Discussion Paper 24

REVALUATION OF THE CHINESE CURRENCY AND ITS IMPACT ON CHINA

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Revaluation of the Chinese Currency and Its Impacts on China

Yongnian Zheng, Jingtao Yi, Minjia Chen *

ABSTRACT

This paper reviews and assesses the policy debates on the RMB revaluation issue and the reform of China’s foreign exchange rate regime, from both inside and outside China. It focuses on two key issues: the extent of revaluation and its impact on China. The policy debates and the consequent decisions on revaluation indicate that despite continued international pressure, it is unlikely that the Chinese leadership will make any radical changes to the RMB in the near future. But, it is reasonable to expect that the Chinese government will continue its gradualist approach towards achieving China’s long-term objective of a flexible regime.

KEYWORDS: exchange rate, revaluation, the renminbi (RMB), foreign exchange reserve, exchange rate regime
JEL Classifications: E58, E65, F31

China’s Decision to Revalue the Renminbi (RMB)

China’s currency, the RMB, was pegged to the U.S. dollar at a rate of around 8.28 RMB to 1 U.S. dollar for 11 years from 1994, when the official rate of RMB was depreciated to the prevailing market rate and China started to adopt a unified exchange rate. For many years, the issues surrounding China’s fixed exchange rate have been some of the hottest topics in international macroeconomics. Since 2001, much of the interest has been provoked by waves of speculation that China would let the RMB appreciate against the U.S. dollar because of its surprising strength and astonishing external achievements, and because of a decline in the U.S. dollar. In recent years, the RMB exchange rate has attracted considerable global attention due to China’s consistently large trade surpluses and its rapid accumulation of foreign exchange reserves. The U.S., Japan, and other G-7 nations put increasing pressure on China to revalue the RMB. Since China was one of the largest trading partners of the U.S., and among the top trading partners of Japan and many Asian and European countries, any adjustment to the currency’s trading value was likely to have significant implications for global trade flows, as well as for China’s own economic growth and social stability. The phenomenon provoked a vigorous global debate over whether the RMB was undervalued.

Economists worldwide held diverse opinions on the revaluation of the RMB. Morris Goldstein and Jeffrey Frankel reported a large degree of undervaluation and pressed for revaluation,¹ whereas Lawrence Lau and Joseph Stiglitz, Michael Funke and Jorg Rahn argued that there was no credible evidence that the RMB

was significantly undervalued. Ronald McKinnon and Gunther Schnabl claimed that the RMB should not appreciate, given its stabilizing role in East Asia.

In response to increasing external pressure, government officials in China, including Chinese Premier Wen Jiabao, declared that China would not yield to any external pressure for radical reform of the RMB and that this would only slow down China’s reform process. Wen also emphasized that the Chinese government would take the initiative to advance the exchange rate reform as long as suitable criteria were met, and only thereafter would China follow market rules in proceeding with the reform.

Nevertheless, on July 21, 2005, the RMB was revalued by 2.1 per cent to trade at a rate of 8.11 RMB to 1 U.S. dollar. The People’s Bank of China (PBC), China’s central bank, announced that the currency’s value would be linked to an undisclosed basket of currencies. With this measure, the new regime was seen by Chinese officials as a more flexible, managed floating exchange rate system based on market supply and demand. Subsequently, on August 10, 2005, the PBC published the composition of the currency basket, which included the U.S. dollar, European Euro, Japanese Yen, Korean Won, as well as the currencies of Singapore, the UK, Malaysia, Russia, Australia, Thailand and Canada. So far, the highest the RMB has appreciated by was 3.7 per cent at the time of the initial revaluation to 7.81 RMB against the U.S. dollar in December 2006.

The RMB revaluation was seen as a calculated political move in response to mounting external pressure. While external pressure played a role in pushing the Chinese government to revalue its currency in 2005, China’s domestic factors were also highly relevant. Under China’s political system, while economic rationality is an important factor in determining the leadership’s policy preferences, the revaluation of the RMB was ultimately a political decision made under complicated internal and external circumstances. The Chinese leadership had to go beyond economic concerns and take key domestic interests into account when making the decision.

