TD Economics

Topic Paper

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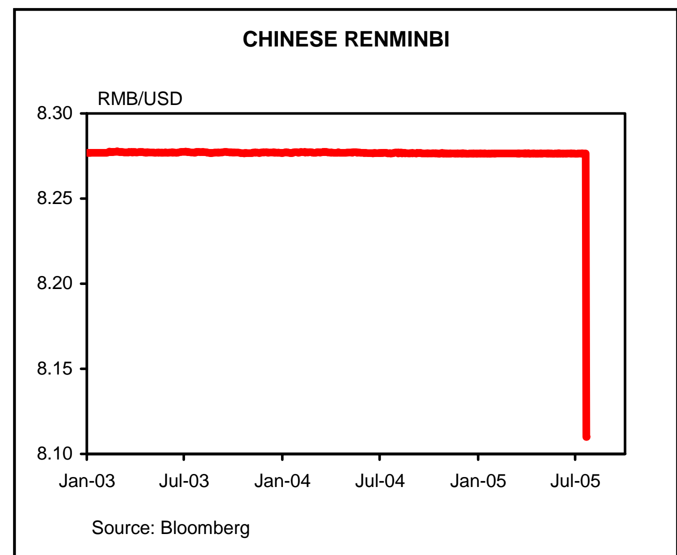
CHINA REVALUES THE RENMINBI

The Chinese government caught financial markets off guard yesterday with an announcement that it is implementing a modest upward revaluation in the renminbi's exchange rate versus the U.S. dollar and shifting the structure of the exchange rate away from a fixed dollar peg to a managed float. Although both moves were widely anticipated, yesterday's timing came as a surprise, and the size of the revaluation – about 2 per cent – was more modest than many analysts had expected. Asian currencies jumped higher on the news, but reaction in foreign exchange markets more broadly was muted, largely owing to the fact that a great deal of uncertainty remains about the details of the new currency regime. In fixed income markets, U.S. Treasuries ended the day lower, with the 10-year yield up 12 basis points, although other factors were also at play in the move – chiefly, the release of the June 30th FOMC minutes, which indicated that some committee members are more concerned about upside risks to inflation.

How is the renminbi changing?

The People's Bank of China (PBOC) announced that the renminbi's fixed peg to the U.S. dollar is being abandoned in favour of a managed floating exchange rate, anchored to a basket of currencies. The PBOC has not disclosed the content of the basket, other than to indicate that it will still include the U.S. dollar. The renminbi's exchange rate to the U.S. dollar is being moved up to 8.11 RMB/USD from the previous level of 8.27 RMB/USD, and authorities will continue to allow the currency to fluctuate within a band of +/-0.3 per cent on either side of this central parity rate. The renminbi will also fluctuate versus the other unnamed currencies in the new basket, within an unspecified trading band. The PBOC indicated that the procedure for managing the new exchange rate would



be to announce the renminbi's closing price against "a foreign currency, such as the U.S. dollar" each day, which would become the central parity for trading in the renminbi the next day. The implication is that the currency will now essentially function like a crawling peg, the value of which will be adjusted daily.

Yesterday's announcement leaves a great deal up in the air. The reference to "a" foreign currency – if this is what the PBOC intended to say – suggests that the Bank may not always quote the closing rate in reference to the U.S. dollar. More broadly, the decision not to announce either the constituent currencies in the basket or their weights makes it extremely difficult to speculate about where the pressures are likely to be felt in response to this move. More information may be forthcoming in the following days, but the PBOC may also choose to take a page from the Monetary Authority of Singapore (MAS), which manages the Singapore dollar in relation to "a weighted basket of currencies of our major trading part-

