Impact Of China's Yuan Revaluation

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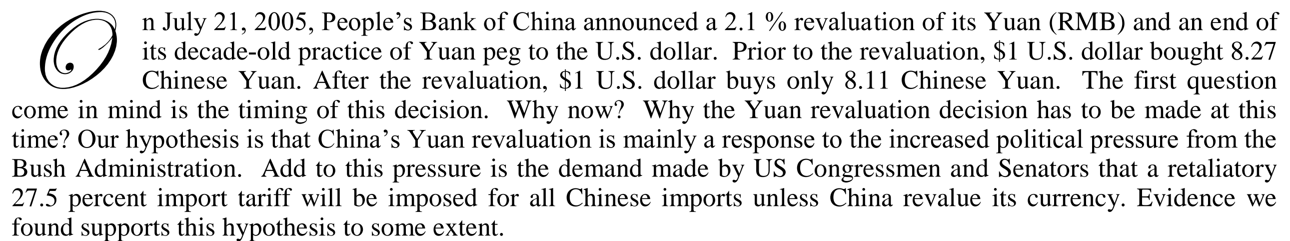
ABSTRACT

In the past two years, the Bush Administration, members of Congress and a few senators, such as Sen. Charles Schumer of New York and Sen. Lindsey Graham of South Carolina and others have put pressure on China to abandon her peg the Chinese "Yuan" to the U.S. Dollar. These efforts finally succeed. On July 21, 2005, People's Bank of China announced that the Chinese Yuan is no long pegged solely to the U.S. dollar, instead, the Yuan is now linked to a basket of currencies, including Dollar, the Euro, the Japanese Yen, the Korean Won and other currency from any country that had at least $10 billion trade with China. In this paper we ask the questions: what is the impact of China' Yuan revaluation decision? Does this means that China no long stockpile U.S. Treasury Bills? The American consumers can no longer benefit from the low-priced consumer goods manufactured in China? And in what way the U.S. economy will be affected, if at all?

INTRODUCTION



On July 21, 2005, People's Bank of China announced a 2.1 % revaluation of its Yuan (RMB) and an end of its decade-old practice of Yuan peg to the U.S. dollar. Prior to the revaluation, $1 U.S. dollar bought 8.27 Chinese Yuan. After the revaluation, $1 U.S. dollar buys only 8.11 Chinese Yuan. The first question come in mind is the timing of this decision. Why now? Why the Yuan revaluation decision has to be made at this time? Our hypothesis is that China's Yuan revaluation is mainly a response to the increased political pressure from the Bush Administration. Add to this pressure is the demand made by US Congressmen and Senators that a retaliatory 27.5 percent import tariff will be imposed for all Chinese imports unless China revalue its currency. Evidence we found supports this hypothesis to some extent.

Examining Chart 1, Table A and Table B, one can see the magnitude, the speed of growth and the trend of US trade deficit with China since 1990. Indeed the rate of increase is average 24.97 % per year in the last three years compare to that of the previous 5-year period before 2000 of the average growth rate of 16.96 % per year. The magnitude of the US trade deficit with China, on the other hand, was $103 billions in 2002, $124 billions in 2003, was more than $162 billions a year in 2004 and another 20%-30% per year increase is projected in 2005. What's more, China exports six times as much to America as it imports from U.S. in the first half of 2005. It is also reported in the press that China's foreign reserves have grown sharply by $117 billions dollars in 2003 to a total of $403 billions. In June, 2005, China's foreign currency reserves have almost doubled by reached $711 billions, an increase of 51 percent compare to that of 2004.

The most important message buried in these statistics is the fact that there is no ending in sight as far as the worsening U.S. trade deficit with China is concerned. To any causal observer the distinctive impression is that this situation should not be permitted to go on forever. No wonder that American politicians reacted, and the Chinese government had been made to feel this political pressure. In order not to antagonize any more her most important customer of her exported goods—the United States, China finally comes to the realization and concludes that she better changes its Yuan-Dollar peg policy now.

Table A: U.S. Trade With China: 2005

All figures are in millions of U.S. dollars.