With China’s strong export momentum and continuous increase in trade surpluses, especially in the case of its trade dispute with the U.S., the RMB continued to face intensive external pressure for further revaluation. The future of the RMB is of major concern to China as well as other Asian and developed countries.

This paper reviews and assesses the policy debates surrounding the reform of China’s exchange rate regime in the light of the RMB revaluation. There were two key issues in these debates. The first was whether the RMB was significantly undervalued due to China’s large trade balance and foreign exchange reserves. The second concerned the impact of the RMB revaluation on China. This was important in guiding China’s decision-making, especially for further reform in the RMB exchange rate system. An initial assessment of the RMB revaluation and its impact enables us to see the major factors involved in China’s decision-making process, and helps us understand what might happen to the RMB in the future.

The RMB Revaluation and Equilibrium Exchange Rates

China has faced intense pressure to revalue the RMB in recent years and the situation did not improve even after the new managed floating regime was launched in 2005. The general sentiment that the RMB exchange rate was undervalued implied that there was an underlying equilibrium level for the RMB exchange rate and that the currency was in a state of disequilibrium.

In the literature, equilibrium exchange rates have been defined in a variety of ways, based on different models. The macroeconomic balance approach (MB) is one of the main established approaches to equilibrium exchange rates. The MB approach specifies that the equilibrium exchange rate achieves both internal balance and external balance. The internal balance fulfils full employment and maintains domestic economic stability while the external balance maintains a sustainable current account and clears the balance of payments. This study of the RMB revaluation refers to the MB approach. In principle, there are three basic empirical tests to assess whether a currency’s exchange rate is in equilibrium and whether further implied undervaluation or overvaluation is needed.

The first is the foreign exchange reserve test. If the central authorities intervene to buy or sell foreign exchange, official foreign exchange reserves will increase or decrease, implying that the supply of foreign exchange will be above or below demand at the current spot price. Hence, the domestic currency will be undervalued or overvalued in current terms according to the benchmark implied by the foreign exchange market. The change in foreign exchange reserves signals the misalignment of the currency’s exchange rate from the equilibrium. In spite of the fact that the supply of and the demand for foreign exchange could be influenced by temporary factors that have no ultimate effect on the equilibrium, a sustained rise in official foreign exchange reserves can be interpreted as indicative of an appreciation of the currency. Since this test is constrained by capital controls, it is not as relevant to China as it is to those countries with free capital flows.

Figure 1. China’s Foreign Exchange Reserve Accumulation 1979-2005


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Figure 1 shows that total foreign exchange reserves accumulated very slowly in the early years of China’s 1979 reform, but have increased dramatically since 2001. This can be read as an indicator of appreciation of the RMB in recent years. But the interpretation is constrained by capital controls. Since the early years of China’s reform and the opening-up policy of 1979, the regime of capital inflows has gradually been reformed, but China still has strict controls on capital outflows. With further controls on foreign exchange transaction, domestic exporters can retain only a very small part of foreign exchange earnings; the remainder is held by the PBC in the form of official foreign exchange reserves. The accumulation of China’s foreign exchange reserves was not only due to the country’s trade surpluses but also to the contribution of foreign direct investment (FDI) and speculative capital inflows in expectation of the RMB revaluation. In fact, during the 2001-04 period, the current account surpluses only accounted for 34.9 per cent, 46.3 per cent, 39.2 per cent, and 33.3 per cent, respectively, of the total reserve accumulation, with the remainder accounted for by FDI and other capital inflows. The dominant source of the accumulation in 2003 and 2004 was clearly non-FDI capital inflows in response to market expectations of the future of the RMB/USD exchange rate, rather than changes in underlying fundamentals, as shown in Table 1. According to IMF economists Eswar Prasad and Shang-Jin Wei, the dramatic surge in foreign exchange reserves since 2001 was mainly attributable to non-FDI capital inflows, rather than current account surpluses or FDI flows that would imply changes in fundamentals. In this case, the recent rapid rise of China’s international reserves is less likely to be indicative of fundamental changes that would require an RMB appreciation.