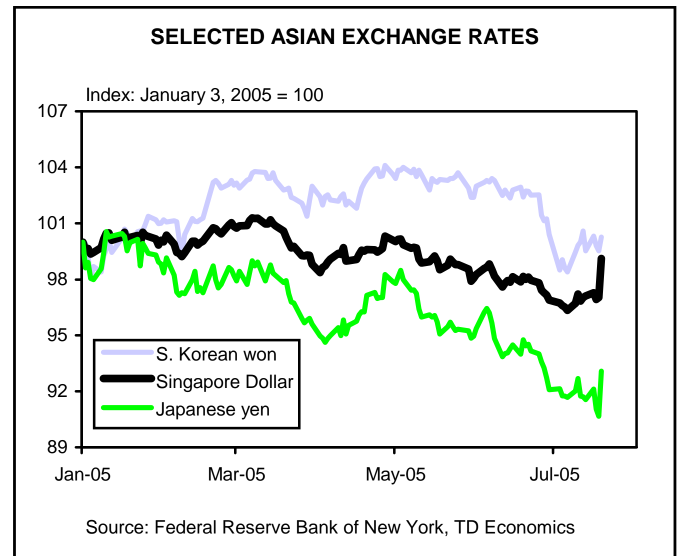
ners", with no further details provided. While the arrangement leaves something to be desired in the way of transparency, it does have the virtue of making the exchange rate a more difficult target for speculators.

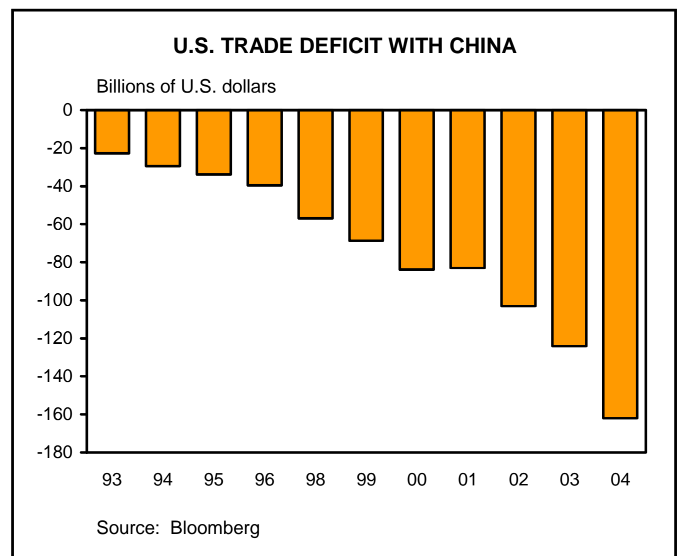
The announcement by China triggered expectations that other Asian countries with fixed or quasi-fixed exchange rates – such as Singapore – might follow suit. In the event, the MAS announced the changes in the renminbi would "not have a major impact on the Singapore dollar or on our exchange rate regime". Hong Kong, which pegs its currency to the U.S. dollar, also announced that it had no plans to alter its currency regime, although the Hong Kong dollar's trading bands versus the greenback were widened in May. However, Malaysia announced that its ringgit – which has been pegged to the U.S. dollar at 3.80 MYR/USD since September 1998 – would move to a managed float immediately. So far, the central bank has not provided any information about the content of the basket, but it did note in a statement that the ringgit's current valuation is consistent with economic fundamentals, making it unlikely that it would "deviate significantly from the current prevailing level".

Other Asian currencies traded higher on the news yesterday, reflecting a view that central banks in the region – which have intervened aggressively to keep their currencies stable versus the renminbi and the U.S. dollar – will be prepared to countenance a modest appreciation in line with the rise in RMB/USD. As has been the case all along, the Japanese yen and the Korean won – the most freely floating currencies in the region – saw much of the upward pressure. The move in the yen was particularly pronounced, with the currency rebounding from a fourteen-month low of 113.5 JPY/USD it hit earlier this week, to 110.5 JPY/USD, for a gain of 2.5 per cent.

Why now?

