

# Currency Management Under A Hybrid System: Case Of The Yuan

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## ABSTRACT

*The purpose of this research paper is to analyze the Renminbi (the Chinese currency), suggesting whether or not the currency should be allowed to float. The paper makes the use of four popular approaches to determine whether or not the currency is currently undervalued, and if so, what mechanisms should be used to allow for its proper valuation. According to the purchasing power parity (PPP), balance of payments approach, and the asset management approach, the Chinese currency is undervalued and will therefore appreciate in the future. For the long run, the floating of the currency is advisable; however, in the short run, it will not be in the best interest of the Chinese economy given the nature of its banking system. Adopting a pure float could possibly cause major macro and micro economic imbalances that would be difficult to tackle. Instead, suggesting the pegging of the Renminbi against a basket of currencies to ensure system wide flexibility and stability is the best course of action.*

## INTRODUCTION

China's economic performance this past decade helped propel its stature amongst the emerging market economies as one of the fastest growing economies with nearly double-digit, real-GDP, growth rates. As a result of the Chinese government's launching of economic reforms since the 1970's that made the country more open for international business, the Chinese government and the Central Bank have been practicing a fixed-exchange rate by pegging the Renminbi to the U.S. Dollar.

Although there were several phases in the modification of the Chinese exchange rate policies in the period ranging 1979-2006, the most major characteristic of them all was the strong government influence on the foreign exchange regime and fixed exchange rate policy. China consistently utilized the exchange rate policy as a tool for achieving internal stability, ultimately promoting its export and economic growth.

In 2005, China changed its exchange-rate policy by fixing the Renminbi to a basket of currencies that consisted of the U.S. Dollar (USD), Japanese Yen (YEN), and the Hong Kong Dollar (HKD)<sup>1</sup>. Nevertheless, this new currency policy has not significantly changed the relationship between the Renminbi and other basket currencies in terms of Renminbi value. More notably, China has not shared their complete list of basket currencies with relative weights; thus hiding any further indication as to the remaining presence of the Central Bank's direct influence on the Renminbi's exchange rate.

The central issue grasping the attention of macroeconomists and China's major trading partners is whether China should change its dominantly fixed exchange rate regime towards a more flexible policy that would better reflect the market conditions, therefore establishing a more realistic value of the Renminbi. The underlying argument asseverates the fact that China persistently maintains an undervalued Renminbi currency to create a large external imbalance whose repercussions on the stability of the global economy affect the world's largest economies, most

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<sup>1</sup> "China on Thursday took an important step forward in its move toward a market economy, announcing it would increase the value of its currency, the yuan, and abandon its decade-old fixed exchange rate to the U.S. dollar in favor of a link to a basket of world currencies." – Washington Post Foreign Service: "China Ends Fixed-Rate Currency". Peter S. Goodman, July 22, 2005

notably, the United States, Japan, and the European Union. The great irony of course is the fact that these three economic powers are China's major trading and investment partners.

The paper will also give a brief, historic outline of the Renminbi exchange rates in addition to analyzing China's fundamental, macroeconomic indicators (i.e., GDP, BOP, inflation, interest rates, and unemployment). In addition, China's political environment will be analyzed being that it directly affects the behavior of the macroeconomic indicators, which in turn, further impact the Renminbi's exchange rate. The objective is to evaluate China's ability and benefits it can possess in maintaining a fixed exchange rates versus shifting it toward a floating regime.

## **THE RENMINBI EXCHANGE RATE**

The Renminbi's exchange rate policy has long served as a dispute between China and its major trading partners who believe that China has been artificially maintaining its depreciated exchange rate in order to further boost exports. The undervalued currency along with increased productivity coupled with relatively inexpensive labor that make China's manufacturers more competitive related to its major trading partners are considered to be additional factors affecting exchange rate policy. Some analyses suggest that this situation led to a higher trade imbalance and larger trade deficit in some of the leading world economies, specifically the United States.

There have been several modifications in China's exchange rate regime after it had initiated its transition toward a more economically open society in 1979<sup>2</sup>. During the period of 1979-1993, China had utilized its exchange rate as a tool for financial planning within its planned economy. This period characterized a fixed exchange rate policy pegged to the USD. In this period, the Renminbi had been gradually devaluated in order to meet the needs of desired economic growth. The official integration of the Renminbi exchange rate and foreign exchange swap rates of 1994-1997 changed the exchange rate regime into a "managed float system". Immediately upon this integration, the official exchange rate was lowered to 33.3%.