Table 1. China’s Foreign Exchange Reserves - Sources of Accumulation

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<tbody>
<tr>
<td>Total reserves, excl. gold ($U.S. billion)</td>
<td>107</td>
<td>142.8</td>
<td>149.2</td>
<td>146.2</td>
<td>165.6</td>
<td>212.2</td>
<td>286.4</td>
<td>403.3</td>
<td>609.9</td>
</tr>
<tr>
<td>Total reserve accumulation, excl. gold ($U.S. billion)</td>
<td>31.6</td>
<td>35.8</td>
<td>6.4</td>
<td>-3</td>
<td>19.4</td>
<td>46.6</td>
<td>74.2</td>
<td>116.9</td>
<td>206.6</td>
</tr>
<tr>
<td>Current account balance ($U.S. billion)</td>
<td>7.2</td>
<td>29.7</td>
<td>29.3</td>
<td>21.1</td>
<td>20.5</td>
<td>17.4</td>
<td>35.4</td>
<td>45.9</td>
<td>68.7</td>
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<tr>
<td>Net FDI flows ($U.S. billion)</td>
<td>38.1</td>
<td>41.7</td>
<td>41.1</td>
<td>37</td>
<td>37.5</td>
<td>37.4</td>
<td>46.8</td>
<td>47.2</td>
<td>53.1</td>
</tr>
<tr>
<td>Current account balance (% GDP)</td>
<td>0.8</td>
<td>3.9</td>
<td>3.1</td>
<td>1.9</td>
<td>1.7</td>
<td>1.3</td>
<td>2.4</td>
<td>2.8</td>
<td>3.5</td>
</tr>
<tr>
<td>Total reserve accumulation (% GDP)</td>
<td>3.7</td>
<td>3.7</td>
<td>0.6</td>
<td>0.8</td>
<td>0.9</td>
<td>3.8</td>
<td>5.3</td>
<td>7.1</td>
<td>10.7</td>
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The second test is the trade balance test. The trade balance is referred to as the visible balance in the current account balance. An invisible balance, which includes net property income flows, has no direct relationship with the exchange rate. A visible balance that includes exports and imports will instead be affected by exchange rate movements as they induce the effect of expenditure-switching between domestically-produced goods and foreign imports by altering relative

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prices between countries. A currency’s appreciation reduces the price of imports in terms of domestic currency and increases the price of exports in terms of foreign currency. This tends to increase imports and reduce exports. The equilibrium exchange rate is considered as one that clears the trade balance, which implies that a zero balance maintains an equilibrium level for the exchange rate. If the trade balance is consistently positive, the currency is considered to be undervalued and if the balance is negative, the currency is overvalued.

Figure 2. China’s Trade Balance 1994-2005

![Figure 2. China’s Trade Balance 1994-2005](image)


Figure 2 shows that the overall trade balance was consistently positive from 1/1994 to 9/2005. This implies an undervaluation of the RMB in the 1994-2005 period, with the extent of undervaluation especially severe in 2004-05. But, the trade balance test is constrained in the case of rapid and large capital flows across countries. The exchange rate can be maintained if the trade deficit is financed by net property income inflows or if the current account deficit is maintained by net capital inflows (as implied by the criterion of external balance). In this case, the exchange rate is also believed to achieve equilibrium.

Here, a confusing argument is that U.S. officials attribute their growing trade deficit to an allegedly undervalued RMB. The U.S. deficit with China was $162 billion in 2004, or 24 per cent of the total U.S. deficit, an increase of $38 billion from 2003, when it was already 23 per cent of the total U.S. deficit. These figures were higher than the U.S. direct country-to-country deficit with any other country. However, the bilateral trade flows alone cannot determine an equilibrium exchange rate for a country, and hence do not show whether the RMB was undervalued or not. Chinese economist Liu Zunyi argued that although China ran a trade surplus with the U.S., it had a trade deficit with many East and Southeast Asian economies, including Japan and the four newly industrialised economies (NIEs), i.e., South Korea, Hong Kong, Singapore and Taiwan, which were also trading partners of the U.S.\(^\text{10}\) In addition, China’s large trade surplus with the U.S. was mainly due to China’s comparative advantages in cheap labour costs, which had attracted U.S. firms as well as other Asian firms to shift their labour-intensive manufacturing production bases to China in order to maintain cost competitiveness. China’s exports to the U.S. and the EU stemmed from the re-exporting of large volumes of materials, parts and substances imported from