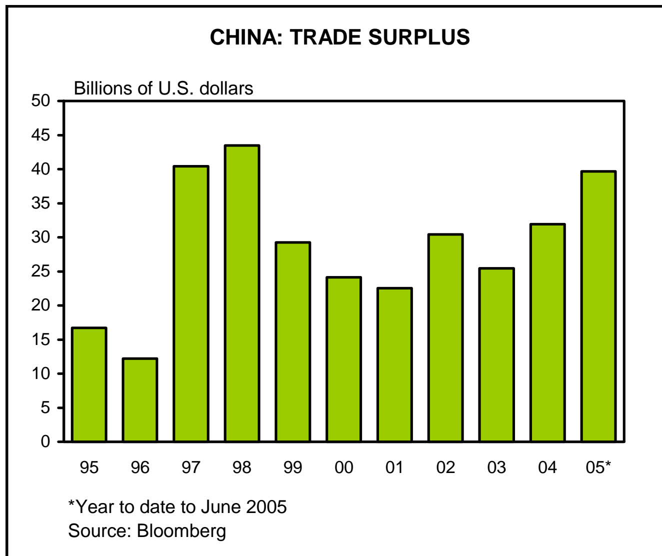
In the May 31 issue of *Global Markets*, we listed a number of developments that were fuelling increased speculation about a near-term adjustment in the renminbi. One of those factors – and, likely the proximate cause of yesterday's move – is the growing threat of a protectionist backlash in the United States, reflecting concern about the country's trade deficit with China and the loss of U.S. manufacturing jobs some attribute to competition from cheap Chinese imports. Although the U.S. Treasury Department resisted pressure earlier this spring to name China a currency manipulator in its bi-annual report on foreign exchange practices, a number of bills are currently before

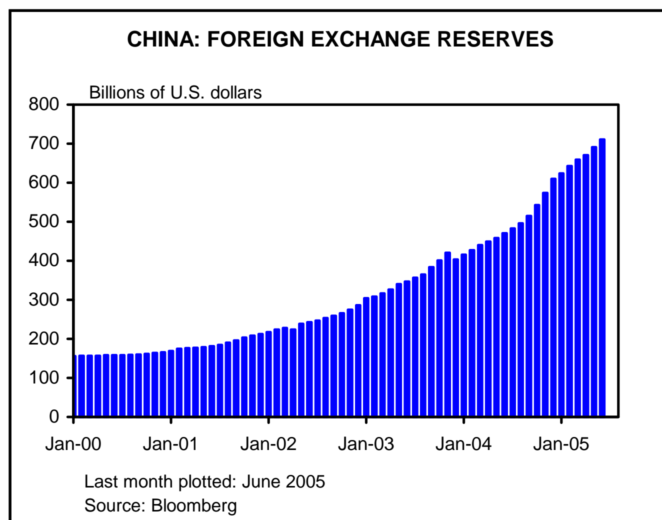




the U.S. Congress containing proposals to retaliate against China for 'unfair trade practices' – of which the renminbi's peg to the U.S. dollar is frequently cited as an example. The best known of these bills is a bipartisan amendment calling for 27.5-per-cent duty to be imposed on all Chinese imports. A vote on the bill, which was due to be held this month, was delayed, following vocal criticism of the measure from Treasury Secretary Snow and Fed Chairman Greenspan late last month. The postponement may have prompted China to act, to take advantage of this window of opportunity before it closes.

At the same time, the move can also be justified in response to developments in the Chinese economy. Recent data show that China's trade surplus continues to balloon, with the trade surplus for the first half of 2005





already larger than the surplus recorded in all of 2004. Together with mounting speculation that a revaluation was imminent and strong capital inflows into China, this has led to an explosion in the country's foreign exchange reserves, as the central bank has been forced to buy U.S. dollars to maintain the value of the peg. That, in turn, has contributed to an expansion in liquidity that authorities have found it difficult to sterilize, impeding their efforts to cool the pace of economic growth. This week's GDP report provided another warning sign in that regard, revealing that China's economy expanded by a blistering 9.5 per cent in the second quarter, maintaining the red-hot pace seen over the last few quarters. This underscores the fact that the expansion remains more rapid than authorities would like, despite a raft of interest-rate increases and other administrative measures that have been implemented in an effort to curb activity in the frothier sectors of the economy.