The rate integration and transition to a managed float regime reversed the trend. As a result, the Renminbi started to slightly appreciate vis-à-vis the USD during the three-year period of 1994 to 1997. During the period of 1998-2004, the Asian crises had affected the general capital outflow from the region. There were expectations that the Renminbi would devalue. Nevertheless, the Chinese government intervened and refused to devalue the Renminbi, keeping it at the fixed level pegged to the USD. Throughout this time, the Chinese government maintained a tight control of the Renminbi's value according to the objectives of its economic policy. To this day, preserving internal stability and utilizing exchange rate policy in order to support its export activities have consistently been major goals of the Chinese government.

The most recent policy modification occurred in August 2005 by pegging the Renminbi to a basket of currencies. The Central Bank of China called the currently modified, exchange rate arrangement a "managed float system"<sup>3</sup>. The People's Bank of China (PBC) quotes spot rates of the Renminbi (RMB) against a basket of currencies (which include the USD, YEN, and HKD) on a daily basis. The rates are calculated as a weighted average of exchange rates at which transactions are made at the PBC's Shanghai Foreign Exchange Trade Center. The Chinese government is reluctant to publish a complete list of the currencies it takes into the basket. Exchange rates of the RMB against other foreign currencies are calculated by commercial banks based on the cross-rates between rates of RMB against the USD, and USD rates against other currencies in international markets. The exchange rates are expressed in RMB per 100 foreign currency units. The table below shows a sample of the historical exchange rate of the RMB compared to currencies that serve as a basket.

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<sup>2</sup> "The Evolution of the Renminbi Exchange", Asian Development Bank Institute. Tokyo, Japan. (May 6, 2006)

<sup>3</sup> "Under the rules introduced in July, the renminbi can only deviate by up to 0.3 per cent against the dollar each day. The closing fix on each day automatically became the new opening price on the following trading day." – Financial Times: "Renminbi Expected to Rise After New Trading Rules". Steve Johnson, January 5, 2006

Date	USD	JPY	HKD	EUR
1/1/2002	0.1210	15.929	0.9433	0.1357
1/1/2003	0.1210	14.3702	0.9433	0.1152
1/1/2004	0.1210	12.9919	0.9394	0.09619
1/1/2005	0.1210	12.3922	0.9404	0.08918
1/1/2006	0.1239	14.5798	0.9607	0.1046
1/1/2007	0.1282	15.2762	0.9977	0.09721

Source: [www.oanda.com](http://www.oanda.com)

In conclusion, in spite of the fact that the Chinese Government calls the new policy a “managed float”, a more detailed analysis of the relative macroeconomic indicators and currency movements indicates that their policy is still much more managed than floated. Pegging the RMB to a basket of currencies (which lacks details regarding its composition and corresponding weights) leaves a large space for monetary authorities to affect currency movements in any desired direction. The table below shows selected historic exchange rates between RMB and basket currencies.

#### Since the change to the basket of currencies

	USD	YEN	HKD	EUR
7/21/2005	0.121	13.6394	0.9409	0.09958
8/21/2005	0.1235	13.6497	0.9601	0.1017
9/21/2005	0.1238	13.8514	0.9606	0.1021
10/21/2005	0.1238	14.2877	0.9605	0.1031
11/21/2005	0.1239	14.7649	0.9606	0.1052
12/21/2005	0.1239	14.3829	0.9608	0.1032
1/21/2006	0.1241	14.3244	0.9624	0.1027
2/10/2006	0.1242	14.7245	0.9638	0.1037

Source: [www.oanda.com](http://www.oanda.com)

#### GDP AND ECONOMIC GROWTH OF CHINA

China’s rapid economic growth is in large part due to the economic reforms it had implemented in the late 1970’s. In the 10-year period ranging from 1986 to 1996, the Chinese economy had achieved impressive economic growth of 10% annually on average (measured in real GDP terms). This percentage slightly declined in the next decade to an average, annual growth of 8.4% in the subsequent 10-year period ranging from 1996 to 2006<sup>4</sup>. Nevertheless, China has still been the fastest growing economy in the world. The results are even more impressive considering the currency crises that shook the whole region in that period through Asia’s “tequila effect” in the mid to late 1990’s. In addition, some of the major economic powers in the world, along with other major Chinese trading partners, experienced a recession in the 2-year period ranging from 2001 to 2003. An analysis of the Chinese macroeconomic indicators for this period, specifically GDP and trade balance, indicates that China was able to absorb these disruptions except for the slight decline in its GDP growth. (See the table below)

China had gradually initiated reforms of its industries in the 1980’s to shift them more toward market orientation, making them more competitive. In the agricultural sector, reforms consisted of dismantling the commune system and introducing the household responsibility system that provided peasants greater decision-making in agricultural activities<sup>5</sup>. Manufacturing industries were mostly spurred by attracting foreign investments that occurred in a variety of industrial and consumer goods. With its abundant labor resources and more relaxed regulations related to foreign investments, China had attracted many powerful multi-national enterprises (MNE) that had begun to

<sup>4</sup> International Monetary Fund, World Economic and Financial Surveys - “World Economic Outlook: Globalization and Inflation.” April 2006

<sup>5</sup> Country Watch database

heavily invest in China, effectively utilizing the relatively inexpensive labor, gaining an access to this large market that showed indication of liberalization in the area of business.