Month	Exports	Imports	Balance
January 2005	2,609.2	17,863.7	-15,254.5
February 2005	3,082.4	16,953.6	-13,871.2
March 2005	3,305.4	16,209.5	-12,904.2
April 2005	3,405.1	18,119.7	-14,714.6
May 2005	3,296.1	19,050.3	-15,754.2
June 2005	3,394.2	20,988.0	-17,593.8
TOTAL	19,092.4	109,184.8	-90,092.5

Sources: U.S. Dept. of Commerce

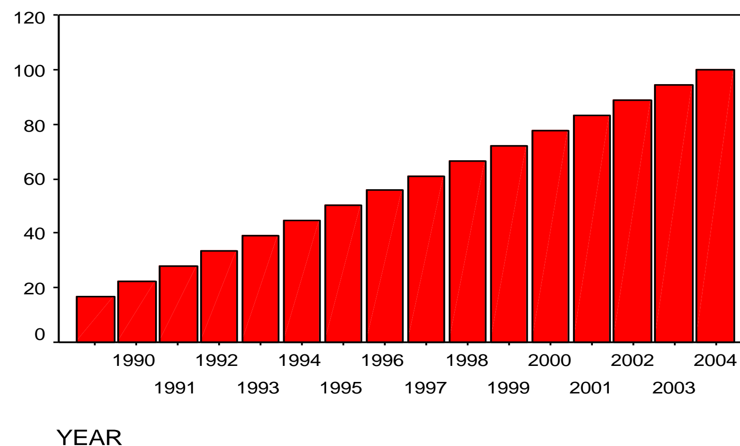
Table B: U.S. Trade With China: 1990-2004

All figures are in millions of U.S. dollars.

Year	Exports	% Change	Imports	% Change	Balance	% Change
1990	4,806.40	-0.16	15,237.40	0.27	-10,431.00	0.673163
1991	6,278.20	0.31	18,969.20	0.24	-12,691.00	0.216662
1992	7,418.50	0.18	25,727.50	0.36	-18,309.00	0.442676
1993	8,762.90	0.18	31,539.90	0.23	-22,777.00	0.244033
1994	9,281.70	0.06	38,786.80	0.23	-29,505.10	0.295390
1995	11,753.70	0.27	45,543.20	0.17	-33,789.50	0.145209
1996	11,992.60	0.02	51,512.80	0.13	-39,520.20	0.169600
1997	12,862.20	0.07	62,557.70	0.21	-49,695.50	0.257471
1998	14,241.20	0.11	71,168.60	0.14	-56,927.40	0.145524
1999	13,111.10	-0.08	81,788.20	0.15	-68,677.10	0.206398
2000	16,185.20	0.23	100,018.20	0.22	-83,833.00	0.220683
2001	19,182.30	0.19	102,278.40	0.02	-83,096.10	0.008790
2002	22,127.70	0.15	125,192.60	0.22	103,064.90	0.240310
2003	28,367.90	0.28	152,436.10	0.22	124,068.20	0.203787
2004	34,744.10	0.22	196,682.00	0.29	161,938.00	0.305234

Chart 1 U.S. Trade Deficit with China

1990-2004



TWO HYPOTHESES

The changing value of U.S. Dollar and the worsening U.S. Trade Deficits with China are, in our judgment, the two most important implications after China decides to sever the Yuan-peg-to-Dollar linkage. We thus propose the following two hypotheses to be examined in depth:

1. China's currency revaluation would change the status of U.S. dollar as Asian's dominant trade currency.
2. China's currency revaluation would help to relieve the trade frictions between U.S. and China.

DETHRONE THE U.S. DOLLAR AS ASIAN'S DOMINANT TRADE CURRENCY

One impact of China's Yuan revaluation is easy to observe: this is the beginning of the long-term strengthening the value of Chinese Yuan against the U.S. Dollar. China's Yuan becomes the new anchor currency in Asia. If America does not keep her economy in order, and if U.S. does let her balance-of-payments problem deteriorating further, some time in the future, the loss of value and confidence in the U.S. Dollar in Asian countries and possibly in other part of the world will become inevitable. As for now, we hypothesize that China's Yuan revaluation would, to some extent, reduce the U.S. dollar as Asian's dominant currency.

U.S. Dollar is normally the preferred currency for international foreign exchange transactions. In the past, settlement in foreign exchange account in Asian countries is, for the most part, in U.S. Dollars, and to a less extent, in Japanese Yen. Now, after Yuan increase its value overtime, it is therefore conceivable that these settlements could now be made in Chinese Yuan. What's more, U.S. Dollar often used as an intermediary currency between two Asian countries in trade settlement. The wisdom of the policy of any Asian country persistently use of U.S. Dollar as an intermediary currency in exchange rate becomes questionable. Chinese Yuan could therefore be elevated to be the intermediary currency in Asia instead.