The magnitude of yesterday's move – just 2 per cent, versus expectations for a revaluation of as much as 10 per cent, when it occurred – is consistent with Chinese authorities' demonstrated preference for incrementalism. It also likely represents an effort to combat protectionist sentiment in the U.S. at the lowest possible cost to Chinese export competitiveness. Indeed, to the extent that authorities are successful in stemming new investment – the locus of the over-heating in the economy – maintaining a vibrant export sector is all the more important in order to defuse capacity pressures at home by ensuring a continued outlet for Chinese production abroad.

As regards the timing of yesterday's move, it is noteworthy that China had become more strident in defending the peg in recent months – while simultaneously taking further steps to pave the way for an adjustment, including expanding trading in its interbank market to include eight pairs of currencies. Some judged that this might be a signal that the government was preparing for a surprise move. That now appears to have been the case. And, while the small size of the revaluation is unlikely to appease U.S. legislators, the gesture – which many believe will be the first in a series of upward revaluations – should help ease tensions ahead of Chinese president Hu Jintao's scheduled meeting with U.S. President Bush in September.

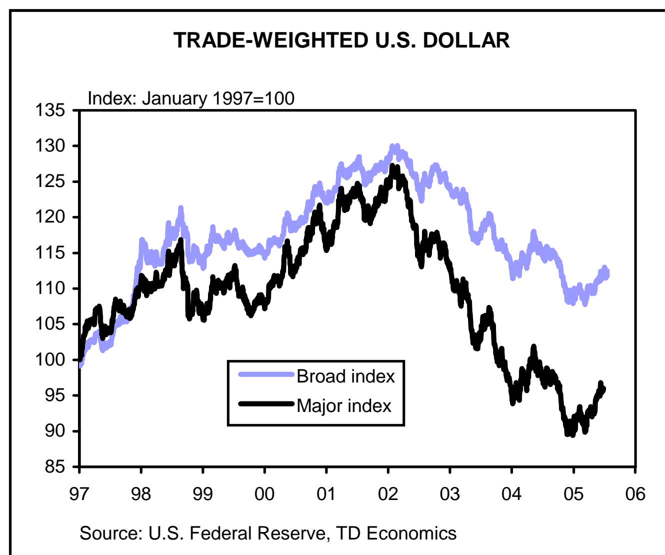
Implications for currencies…

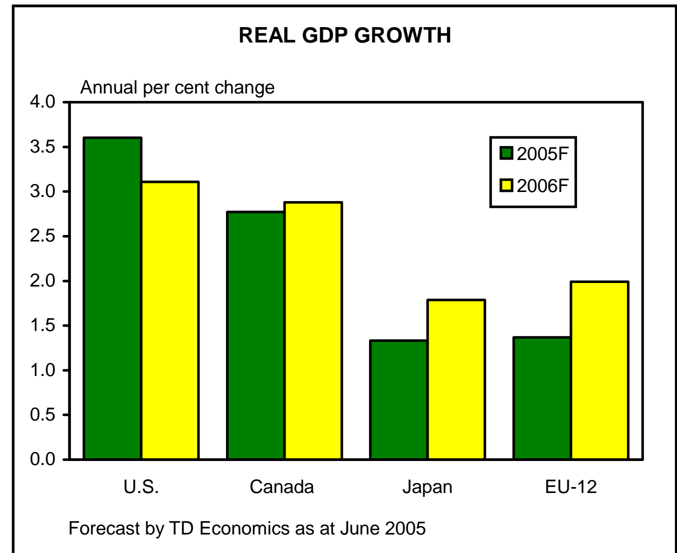
With respect to the implications for currency markets, today's move is not likely to have a particularly dramatic impact – and, not just because the headline revaluation is a modest 2 per cent. To be sure, the PBOC statement indicates that the renminbi will be permitted to fluctuate by +/-0.3 per cent versus the U.S. dollar each day. It also indicates that the quoted closing rate for the currency will become the new central parity rate of the next day's trading band. Theoretically, that means that, if the PBOC were to quote the closing rate each day versus the U.S. dollar, and the renminbi were to rise by the full 0.3 per cent each day, the currency could climb by more than 30 per cent versus the U.S. dollar by the end of the year. However, it is not conceivable that the PBOC would accept that large a move – not only because of the dent this would put in China's exports, but also because of the strains it would place on the country's still-shaky banking system. As a result, the implication is that the PBOC will intervene in foreign exchange markets to keep any actual rise in the