One of the key drivers of Chinese economic growth was the export of goods. China was the fourth largest trading nation with consistent, surplus growth in the trade balance. In the last decade, China had a rapidly consistent, surplus growth in their current account and trade balance. It is worth mentioning that more than 50% of Chinese export comes from foreign companies that have manufacturing operations in China. This indicates that China has been able to improve the competitiveness of their industries, simultaneously attracting large capital inflows mostly through foreign direct investments (FDI).

The major part of GDP is 48.1% industry based, which includes manufacturing and construction. Services contribute approximately 40% while agriculture contributes to 11.9% of GDP (CIA estimate for 2006)<sup>6</sup>. The rapid economic growth of China in the last two decades has resulted in China being the second largest economy in the world in 2006 behind the U.S. (measured in terms of PPP)<sup>7</sup>. Nevertheless, in per capita terms, China is still far behind most developed countries and it is still in a category of emerging economies with low middle incomes (based on World Bank classification). The table on the following page clearly illustrates these discrepancies between high GDP growth and still very low per capita distribution. Over 10% of the population (or more than 150 million of the Chinese) lives below the poverty line<sup>8</sup>.

Another significant problem for Chinese economic growth is a high disproportion between regional developments. Most of the business activities that account for the majority of GDP occur in eastern, coastal provinces and in several major cities. On the other hand, China has highly undeveloped and poor interior regions with masses of redundant labor that had been laid off from inefficient state owned enterprises that were liquidated as a result of Chinese economic reforms and an inflow of highly competitive MNE's. The unbalanced economic growth and still high percentage of poor populations will represent the major challenge for the Chinese to further economic growth. In addition, China still faces challenges to achieve higher efficiencies in certain sectors that are fundamental for sustainable economic growth. The banking sector is still not completely reformed and is burdened with high numbers of non-performing loans that strongly weakened the state-run banking system. In addition, there are still large numbers of inefficient state-owned enterprises that hinder growth. The tables below summarize the information regarding Chinese GDP growth.

Period	1986-1996	1997-2006	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Real GDP	10	8.4	8.8	7.8	7.1	8	7.5	8.3	9.5	9.5	9	8.2

Source: IMF World Economic Outlook, September 2005

**GDP growth**

	2000	2001	2002	2003	2004
Real Gross Domestic Product US \$'s (billions of US dollars)	1,079.19	1,160.33	1,253.17	1,367.21	1,494.45
Total Population in million persos	1,268.85	1,276.88	1,284.28	1,291.50	1,298.85
Real GDP Per Capita US\$ (Thousands of US Dollars Per Person)	0.8505	0.9087	0.9758	1.059	1.151

Source: Country Watch

<sup>6</sup> The World Factbook – Central Intelligence Agency (C.I.A.), United States of America. January 18, 2007

<sup>7</sup> World Bank PPP GDP 2006

<sup>8</sup> According to the Asian Development Bank, about 10.5 percent of the urban population and 25.5 percent of the rural population would be classified as poor in 1999.

## BALANCE OF PAYMENT EFFECTS

China had a consistently growing surplus in their current account balance during the 9-year period from 1997 to 2006. The surplus grew from \$34.4 billion in 1997 to \$115.6 billion in 2005. Export growth remains to be the major driver of China's economic growth, being that is an area where China has become highly competitive. China's major trading partners include Japan, EU, United States, South Korea, Hong Kong, and Taiwan. According to U.S. statistics, China had a trade surplus with the U.S. of \$124 billion in 2003. This development of the Chinese export sector was supported by policies that fostered inflows of FDIs in the manufacturing sector. Foreign invested manufacturers produce about half of China's exports.

Competitive advantages in these manufacturing areas were a combination of several factors. First, the Chinese government had a clear strategy regarding which industries were to develop by gradually opening its space for foreign investments in those areas. Second, consistent with the "Factor Proportion Theory" and "Factor Mobility Theory", China utilized its abundant and relatively cheap labor to attract foreign investors. At the end, China utilized its fixed exchange rate policy in order to set the Renminbi on a desired level to correspond with its economic policy objectives.