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China’s other Asian trade partners such as Japan, South Korea and many Southeast Asian economies. As one of the world’s major manufacturing centres, China has turned “Made in Asia” into “Made in China”. There should be no surprise that China’s rapidly increased share of world merchandise exports was matched closely by a decline in the share of Japan, and to a lesser extent, of the Asian NIEs. The World Trade Organisation (WTO) statistics show that China’s share of world exports rose from 2.8 per cent to 5.8 per cent between 1993 and 2003, while shares of Japan and the Asian NIEs fell from 9.6 per cent to 6.3 per cent and 10 per cent to 9.5 per cent respectively. Finally, according to Albert Keidel, given the condition of global trading linkages, a country’s world surplus – rather than its share of the U.S. trade deficit – is the true measurement of its contribution to global imbalance. In this context, China’s global surpluses in 2003 and 2004 were only 7 per cent and 8 per cent, respectively, of the U.S. deficits, whereas the surpluses attributable to Japan, the oil exporters and the EU combined accounted for more than 60 per cent of the U.S. deficits. Therefore, regardless of the source of the U.S. trade deficits with China, a revaluation of the RMB, even to a large extent, would be little help in reducing the U.S. overall trade deficit.

The third test is the inflation test. If the central authorities intervene to buy or sell foreign exchange with domestic currency, money supply will rise or fall, carrying implications for inflation. When they constantly purchase foreign exchange in the market, money supply will expand and domestic prices will increase accordingly. As a result the economy will experience high inflation and the currency will be considered to be undervalued, as implied in this circumstance. This test is flawed in cases of imported inflation, caused by, for example, large-scale imports of petroleum to China, and in situations where inflation is stimulated by heavy domestic demand (i.e. consumption and investment), as is apparent in the real estate sector bubbles in most medium and large cities in China. There could be other factors causing domestic inflation instead of exchange rate movements. Therefore, one should be cautious in interpreting inflation as a sign of the disequilibrium of the exchange rate.

Figure 3. China’s CPI-based Inflation 1994-2005

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\text{Source: China’s National Bureau of Statistics, 2006.}
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Figure 3 shows that the inflation is modest, as indicated by the movement of percentage changes in China’s consumer price index (CPI) within a band of -2 per cent to +2 per cent from 1994-2005. This could be the combined effect of continuous, mixed macroeconomic policies aimed at smoothing economic fluctuations induced by external factors (the RMB exchange rate-relevant issues) as well as internal factors, which do not help us assess whether the RMB was undervalued. Morris Goldstein and Nicholas Lardy argued that industrial goods prices, as an appropriate measure of inflation for China, which are free of the price controls that moderate reported CPI inflation, rose by more than 6 per cent in 2004 compared with 2 per cent in 2003, and there was slight deflation before that. On the inflation front, the evidence is far from benign in the 2003-05 period. However, the interpretation is still constrained in the case of inflation that is induced by other factors rather than exchange rate fluctuations.

Recent research estimating the equilibrium RMB exchange rate indicated the RMB to be undervalued in most cases, but estimates of the extent of undervaluation ranged from 10 per cent to 40 per cent before July 2005, when the new regime was launched. Morris Goldstein reported a revaluation of 15 per cent to 30 per cent for the RMB against the U.S. dollar based on the data of China’s balance of payments and from the viewpoint of global payment imbalances. Michael Funke and Jorg Rahn estimated a peak undervaluation of the RMB of around 15 per cent against the U.S. dollar in 2001, but they also argued that there was no evidence of the RMB being substantially undervalued between January 1985 and April 2002. Jeffrey Frankel used the PPP model and estimated a 36 per cent undervaluation of the RMB against the U.S. dollar in 2000, based on a cross-country regression of 118 countries. In this literature, the magnitude of the misalignment of the RMB from the equilibrium depends on the assumptions that researchers make in their models and their approaches to estimation. Although there has been no consensus on this issue, the debate continued to create a strong push for the RMB’s further revaluation.