currency gradual – as it has been doing all along. Indeed, the renminbi was already permitted to fluctuate by +/-0.3 per cent versus the U.S. dollar under the old regime. The PBOC simply intervened to prevent this from happening, and it will likely continue to do so, to ensure that the renminbi rises in an orderly fashion. That is also the conclusion suggested by the PBOC's statement, in which it describes its objective as "maintaining the RMB exchange rate basically stable at an adaptive and equilibrium level."

The likelihood that Chinese authorities will seek to contain the pace of the renminbi's appreciation implies that any re-alignment in the rest of the Asian currency bloc will be similarly muted. That seems particularly the case for currencies like the Korean won, which have already recorded big gains over the last twelve to eighteen months. Indeed, the Bank of Korea was quick to note that it would act to curb speculative pressures in the won market. And, that suggests that, while the U.S. dollar will be weaker on a trade-weighted basis as a result of yesterday's developments, a pronounced depreciation in the near term is unlikely – particularly given the robust economic growth and interest-rate differentials that favour the dollar over most of its industrialized country trading partners.

The implications for the floating currencies are more ambiguous. On the one hand, evidence of more flexibility in the Asian currency bloc could be good news for large, liquid currencies like the euro, which have borne the brunt of past bouts of depreciation in the U.S. dollar. Should the greenback come under renewed selling pressure, these currencies may not have to do as much of the heavy lifting. On the other hand, floating currencies that are included in the renminbi's new trading basket may experience some offsetting upward pressure, as the Bank of China diversifies its foreign exchange reserves in line with the composition of the new basket. Frankly, we just don't have enough information to make any strong inferences about what the dominant trends will be for the major currencies, either versus the U.S. dollar or on the crosses.