Another aspect of the Chinese opening up their economy to foreign investment was its integration into the world trading system. China demonstrated its intentions to increase its participation in world trade by joining the Asia-Pacific Economic Cooperation (APEC) group in 1991. APEC promotes free trade and cooperation in the realm of economics, trade, investment, and technology. Additionally, China formally joined the World Trade Organization (WTO) in December 2001. In an effort to join the WTO, China agreed to lower tariffs and abolish market impediments. The Chinese and foreigner investors gained the right to import and export on their own by selling their products without going through a government middleman. The agreement also opened up new opportunities for international companies to invest in China with less complications, providing services like banking, insurance, and telecommunications. Although China has made progress toward WTO requirements, there are still certain issues related to protection of legal rights and piracy issues. Another impediment for further growth of FDIs in China rests in the untransparent and inconsistent enforcement of laws that lacks any kind of an adequate legal infrastructure<sup>9</sup>.

As part of its admission into the WTO in 2001, China made a commitment to eliminate certain trade-related investment measures by opening up specified sectors that had previously been closed to foreign investment. New laws, regulations, and administrative measures to implement these commitments are now being issued. Remaining barriers to foreign investment include opaque and inconsistently enforced laws and regulations, not to mention the lack of a rules-based, legal infrastructure. Nevertheless, in spite of these problems, China has continued to be one of the largest recipients of FDIs in the world, receiving over \$63 billion in 2006<sup>10</sup>, for a cumulative total over \$500 billion.

### Trade balance

	2000	2001	2002	2003	2004
Total Exports (billions of US dollars)	2,299.70	2,467.07	2,995.34	3,985.69	2,420.00
Total Imports (billions of US dollars)	2,075.70	2,246.57	2,715.94	3,717.09	1,960.00
Trade Balance (billions of US dollars)	-224	-220.5	-279.4	-268.6	-460

Source: Country watch

<sup>9</sup> "Risks and Opportunities of a Rising China" – The Heritage Foundation. June 22, 2006

<sup>10</sup> "FDI in China Tops 63 Bln U.S. Dollars in 2006" – [People's Daily Online](#)

China's major export partners are the following nations: US 21.0%, EU 18.1%, Hong Kong 17.0%, Japan 12.4%, ASEAN 7.2%, and South Korea 4.7%. On the import side, the major partners are: Japan 16.8%, EU 12.4%, ASEAN 11.2%, South Korea 11.1%, US 7.9%, and Russia 2.2%.<sup>11</sup>

### Balance of Payment

	2000	2001	2002	2003	2004
Current Account (US dollars-millions)	20.519	17.401	35.422	45.875	38.256
Foreign Balance on Goods and Services (US dollars-millions)	28.874	28.084	37.383	36.079	n/a
Foreign Net Investment Income (US dollars-millions)	-14.666	-19.175	-14.945	-7.838	n/a
Foreign Net Current Transfers (US dollars-millions)	6.311	8.492	12.984	17.634	20.01
Capital & Financial Account (US dollars-millions)	1.923	34.88	32.291	52.82	42.51
Net Errors & Omissions (US dollars-millions)	-11.748	-4.732	7.504	17.985	12.745
Overall Balance (US dollars-millions)	10,693.00	47,447.00	75,217.00	116,586.00	n/a
Official Foreign Currency Reserves (US dollars-millions)	168.278	215.605	291.128	408.151	614.5
Current Account (Percent of GDP) (percent)	0.019	0.0146	0.0272	0.0312	0.023

Analyses of the trade balance for the recent period (2000-2005) indicates a growing surplus and inflow from the goods and services transactions. An increasingly growing surplus indicates that the Chinese economy is still highly competitive externally. Everything else constant, this would increase demand for the Renminbi and cause its price to appreciate vis-a-vi other currencies.

Analyzing further current account components, we can see a similar growing trend. Nevertheless, the growth in this category is slower and was in slight decline in 2003. This suggests that some of the large surpluses in the trade balance might have been offset by deficit/outflow of income and/or transfer components of the current account. The table above shows that net investment income component is particularly impacted here since there is a high volume of FDI and portfolio investment in China that caused certain repatriation of the profits related to these activities.

On the capital side, we can see that China has achieved consistent and rapidly growing surplus and net inflow in this account. This means that the net amount of FDI, portfolio investments, and other investments in China had overcome the Chinese investments abroad. This net capital inflow in China would put additional pressure for the Renimbi to appreciate vis-a-vi other currencies, assuming everything else constant.