So far China reforms the Yuan exchange rate mechanism in a deliberate and controlled manner. The new system is very similar to Singapore's managed "basket, band and crawl" model in which currency floats within a set band. People's Bank of China at the present time does allow a trading band of 0.3 percent on either side of the mid-rate. Yuan is now linked to a basket of currencies, including Dollar, the Euro, the Japanese Yen, the Korean Won and other currency from any country that had at least $10 billions trade with China. It is obvious that the exchange value of Chinese Yuan has slowly but surely adjusted upward with an official sanction.

In the past China and the other Asian countries have sought deliberately to keep the value of their currencies low. The objective is that to make the Chinese goods exports and goods produced in other Asian countries more competitive in the International market place. Once a sufficient amount of U.S. Dollar reserve has been built-up, a common used mechanism is that China and these Asian countries begin to purchase the dollar-based assets, (i.e., U.S. Treasury Bill); thereby indirectly financing the US balances of payments deficit. It is also an economic reality that the excessive purchasing of US Treasury Bill by China and other Asian countries is the major cause of the distortion of the monetary policy in their economies. After the start of the Yuan revaluation process, we expect that these Asian countries will begin to adjust the value of their own currencies upward, and are now willing to ride higher with Chinese Yuan. One consequence of these actions: they will gradually reduce the quantity of their purchase of U.S. Treasury Bill. That the internationalization of Yuan; the mutual dependent relationship; the capital transactions and movements between and among Asian and Pacific countries will therefore now become even stronger after Yuan's revaluation.

There are now four major world currencies: Dollar, Euro, Yen and Yuan in the international trade arena. Economic conditions within and related to United States, European Union, Japan and now China will, no doubt, affect and influence the relative movement of these four currencies. China's Yuan revaluation, in the long run is expected to shift the imbalances in the global economy.

Earlier this year when report surfaced and later it was found to be false that South Korean and Japanese authorities were considering lessening their dollar holdings, U.S. stock market did experience a severe turbulence in a day or two. This episode does illustrate the fear that a rush out of U.S. Dollar could possibly very well induce a financial crisis worldwide. Now, China's decision of de-pegging Yuan-U.S. Dollar linkage does make this kind of

transaction, and switching out of U.S. Dollar much easier to accomplish, and with a minimum stock market disruption.

On another front, Article 8 of the International Monetary Fund (IMF) Articles of Agreement forbids country that use IMF funding to put restrictions on current account transactions. According to the assertion made by economist Tomoyuki Nakagawa of Institute of International Policy Studies that after a country adopts Article 8 of IMF code, it will begin the process of abolition of all capital transaction control, even though it may go slowly at the beginning. Examining Table C (on page 8) above that one can see a similarity do exist between Japan's case and possibly that of China's case? 9th year after adopted IMF Article 8, Japan, on a trail basis, floats her exchange rate system. To follow the same development pattern, 9th year after China adopt IMF Article 8, China begins to widen floating range of Yuan in July 2005. 16th year after Japan adopted IMF Article 8 Japan completes abolition of all capital transaction control. Again, to follow this same development pattern, we expect that before year 2008, China will hold its first Olympics at Beijing, or year 2010 the first ever World Expo to be held in Shanghai, China will see fit to float completely its currency and fully liberalize its capital transactions control. Should that day come then the effect to the world economy will be enormous.

Table C
Chronology Of Japan And China After Their Adoption Of Article 8 Of IMF Code

	Year	Japan	Year	China
1st year	1963 1964	Widened floating range of yen (0.5 to 0.75%). Adopt IMF Article 8. Tokyo Olympics held.	1996	Adopted IMF Article 8.
5th year	1966 1967 1969	Loosened Currency restrictions (up to $500). Capital Account liberalization step1. Capital Account liberalization step2.	1998 2001	Loosened foreign exchange. Business concentration rule. Entered WTO in December.
7th year	1970 1971	Capital Account liberalization step 3. Loosened Currency restrictions(up to $1000). Temporary shift to floating system.	 2003	 Calls for Yuan revaluation.
9th year	1973	Floating exchange rate system.	2005	July, 21, de-pegging Yuan-Dollar Yuan revaluation begins.
16th year	1980	Abolition of all capital control.	2006 2008 2010	Total market access in accordance with WTO Agreement. Olympics in Beijing. World Expo in Shanghai.