**Impacts of the RMB Revaluation on China**

In response to international debates, Chinese Premier Wen Jiabao said that China would further advance the reform and forge a more flexible mechanism which would adapt to changes in market supply and demand. He recognized that this reform would represent a systematic project involving many aspects. During this course of reform, the Chinese authorities would have to take into account numerous factors, including China’s macroeconomic performance, social development, international income and expenditure, the progress of banking reform, economic growth, employment, the level of financial regulation, resiliency of enterprises and the effect on foreign trade, as well as the global economic and financial situations. Wen also claimed that China had to uphold the principles of independent initiative, controllability and gradual progress while carrying out reforms of the RMB exchange rate and moving towards a more market-oriented and flexible regime.

The decisions of China’s policy-makers would not be influenced solely by external constraints, as the Chinese government follows the principles of independence, taking into account domestic interests. The 2.1 per cent initial appreciation on
July 21, 2005 could actually be interpreted as a solution which the Chinese authorities constructed after comprehensively weighing the pros and cons of an appreciation, and the impact on China in terms of economic, social and political interests. The fear of negative consequences resulting from any rapid changes in China’s exchange rate regime has led the Chinese leaders to favour a gradualist approach.

Export

The Chinese authorities were concerned with the inverse impact of the RMB’s revaluation on China’s exports and hence economic growth, based on observations of Japan’s experiences in the mid-1980s. In 1985, in order to suppress Japanese exports, the U.S. and some other major industrialised countries forced Japan to sign the Plaza Accord to revalue the Yen by 30 per cent. This accord was considered to be one reason for Japan’s subsequent economic recession in the 1990s. After the initial revaluation of the Yen, the Japanese export industry lost almost all its price competitive advantage and it had to move its manufacturing bases to other East Asian countries. The Japanese economy, which was at its peak, lost its international competitiveness and ended up with a recession.

Chinese economist Yu Yongding argued that since China’s export industry is, for the most part, characterized by processing trade, and that manufacturers in the industry have strong adaptability, China’s trade situation would not be fundamentally affected if the value of the RMB rises by a small margin. Yu also believed that the RMB appreciation would force some inefficient exporters to exit from the industry and ease the vicious competition in international markets. As a result, as the terms of trade improve, China’s trade surplus would increase. In addition, Chinese companies would be motivated to develop their competitiveness by advancing operational efficiency and not relying solely on cheap labour costs.

In our opinion, the revaluation will have a short term negative impact on China’s export. However, this will optimise China’s trading structure, reduce processing trade, improve technology and relocate resources to the non-trade sectors in the long run. This could advance the development of the service sector and promote domestic demand in support of China’s economic growth, diminishing the heavy reliance on external demand.

Foreign Investment

Foreign investment remains important for China’s economic development; it has made a large contribution to the success of China’s reform and opening-up policy in promoting economic growth. The impact of the RMB revaluation on foreign investment is also of concern to the Chinese authorities. It appears paradoxical: it increases investment costs for foreign firms and so discourages foreign investment on the one hand, while enhancing their profits by increasing revenue on the other. The impact is likely to be neutral, given other factors.

However, the two factors most appealing to foreign investors are China’s potentially huge market and cheap labour costs. Labour costs in China continue to remain relatively cheap compared with other countries and contribute to its strong international competitiveness. Due to this factor, in combination with lower prices of imported raw materials, the RMB revaluation could hardly change the price competitive advantage of foreign-funded firms in the international market. The average profit margin of multinational companies in China was around 13 per cent, thus a 5.8 per cent appreciation against the U.S. dollar, up to December

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2006, would not affect foreign investment decisions to any large extent. One main type of foreign capital inflow is FDI, and its driving force will be a potentially huge market in the future in China. A revaluation of the RMB would have a minuscule effect on this type of inflow.

Another main type of foreign capital inflow is speculative money flows. The RMB revaluation directly rewarded the speculators behind those inflows that took place before July 21, 2005, and will motivate further speculative inflows, which could satisfy the self-fulfilled cyclical expectations of the RMB revaluation. In addition, most of the hot money was believed to flow to the real estate sector or other domestic investment sectors, which caused domestic prices to rise rapidly and led the economy to overheat. Chinese economist Liu Manping estimated that over US$ 70 billion of speculative money inflows was channelled into the real estate market in 2004 and this figure was becoming much higher in 2005. Foreign direct investment in China’s real estate market was allowed in 2002. From then on, foreign investors focused on the prosperous real estate market of China’s big cities and gained excessive earnings, shown by the extremely high-price property deals of Macquarie Bank, Goldman Sachs and Morgan Stanley in Shanghai in 2005. Consequently, in the short term, the RMB revaluation would mainly influence the high-quality real estate markets in big cities and, to a much lesser extent, affect the transaction decisions of the medium- and low-quality ones.