Based on the analysis of the two major components of Chinese BOP, the conclusion is that the two accounts do not balance. The natural consequence of this situation was a substantial increase in the foreign currency reserves that China had obtained. China had a net inflow and surplus in both of the major BOPs accounts, indicating an increased demand for both Chinese goods and services, along with capital and financial assets. Since China had a fixed

<sup>11</sup> "Economy of the People's Republic of China" – Wikipedia, The Free Encyclopedia

exchange rate regime, its Central Bank had to intervene and maintain this exchange rate by selling Renminbi based on increased demand for it. Increased demand for Chinese assets, products, and services put pressure on the Renminbi and forced the Chinese government to sell its currency, thus increasing its foreign currency reserves. This situation led to a worldwide debate of the need for China to abandon its fixed exchange rate policy and let the Renminbi adequately reflect movements in balance of payments accounts, effectively bringing its reserves on a more appropriate level.

## INFLATION IN CHINA

### Prices and Exchange Rates

	2000	2001	2002	2003	2004
Consumer Prices (Index - 1995 = 100)	0.3	0.5	-0.8	1.2	5.3
Inflation Rate (% Growth in Consumer Prices) (percent)	n/a	66.667	-260	-250	341.667
Exchange Rate Currency per \$US (Average) (yuan / \$US)	8.278	8.277	8.277	8.277	8.276
Exchange Rate Annual % Growth (percent)	n/a	-0.0169	-0.0012	0	-0.006

Source: Country Watch

Period	1986-1997	1997-2006	1997	1998	1999	2000	2001	2002	2003	2004	2005
Inflation - Consumer prices	11.9	1.3	2.8	-0.8	-1.4	0.4	0.7	-0.8	1.2	3.9	3

Source: IMF World Economic Outlook, September 2005

Historical analysis of inflation rates in China measured through the increase of consumer prices indicates increased stability in price levels in the last decade. The analysis reveals that China may even have had certain deflationary pressures in 1998, 1999, and 2002. The deflationary pressures and low inflation in this period can indicate increased productivity in the Chinese economy that was consistent with GDP growth achieved in these years. However, if we look at the GDP growth in this period we can notice a slight decline in China's numbers as well. This downturn was affected by the consequences of the Asian currency crises and the initiation of the slight worldwide recession in the beginning of the new century. Another reason for deflationary pressures can be found in relatively lower consumptions in China in this period with a higher propensity to save. This was also supported by the extremely tight fiscal policy of the Chinese government who set price stability as one of their absolute priorities.

From the standpoint of the exchange rate impact, it is obvious that China had generally lower inflation than the U.S. in this period. Everything else constant, this would result in an appreciation of the Chinese Renminbi if it would be left to float. However, in this period, the Chinese government maintained control over its currency. The exchange rates remained pretty much on the same level.

We can further see that in 2004 and 2005 consumer prices in China significantly grew, which can indicate stronger economic growth, increased consumer spending, and confidence. U.S. inflation rates in 2004 were lower (2.4%), which would have resulted in the appreciation of the USD, everything else constant. However, we can see that in 2004, the RMB appreciated slightly, indicating that factors other than the respective inflation rates contributed to this trend. In 2005, the Chinese government changed its exchange rate policy by pegging its currency to a basket of currencies. We can observe that in this inflationary period, China declined (lower than in the U.S.) and that the Renminbi slightly appreciated vis-a-vis all three basket currencies, which is to some extent, consistent with inflationary movements (in the U.S. case).

For the purpose of exchange rate analyses and the Chinese ability to maintain a fixed exchange rate, it is important to note that China was able to maintain price stability, ultimately keeping a control on inflation. There are no major signs of instability in the short term since China keeps transferring its growing reserves overseas (mostly into U.S. securities) instead of increasing its domestic consumption, which can cause inflationary pressures, particularly in combination with high GDP growth rates. In the long term, there is a threat of inflationary pressures with the higher growth of the Chinese economy, resulting in a potential “overheating”. This can be the result of increased domestic incomes and eventually higher consumption. Nevertheless, since statistical data shows a significant part of the Chinese population lives below the poverty line, the inflation caused by increased income is no immediate threat.

**INTEREST RATES IN CHINA**

Chinese Central Bank interest rates were higher in the period ranging 2000-2005 than those in the U.S. and Japan. However, the Chinese currency market cannot be considered efficient; hence, the International Fisher Effect is unable to accurately predict future spot rates through forward rates. If we observe exchange rate movements for this period, we cannot see consistency that would correspond with the International Fisher Effect. Besides this, it is important to look at the economic structure of China in order to analyze the impact of the interest rates on the currency. The manufacturing oriented sector in China is a major driver of economic development. An increase in interest rates can increase the expenses of businesses that fund operations with debt. Everything else constant, this would lead to inflation and further pressuring for the Renminbi to be devalued in a fixed exchange rate policy regime.

