chinese exports to the US totalled close to $365 billion in 2010 and $86 billion in the first quarter of

2011 while the Renminbi has increased by 5.1% in value over the same period of time relative to the Dollar[14]. These statistics indicate that the rebalancing that is required for the US to get its trade deficits in order is not going to come about just by the Renminbi's appreciation relative to the Dollar (Figure ix). Furthermore after a dip in Chinese imports in 2009 of -10.6%, the US is back to its deficit building ways with an increase of 24.8% in 2010 according to US Census Bureau. This growth rate of imports by the US of Chinese products in 2010 is characteristic of the rate of growth before the financial crisis. Again it is important to note that the pre-financial crisis growth rates in imports from China occurred with the backdrop being that the Renminbi remained pegged at 8.28 Renminbi to the Dollar till 2005, and then appreciated steadily till the unfolding of the financial crisis.

Figure-ix



Data: www.census.gov, CIA world fact book

Conclusion

Taking into account, the open economy trilemma, the rise in inflation, and the burgeoning foreign exchange reserves, and how these factors dynamically interact to affect the Renminbi's exchange rate, the policy choice for the Chinese is amply clear – appreciation is no longer an option, but a necessity. Gradual appreciation of the exchange rate has been a process that was started in 2005, and experienced a slight bump in the road due to the financial crisis. Since middle of 2010, this process is back on track, and Chinese policymakers will continue to try to balance the costs and benefits of appreciation, while letting the market dictate the direction. This is likely to be a gradual process as it has been so far.

The exaggerated nature of the concern in the West about Chinese exchange rate manipulation is unfounded. Within the evolving paradigm of this globalized world, it is increasingly the case that excess mutual dependence in areas of trade and commerce is not uncommon. Indeed the Chinese and the Americans have understood the complicated nature of their economic relationship, and are not trying to strategically outmanoeuvre each other just yet. The practical reality is that China cannot afford to take a 'monetarily hostile' stance towards the US because of its massive dollar reserves, and the US cannot do the same since China finances a large portion of its borrowing. Further, both the countries would benefit from mutual cooperation, both on trade and currency issues.

The current inflationary scenario that is widely prevalent in emerging Asian nations, including India, makes China's problems non unique. The fact that a significant portion of the world's population will be struggling to come to grips with the price increases in life's essential commodities including food and oil, makes this present decade a veritable minefield of policy choices. Theoretically, the contradictions and solutions for countries like China and India are not hard to see, and indeed are not completely dissimilar, but the gap between theory and practice in these developing economies is significant.

The end game as far as the exchange rate management in China is concerned should look towards establishing a less controlled and more market oriented exchange rate–one that is determined by actual demand and supply factors. This would allow China to move towards having a more effective monetary policy and controlling inflation with the positive externality being - friendlier economic relations with the West. It would give China a more influential voice in the international markets, something it has been craving for. Furthermore, this would allow the Chinese to transition from a saving economy to a spending one.

The increased purchasing power that the steady appreciation of the Renminbi would bring, would translate into increased purchasing power for the burgeoning Chinese middle class. Chinese policymakers are well aware that export oriented growth will not last forever. The strong fall off in exports during the financial crisis has solidified the fear of depending too heavily on foreign consumption, especially demand from the OECD countries. Domestic demand is the order of the day, and this can be given a big push by continued appreciation, and increases in wages. Therefore it can be argued, that appreciation of the Renminbi would be prudent on all accounts; politically, strategically, and economically.

Ends Note:

1. For example: the massive injections of cash into the U.S economy after the financial crisis hit, have lead to artificially engineered low interest rates which directly influence exchange rates.
2. Since May 21st, 2007 Renminbi exchange rate against the Dollar does not exceed 0.5% of the central parity rate within the range. From July 21st 2005 till May21st 2007, the fluctuation range was even smaller at 0.3%.
3. Obstefeld and Taylor (1998).
4. Net Capital Outflow = Purchase of Foreign Assets by Domestic Residents – Purchase of Domestic Assets by Foreigners (Mankiw 2008)
5. http://www.reuters.com
6. The post Asian Financial crisis period of China's exchange rate is worth noting because while most other Asian currencies depreciated against the dollar (data), the Renminbi could not because of the fixed peg to the Dollar. This lead to a less than optimal result since monetary loosening was not really an option and China had to weather the storm head on. A result of not being able to depreciate its currency was that its exports became less competitive, especially compared to the export oriented ASEAN nations. The reluctance to remove the peg in fact increased China's standing in the region as it helped other affected countries become more competitive. This was also the time that Chinese policy makers realised that many structural problems existed in the Chinese economy and that there was over-reliance of trade with the United States.
7. $586 billion as oppose to approximately $3 trillion by the U.S over the various "quantitative easing " programmes.
8. See "Emerging market countries, capital inflows," Institute of International Finance, June 1, 2011
9. Estimates range from 60%-70% depending on the source.
10. US Census Bureau
11. See: http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Innovation-and-Sustainable-Growth-at-Hudson-Valley-Community-College/
12. National Bureau of Statistics, China
13. The recent shifts in manufacturing bases and outsourcing parts by companies like Canon, Sony, Caterpillar, Hitachi, Panasonic to name a few, are indicative of this trend.
14. http://www.tradingeconomics.com

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