Source: Bank of Japan and cited by Nakagawa

TRADE FRICTIONS BETWEEN U.S. AND CHINA

Preferential and discriminatory trade agreements are brutal instruments. Free Trade Agreement (FTA), Voluntary Export Restraints (VER), Orderly Marketing Agreement (OMA) and Voluntary Import Expansions (VIE), just name a few, are all commonly used instruments between nations in international trade. These instruments are nevertheless preferential and/or discriminatory trade practices in nature.

China has replaced Japan, in the past few years, as the country with the largest trade surplus with United States. Since China has accumulated a large sum of U.S. financial assets, the bilateral trade between U.S. and China always resulted in China's favor. As a result, U.S. trade deficit with China has greatly increased. This creates frictions between U.S. and China. In order to reduce these trade deficits, U.S. government has used all the discriminatory agreements mentioned above in order to protect the competing U.S. domestic industries. Moreover, China has become a target of antidumping action by the United States in recent years (20% of all antidumping cases in 2004 are cases against China). The antidumping laws have also been the popular policy instruments for the U.S. industries seeking protection from China. For instance, the U.S. textile and apparel industries and the U.S. steel industries have effectively used antidumping cases to raise barriers against Chinese exporters. What's more, there is also a higher likelihood that these Chinese exporters being investigated. Should antidumping duties applied to these Chinese exporters, the antidumping duties amount imposed usually are at a much higher level as well. Nevertheless, policy

makers in both the Bush Administration and the Chinese government are cautioned to the serious consequence which might erupt from these trade disputes. Any antagonism between China and America will destabilize the dollar denominated exchange rate system, and thus destructive to both the U.S. and Chinese economies.

Ever since China's WTO accession agreement, many Asian and Pacific countries have begun to strengthen their bi-lateral trading relations with China, including the sign of their own Free-Trade Agreements with China. The intention is naturally to give each other the preferential access to their respective markets. These FTAs do have, implicitly, the detrimental effect on the third countries, (namely, U.S. and/or Japan).

What's more, a little known fact is that goods produced and exported from China by international companies (including many American multinational companies (MNC), such as Wal-Mart, Costco, Home Depot, etc.) account for almost half of all China's exports. Yuan revaluation will no doubt lead to increased processing and production costs at the manufacturing facilities in China. The cost advantage and value-add by these and other American companies, as a result of the Yuan revaluation, will expect to decrease. It is conceivable that they are hard pressed from now on to turn out a bigger profit year after year as they did in the past. On the other hand, American consumers are expected, as another possible impact of the Yuan revaluation, to pay more for the same product in the future.

Because almost one-fourth overall U.S. trade deficit comes from the trade with China. China's Yuan revaluation, even at a baby step taken in the beginning, is expected to reduce the currency misalignment and the trade frictions between U.S. and China in a few years. One potential major factor to destabilize the U.S. economy will thus be removed. We support therefore the hypothesis that in the future the worsening U.S. trade deficit picture is expected to improve and the trade frictions between U.S. and China will slowly but surely be reduced and/or be eliminated.

CONCLUSION

In this paper we study and examine the impact and practical implications of China' Yuan revaluation decision. Some implications of this decision are immediate in evidence. This currency revaluation decision will help to reduce the U.S. trade deficits with China. The political pressure put by Bush Administration and the U.S. Senators and Congressmen has lightened to the extent it almost disappears as a headline news item. The manufacturing cost advantage and value-add by U.S. MNCs who produce their products in China will decrease. As a result, their profit will reduce. In the meantime, American consumers are expected to pay more for the same product in the future.

What's more, this decision might be the beginning of the long-term strengthening of China's Yuan against the U.S. Dollar. On the other hand, China's currency revaluation would help to cool down its own red-hot economy. As China's economy grow and developed, and as Yuan increases its valuation overtime, if one can borrow the past experience from the Western developed economy, it is reasonable for us to conclude that Chinese companies will, in turn, seek to invest abroad, and they will acquire oversea assets, which will include the purchasing of the U.S. companies. The first ever but eventually failed attempt of Chooc to buy Unocal is just the first illustrated example of this effort. One expects these efforts will continue. China's decision of shifting the Yuan-Dollar pegs to the Yuan peg to "a basket of currency" has indeed, in one sense, a significant impact upon the Sino-American business relation.

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