Yet, most of the Chinese growth is coming from abroad in the form of FDIs and external capital inflows that are relatively cheaper. At the same time, there are more financial and borrowing institutions emerging in the Chinese markets, which can also be impacted by the Central Bank’s interest rates policies. Thus, there are many offsetting components in the analysis of the interest rate’s impact on the RMB. Analyses suggest that the impact of interest rate movements on the Renminbi is secondary due to the mostly fixed exchange rate of its currency and the stronger effects of some other components, such as the balance of payment effects. The tables below show some historical interest rates and comparative data with the US and Japan.

<b>Interest rates</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
Total Interest Rate Amount 1 (bank rate)	3.24	3.24	2.7	2.7	3.33
Interest Rate Number 2 (lending rate)	5.85	5.85	5.31	5.31	5.58
Foreign Exchange Reserves (millions of US dollars)	168.278	215.605	291.128	408.151	614.5

Source: Country Watch

**Interest Rates**

	<u>12.31.00</u>	<u>12.31.01</u>	<u>12.31.02</u>	<u>12.31.03</u>	<u>12.31.04</u>	<u>12.31.05</u>	<u>12.31.06</u>
<b>U.S.</b>	6.5	1.75	1.25	1	2.25	4.25	5.25
<b>Japan</b>	0	0	0	0	0	0	0.25

Source: Federal Reserve Bank of New York, Bank of Japan



**UNEMPLOYMENT IN CHINA**

Based on official statistics that are based on urban areas, the conclusion would be that China has relatively acceptable levels of unemployment. Below are official statistics that indicate unemployment rates in urban areas.

	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>
<b>Unemployment Rate %</b>	3.1	3.6	4	3.1	3.1

Source: Country Watch

Nevertheless, research performed by the CIA reveals a different picture. The CIA fact book database reveals that there was an estimated 4.2% official registered for unemployment in urban areas in 2005. Although unemployment is not directly correlated with exchange rates, it can affect them indirectly through social imbalances within the economy and the supply of cheap labor that further affects the trade balance and other components of the balance of payments. The high percentage of unemployed people will still present the potential for cheap labor and will be the source for the Chinese relative competitive advantage, everything else constant. This can further affect an increase in the Chinese trade surplus and inflow of foreign investments that will put pressures on the RMB to appreciate. However, in conjunction with unbalanced regional growth, higher unemployment might cause social and political problems in the future that can negatively impact economic growth consequently reversing the whole process. This impact might even be stronger with further privatization of the remaining state owned enterprises with high labor redundancy rates.

**POLITICAL CONDITIONS**

China is a politically totalitarian, communist society with the communist party as the leading force. In political terms, China is still a closed, one party society with limited individual rights and freedoms. On the other hand, China launched intensive economic reforms in the late 1970's by deregulating its economy and opening it up for free trade and foreign investments. The gradual economic reforms resulted in rapid economic growth in the last two decades of the twentieth century, establishing China as the second largest economy in the world (measured in real GDP terms based on PPP measurements). Thus, China tries to balance a rigid and authoritarian political system with a more open, liberal economy. This unique mix has so far shown positive results in the economic realm.

Nevertheless, the shift toward a market economy and a focus on being competitive has its price. This process created an uneven distribution of growth benefits throughout the country, which resulted in a large poverty population that can be a political liability and threat for the government in the future. With further liberalization of the Chinese economy and its participation in WTO and other organizations, there are more incentives for local and foreign investors to intensify their activities that will ultimately increase the pressure on remaining state owned enterprises who will be unable to compete because of systematic inefficiencies. At the same time, these enterprises still represent the source of employment for this highly populous country. This all together can further increase a gap between China's social discrepancies, leading to higher unemployment. The major challenge for the government in the next period will be how to maintain sustainable economic growth while keeping social and political tensions under control. Another concern is a more open Chinese economic society that will be able to experience a more liberal political system that will provide more rights, individual freedoms, and opportunities for the population. The result of this can be further pressure on the Chinese communist party to start liberalizing the Chinese political system by introducing a parliamentary democracy.

In order to prevent the negative consequences of eventual political fallout, the Chinese government developed plans for stimulating growth of undeveloped areas and those with poorer populations. The ultimate result of these activities remains left to be seen. If the Chinese Government succeeds in these intentions and maintains political and social stability, and if it simultaneously continues to reform its economy by fostering competitiveness, there is an optimistic outlook for further economic growth in China. That growth would continue to be driven by the strong surplus in trade with additional inflows of foreign investments. On the other hand, a more open economy

coupled with higher disposable incomes of the Chinese population will generally lead to more of an evenhanded balance of payment, calling for a need to introduce more flexibility into its exchange rate policy. According to the theory of “Attributes of Ideal Currency”, China will eventually have to abandon its absolute exchange rate stability if it desires full financial integration and continuous inflow of investments and export of goods.