However, market expectations of a further revaluation of the RMB have tended to weaken. Stephen Green concluded that higher U.S. interest rates in 2005 and weaker local property markets reduced capital inflows. In addition, a sign of depreciation of the RMB in the mid term, in response to changes in economic fundamentals, was implied in China Exchange Rate System Report 2005, an official report published on December 15, 2005. The report indicated that China had a gap of over RMB 2,000 billion in social security funds, over RMB 1,000 billion of non-performing loans (NPLs) in state-owned banks, and enormous local government debts. The RMB’s transaction data also showed that the appreciation had been slowing down in the market, as illustrated by Figure 4. Just after the initial move in July 2005, there was a strong market force to push up the RMB. Starting from September 2005, the RMB’s upward trend had softened and stabilised by the end of the year.

Figure 4. The RMB Transaction Middle Rates in 2005 (Period Average)

\[\text{Figure 4. The RMB Transaction Middle Rates in 2005 (Period Average)}\]


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Employment

The Chinese government also feared that the shrinkage in the export sector would worsen the employment situation, as seen in Zhejiang province, where most of the most textile export companies were located, during the period when the U.S. and the EU cut their import quota of textile products from China. But if the RMB revaluation induces a reconstruction of the export sector, that could improve the efficiency of the sector and the quality of its future exports. A period of high unemployment could be a short-term economic phenomenon in China’s transitional process. Yu Yongding also argued that the improvement of investment efficiency based on or gained from a fall in the trade surplus would realize the potential economic development and improve employment in the future. The example of economic prosperity in the U.S. in the late 1990s seemed to favour the argument.

Chinese economist Liu Wei at Peking University estimated that every 1 per cent growth in GDP could provide 1.7 million employment opportunities in China. To ease the possible unemployment problem he argued that the Chinese government had to maintain continuous economic growth at a high rate. He also suggested that in this context, China should continue the gradualist policy of sustaining a stable RMB exchange rate in order to promote economic growth and employment.

Agricultural Sector

The Chinese leadership prioritised rural issues in their policies and closely scrutinized the impact of the RMB’s revaluation on the agricultural sector in order to circumvent unexpected shocks that would risk China’s economic growth and social stability. China’s agricultural sector has not achieved industrialization yet, and its agricultural products have no competitive advantage in international markets. The majority of these products are consumed domestically and most have not been highly commercialised. If the RMB revaluates at a substantial margin, the prices of agricultural products in international markets in terms of RMB will be dragged down and the domestic demand for imports of agricultural products will increase. Hence, the demand for domestic agricultural products will go down and their prices will decline. The agricultural sector that supports 60 per cent of the Chinese population would be further weakened. Chinese economist Tao Dong examined these effects and suggested that China should not appreciate the RMB by any greater degree than that implied in the current gradualist strategy, considering rural income, social stability and security.

The Prospects for Further RMB Revaluation

According to Chinese Premier Wen Jiabao, to gradually establish a market-based and well-managed floating exchange rate system and to keep the RMB exchange rate basically stable at a reasonable and balanced level is the unalterable direction and the goal of China’s exchange rate reform. Without doubt, China will, and has to continue to advance the exchange rate reform following an independent initiative, controllability and gradual process. But any change will be targeted at maintaining the development and stability of China’s economy and financial system. Wen recognised that China needed to deepen the exchange rate reform and improve services in relevant fields, including improving the foreign exchange market and providing more financial services to enterprises to allow

24 Tao Dong, “There will be Further RMB Appreciation in the Coming Two Years, USD/RMB could be 1:5 in Ten Years,” Xin Caifu [New Fortune] (Chinese magazine), August 15, 2005.
risk management, improving the adjustment mechanism of the RMB exchange rate and intensifying supervision of cross-country capital flows to ensure the smooth operation of the new exchange rate mechanism.