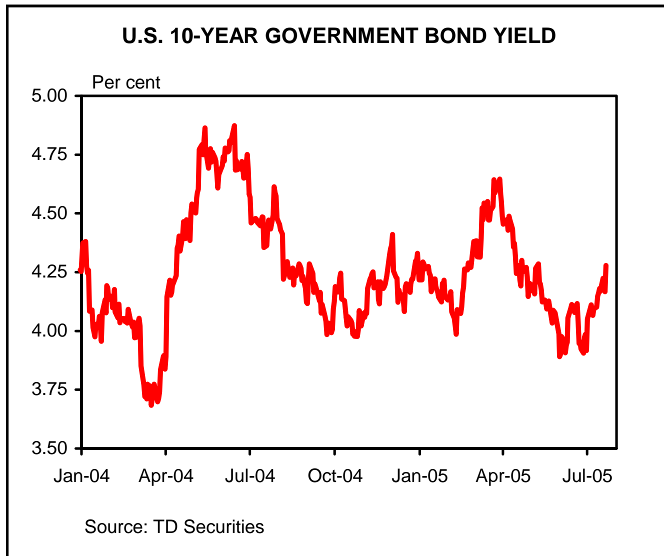


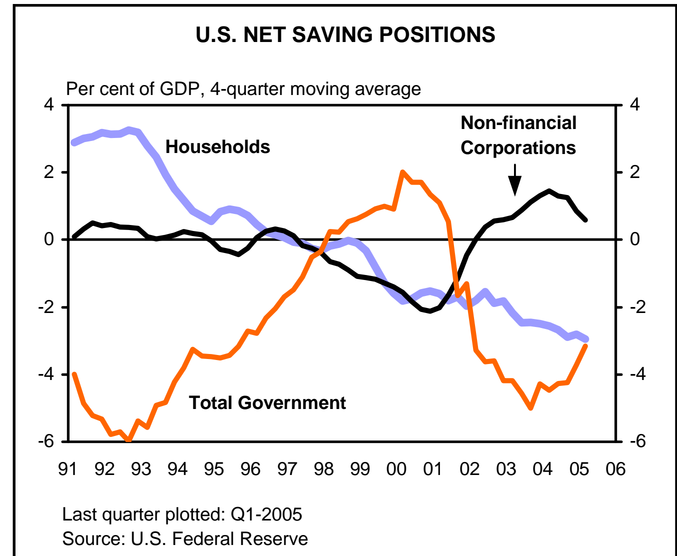


…U.S. government bonds…

In his semi-annual monetary policy testimony to the U.S. Congress this week, Fed Chairman Greenspan put a good deal of emphasis on the low level of long-term U.S. interest rates. One question that arises from today's events is what the likely impact will be on U.S. bond yields, given that a move away from a straight U.S. dollar peg implies that China will need to accumulate fewer U.S. Treasuries. All other things being equal, that is true, but with no information on the weights that the currencies in the new basket are being assigned, it is difficult to judge the extent of the impact on Chinese demand for U.S. debt.

In the near term, there is good reason to think that the impact will be small. For one thing, the renminbi remains deeply undervalued, which suggests that the Bank of China will have to keep accumulating dollars for some time as it works to engineer a gradual rise in the currency. And, even if official flows do taper off – from China and other Asian central banks – with interest-rate spreads still dollar-positive and the U.S. economy outperforming most of the rest of the industrialized world, private capital flows into the U.S. are likely to remain well supported. Ultimately, what matters for yields is the net change in de-





mand at the margin, and it is possible that any drop in official flows could be offset by an uptick in private flows, which would minimize upward pressure on U.S. yields.

That said, it seems clear that a longer-term trend toward currency appreciation in the Asian-Pacific bloc has now been set in motion, which implies a secular decline in demand for U.S. dollars from this part of the world. So, while it may take some time to materialize, the longer term effect is likely to be negative for Treasuries.

…and global savings imbalances

Finally, with respect to global savings imbalances – *i.e.*, the U.S. trade and current account deficits, and the corresponding surpluses in much of Asia – yesterday's move is unlikely to provide much relief. China's trade surplus with the U.S. is in large part a reflection of its low unit labour costs, which give it a competitive advantage in production that is much too big to be unwound by a currency revaluation, especially not one starting at 2 per cent. Moreover, even if Chinese goods were to become relatively more expensive in U.S. dollar terms, they would likely be displaced by imports from another, lower-cost country – and, in the interim, while U.S. firms sought out these cheaper suppliers, U.S. consumers might have to absorb some of the adjustment in the former of higher prices. But, the impact on the trade deficit would be minimal. That is the conclusion of a number of studies on the subject, most of which considered the case of a much larger revaluation in the renminbi – in the order of 10-20 per cent. It is also the view of Fed Chairman Greenspan, articulated in testimony to the Senate Finance Committee in June. The Chairman stated that, while a revaluation in the renminbi would likely redirect trade within Asia, it would have limited consequences for overall U.S. imports, as well as U.S. exports that compete with Chinese products in other markets. He also went on to note – taking direct aim at the argument many U.S. legislators have advanced for threatening trade sanctions against China if the country did not revalue its currency – that "the presumption that a revaluation of the renminbi will notably increase jobs in the United States by constraining imports or expanding exports is without statistical or analytical support."

Ultimately, a key driver of the U.S. trade and current account deficits is the U.S. economy's long-running habit of living beyond its means. Without an increase in saving by U.S. households and the federal government, it is difficult to see how the current account deficit can narrow, regardless of what happens in currency markets. Some stronger growth in industrialized country laggards like the euro-zone and Japan would also help, by stimulating demand for U.S. exports and achieving a better balance in domestic demand growth globally. But, that seems elusive at present. As a result, China is sure to face pressure in the weeks and months to come to allow a more pronounced appreciation in its currency. But, it's a good bet that authorities will continue to act as they did yesterday, and as they have all along – moving in small increments in order to achieve as orderly a transition as possible.

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