However, there is an intensive and ongoing debate in expert circles on a global level whether this huge surplus in Chinese reserves and fixed exchange rate policy is positive for China’s future growth. In addition, with China becoming one of the largest global players in trade and investments, the issue of its currency exceeds internal relevance of this issue or even its bilateral relevance. For example, the U.S. pressures for China to appreciate its currency by letting it float. This becomes an issue of global importance.

### **ARGUMENTS FOR AND AGAINST A RENMINBI FLOAT**

Research suggests that there are conflicting arguments regarding the Chinese foreign exchange policy. Before presenting in details these somewhat conflicting arguments, it would be beneficial to summarize the following:

- China is still one of the fastest growing economies in the world. The size of its GDP and market, along with their volume of international transactions, makes China a global player.
- China is continuously achieving a surplus in both their current account and their financial account that results in an increasing amount of foreign exchange reserves.
- China is still exercising a high degree of direct control over its currency in order to further promote competitiveness of its export.
- China has made stability over its currency and the prevention of inflation the highest priorities of its monetary and economic policies.
- China has a very conservative fiscal policy in order to prevent inflation.
- China is increasingly opening its economy by relaxing barriers for foreign investments, planning to further privatize its economy.
- China has a large disproportion in its economic development and a large portion of its population below the poverty line.
- China is still a politically totalitarian society with limited human rights and inadequate legislature.

### **Arguments In Favor Of Preserving A Mostly Fixed Exchange Rate For The Renminbi**

#### *Undeveloped Financial and Banking Sector*

China is still not ready for a floating regime. The arguments presented by Sebastian Edwards in the Financial Times from August 3 2003 indicated that although floating exchange rates are appropriate for middle and high-income countries, they tend to be highly volatile and destabilising in countries with underdeveloped domestic financial market, especially in those with weak banking sectors. Since China shares both of these characteristics plus the lack of proper hedging instruments, local companies would be exposed to exchange rate risk. The already financially troubled state-owned enterprise sector might collapse as well.

#### *The Existing Exchange Rate System Worked Well; Fix the External Imbalance by Completely Opening Its Markets*

China should not change the exchange rate system that worked well but would rather need to tackle its external imbalance by opening more of its large domestic markets to international competition. The same article states that opening up the economy to trade would generate a welcome surge in Chinese imports from the rest of the world. As imports increase, the trade surplus would be reduced, and the upward pressure on the currency would subside. Another impact of this would be that once it became clear that China would not succumb to the demands that it float the Renminbi, hot money inflows would slow down and the accumulation of international reserves would decline.

*Renminbi Stability is Critical for the Economic Development of Asia*

The Pacific region along with several Chinese government officials claim that Renminbi stability serves China's economic performance and conforms to the requirements of the economic development of the Asia-Pacific region and the entire world. Chinese officials stated that trade deficits of some of the largest of China's partners (for instance the U.S.) are caused by structural problems and fiscal deficits. In addition, floating can cause a potential collapse of highly indebted and still unreformed Chinese banking sector that can further cause a "domino effect" in Asia. Certain international economists who point out that U.S. job loss is not caused by an undervalued Chinese currency and warn that such a move could have major consequences for the international financial system. Morgan Stanley's chief economist Stephen Roach stated that one of the biggest fears is that a float would set off a series of collapses in the highly indebted Chinese banking system. Furthermore, it is estimated that not even a 30 percent revaluation of the yuan would assist U.S. manufacturers, while adversely affecting U.S. firms with large investments in China. Further he stated that Chinese factory sector has become a critical ingredient in the global supply chain.

**Arguments For Letting The Renminbi Float**

*Limited Independence of China's Monetary Policy*

This hampers macroeconomic stability and limits Chinese internal economic balance. Renminbi undervaluation has contributed to growing trade surpluses and, in some years, to huge portfolio capital inflows. The country's Central Bank not only sterilized much of the resulting reserve accumulation but also resorted to administrative controls, limiting bank credit creation. When the Central Bank specifies lending ceilings and sectoral lending priorities, it slows development of a bank's credit culture, setting back another top policy objective<sup>12</sup>.

*Undervalued Renminbi Increases Global Imbalances*

China's inflexible, undervalued currency also drags on the adjustment of global imbalances and increases the risk of a hard landing for the dollar and the U.S. economy with adverse global spillover effects. This huge imbalance will put additional pressure on the dollar to depreciate and U.S. domestic demand to grow more slowly than domestic output (and the reverse in the rest of the world).

*Open Economic Systems Require More Reliance on Market Forces*

China has become an increasingly market oriented economy. The consequence of this is that the Chinese government cannot fix exchange rates, interests rates, and inflation rates at the same time. If exchange rates are fixed, there is little incentive for Chinese interest rates to differ from those in the U.S. If this is the relationship, then price levels are of residual value and cannot be fixed.