Li Deshui, a member of the Monetary Policy Committee in the PBC, stated that China would not allow the free float of the RMB in five years due to its fragile financial markets. Tao Dong pointed out that large and rapid appreciation of the RMB would hurt not only the Chinese exporters but also foreign consumers. He indicated that enlarging the floating range of the RMB and further appreciating the RMB were indeed two different concepts. The former depends on short-term trading volume whereas the latter reflects changes in the long-term macroeconomic fundamentals. Tao suggested that the adjustment in the RMB should follow a gradual and cautious process, considering its impact on the national economy and people’s livelihood, and especially the pressure of employment.

Since its appreciation in July 2005, the RMB continues to face pressure to revalue due to large current account surpluses and rapid accumulation of foreign exchange reserves. China’s trade surplus increased to $102 billion in 2005 and foreign exchange reserves reached $818.9 billion in December 2005. In particular, due to the abrupt and rapid rise of the reserves, the issue of managing excessive reserves has become a focus of China’s exchange rate policy in recent years.

Since 2004, the fastest-growing source of foreign exchange reserves for China was the so-called item “credit transactions” — the U.S. dollar offshore borrowings by the Chinese companies and foreign banks that were converted to the RMB in China. Such borrowings were driven as much by speculation for a revaluation of the RMB as by opportunities to invest in China’s surging economy. The Chinese government tightened controls on offshore borrowings in 2005, especially by foreign banks. With a minor 2.1 per cent revaluation of the RMB against the U.S. dollar and a further modest appreciation since then, the PBC demonstrated that it was able to stick to its own policy while managing internal and external pressures.

Strong inflows will maintain the pressure on China to make the RMB more flexible and responsible to market forces while also keeping attention on how China invests its stockpile of foreign exchange reserves. In light of this, the Chinese authorities focused their exchange rate policy on the following three areas in 2006: first, keeping the exchange rate level of the RMB stable and smooth, though the flexibility of the exchange rate might notably increase; second, promoting the balance of international payments; third, management of the large foreign exchange reserve funds to maintain the effective functioning of monetary policy.

Chinese Economist Zhang Bin suggested that reversing the trend of swift growth in international reserves should be the priority of China’s reserve management. Useful methods included boosting domestic demand, modernising the financial system, reducing the need for saving and allowing the RMB to appreciate. In the long run, optimising economic structure would be key to addressing the issue.

government bonds. This potential shift would have significant implications for global financial and commodity markets. SAFE announced that it intended to optimise the currency and asset structure of China’s foreign exchange reserves to actively boost investment returns. This new move was consistent with the Chinese government’s objective of managing its international reserves to effectively support a national strategy, an open economy and a macroeconomic adjustment.

According to the *China Exchange Rate System Report 2005*, in the following two years, the process of advancing China’s exchange rate policy could be described as “observable and adaptable”. It emphasised that the central bank was capable of maintaining the stability of the RMB exchange rate within a small band of fluctuation, even if the RMB were to have a minor appreciation. It also underlined the fact that in the medium- and long- run, it was still possible that the RMB might depreciate, depending on China’s economic reform process and international financial circumstances.

In recent decades, China has benefited enormously by practicing a gradualist approach to reform, be it in the economic or political realm. China is likely to continue to reform its exchange rate in a gradual manner. While external pressure could frequently be high, China’s capacity to resist such pressure is also strengthened by its growing economy. It is in China’s own interests to reform the exchange rate, but China is likely to do it according to its own plan. External factors will certainly be important when formulating this plan, due to the fact that China is now an important part of the global economy. Nevertheless, what matters more are the Chinese leadership’s perceptions of domestic priorities and its capability to cope with urgent domestic problems. This is what Wen Jiabao meant when he repeatedly emphasised that the exchange rate reform belongs to China’s “sovereignty”.

Radical reforms are unlikely but it is reasonable to expect that the transparency of operations under the new exchange rate regime will increase and the band within which the RMB fluctuates will widen over time. Moving towards a flexible exchange rate regime is China’s long-term objective and it is in the interest of China’s future economic development. It will take a long time for the Chinese government to achieve this target if, as expected, the government continues its gradualist approach.

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