*Political Pressures From Major Trading Partners*

Political pressures from most major trading partners (including China's neighboring Japan and Korea who did significant realignment of their currencies) are mounting on China to align and appreciate its currency vis-à-vis their own. Another problem related to this is that with the opening up of the Chinese economy, this balance cannot last forever and sooner or later some significant appreciation is expected. This situation attracts large amounts of "hot money" in China, both internally and externally. Once significant appreciation happens, this "hot money movement" can create large disturbances in China, both internally and globally.

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<sup>12</sup> "A New Way to Deal with the Renminbi". Morris Goldstein & Nicholas R. Lardy, Institute for International Economics. Op-ed in the *Financial Times*. January 20, 2006

## CONCLUSION

Based on the analyses of Chinese macroeconomic fundamentals, its political framework, and arguments for and against the Renminbi floating, the first conclusion is that the Renminbi exchange rate regime became more global than just an internal issue. The Renminbi regime was the subject of major debate that attracted serious attention of the global public and particularly of the major Chinese trading partners. There are valid arguments in favor of both fixed and floating exchange rates, but neither of these extremes looks to be an optimal solution for China's internal problems, nor for its external disequilibria. Most likely, the solution should be found in a policy that lies in between these extreme points.

Specifically, China is not ready to completely float the Renminbi. Deficiencies in the banking sector, undeveloped financial markets, and an incomplete privatization process (still large number of government subsidized local enterprises) are suggesting that China is still in a transition process and overall is a fragile economy. In this situation, floating the Renminbi would create high internal disturbances in China that would further affect the global economy, being that China is one of the largest trading nations and recipients of FDI.

On the other hand, the Chinese government will have to let something go in order to become a globally integrated market economy. It is not possible that they can fix and control all financial and macroeconomic indicators and still be an integral part of the global economy in the long run. Due to political and economic pressures (the law of supply and demand), China has to make certain adjustments in its Renminbi value. The best way to make this adjustment would be to revalue its currency relative to a basket (10% for example), and then gradually let the Renminbi appreciate without letting it float. The initial step of increasing the Renminbi's value can be done by announcing an official revaluation or by letting market forces appreciate the Renminbi relative to world currencies. By doing this, China would release political pressures<sup>13</sup> and show that it is serious about fixing its external imbalance, but it would also increase its monetary independence and start gaining experience in managing increased flexibility that will be required in the long run.

Nevertheless, this measure will not be successful if it is not combined with other economic policies geared toward solving the Chinese internal gap in income distribution and in regional development. In addition, China has to intensively pursue the transformation of non-efficient, state owned enterprises into private, competing entities, along with creating a stable and market oriented banking system. In order to achieve these goals, China should more actively utilize its fiscal policy by increasing spending in order to decrease the amount of population below the poverty level, developing internal capabilities (currently most of the Chinese export comes from MNEs operating in China).

In order to do that, the Chinese government should invest in education, particularly in the poorest areas, by developing programs for supporting entrepreneurship and small and medium sized enterprises (SME's). This is one way to deal with the further increase of redundant labor that will emerge as a consequence of continued privatization. Another benefit would be that China would utilize its large monetary reserves for solving internal economic and political problems, rather than just investing them in U.S. securities, further increasing an imbalance. A potential negative impact of these measures is inflationary pressure at some point, but increased inflation is a natural consequence of the higher growth, higher incomes, and reduced unemployment. With intensive opening of its economy, China will have to build capabilities to utilize monetary and fiscal policies and keep macroeconomic indicators in balance.

In conclusion, China would need to gradually prepare itself to float the Renminbi at some point in the future, but this should not be done before a strong banking system and financial markets are built. China also needs to start solving issues regarding uneven economic development throughout their country. However, China will also have to be

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<sup>13</sup> "In particular, manufacturing executives worry that unless China loosens its grip on the yuan and complies with international trade agreements, U.S. lawmakers will try to impose punitive measures that could limit access and trade. In the past few months, the Chinese have been allowing the yuan to rise against the dollar and the currency is now 5.7% stronger than it was in July 2005, when authorities initially allowed it to move. But that pace isn't fast enough to satisfy some critics." – 'Paulson Tempers Expectations for China visit', Wall Street Journal, December 7, 2006

more serious in sending some stronger signals that it is ready to play by market rules (fair game) if it wants to contribute to harmonizing the global economy. Thus, a certain initial revaluation of the Renminbi has to take place soon. Another concern that should not be neglected is China's ability to preserve its political system in the long run as the country is developing into more of an open and globally integrated state. The intensity and dynamics of the changes in this area will have a major impact on economic and political stability not only in China, but also the world.

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