

ISAS Insight

No. 88 – Date: 28 December 2009

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The Economics and Politics of China's Exchange Rate Adjustment

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Abstract

China faces significant political pressure from industrialised economies to revalue its currency upward. Internally, China's currency adjustment depends largely on the dynamics of its labour and financial markets. Millions of underutilised Chinese labourers, who are in the process of migration from the countryside to urban areas, give Beijing the upper hand in allowing a gradual revaluation of its currency. However, the growing cost of monetary sterilisation is the key hurdle in keeping its currency undervalued for long. Nevertheless, exchange rates are not always determined by economic forces alone – the breakdown of the Bretton Woods exchange rate system in 1971 and the signing of the Plaza Accord in 1985 are two examples. The available data shows that South Asia is generally not hurt, if not a gainer, by an undervalued Chinese currency.

Introduction

Vladimir Lenin, the leader of the erstwhile Soviet Union, is said to have declared that the best way to destroy the capitalist system was to debauch its currency.² China abandoned the “communist way of development” long ago and it is indeed in Beijing's interest to endure the capitalist system. Nevertheless, its exchange rate policy is literally annihilating the global capitalist system with the exception of its own.

Beijing faces much pressure from almost all the industrialised economies to allow its currency to appreciate as they believe that the undervalued Chinese currency is eroding their export competitiveness. A recent *Reuters*' poll reveals that the renminbi, the Chinese currency, is undervalued by 20 percent.³ *The Economist's* Big Mac Index shows that the renminbi is 49 percent weaker *vis-à-vis* the United States dollar⁴ and the International Monetary Fund also holds a similar sentiment. Moreover, based on China's global current account position or the state of its overall balance of payments, one can say that its currency is significantly undervalued.

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² Keynes, John Maynard (1919), *The Economic Consequences of the Peace*.

³ http://www.forbes.com/feeds/reuters/2009/11/20/2009-11-20T083103Z_01_T308146_RTRIDST_0_CHINA-YUAN-POLL-PIX.html

⁴ *The Economist*, 16 July 2009.

China delinked the renminbi's peg with the United States dollar in mid-2005 and allowed it to appreciate by more than 20 percent, but stopped in late 2008 as the country's export growth slowed markedly owing to the financial crisis. The renminbi remained on par vis-à-vis the United States dollar in 2009 (see Figure 1).

A large part of China's over US\$2.2 trillion foreign exchange reserves is seen as a by-product of its undervalued currency. To prevent the appreciation of the renminbi, the People's Bank of China (PBoC) massively intervenes in the foreign exchange market by selling renminbi and buying dollar assets. It is also widely viewed that China's undervalued currency has fuelled the global financial imbalances – one of the major causes of the current financial and economic crisis. Both the United States and the European Union believe that unless China revalues its currency upward, the global imbalances are likely to persist.

Undervalued Renminbi: Why and How long?

Why does the world's fastest growing economy need an undervalued currency? The more pertinent issue is how long China can enjoy its competitive advantage in exports by keeping its non-tradables cheaper than tradables. The real exchange rate is nothing but the ratio of the goods and services that can be traded in international markets (an iPod, for example) and those that cannot be traded (a haircut, for example).

According to Dani Rodrik, a Harvard economist, China's growth would be reduced by more than two percentage points if its currency were to appreciate by 25 percent in real terms.⁵ He also believes that undervaluation is the second-best mechanism for alleviating institutional weakness and market failures that tax the tradables.⁶ Indeed, most East Asian countries followed the same model in their early stages of development, and thus China is no exception.

Moreover, cross-country experiences, particularly in the developing economies of Latin America, have shown that without putting in place the right institutions including financial market reforms, a more flexible exchange rate system have led to a currency crisis that eventually derailed their economic rise.

How long China can keep its currency undervalued is not easy to forecast. It will depend largely on the dynamics of its labour and financial markets, both of which are highly regulated in China.

Two stylised facts are worth noting here. First, the prices of tradable goods and services tend to fall relative to those of non-tradables. Higher productivity lowers production costs that eventually lower the prices of tradables in international markets. Second, as economies grow,

⁵ This is based on the estimate that a 10 percent appreciation would reduce China's growth by 0.86 percentage points. See Rodrik, D. (2010) "Making Room for China in the World Economy," *American Economic Review*, Papers & Proceedings, May, forthcoming, and *The Financial Times*, <<http://blogs.ft.com/economistsforum/2009/12/martin-wolf-on-chinas-exchange-rate-policy-jim-oneill-and-dani-rodrik-reply/>>.

⁶ Rodrik, D. (2007), "The Real Exchange Rate and Economic Growth: Theory and Evidence", available at <http://www.cid.harvard.edu/neudc07/docs/neudc07_s1_p04_rodrik.pdf>.

their non-tradables become more expensive vis-à-vis tradables, leading to currency appreciation.

There is a huge abundance of labour supply in China, which means the prices of non-tradables could grow slowly, arresting the rapid rise of non-tradables prices. A McKinsey Global Institute Report reveals that, between 1990 and 2005, Chinese cities accommodated 103 million labourers from the rural areas⁷ and they await an influx of another 250 to 350 million migrants by 2025. The same report projects that a whopping one billion people will be living in different Chinese cities in 2030. As a result, China may not face steep wage hikes in every sector.

As China needs to create millions of jobs, a strong currency is the last thing it can afford. However, faster productivity growth will raise wage levels (or overall compensation) in some sectors. China's productivity growth in recent decades has been spectacular – with an 8.1 percent labour productivity growth during the period 1990-2008 which was much higher than in India (4.2 percent), the United States (1.8 percent), the Euro zone (1.5 percent) and Japan (1.1 percent).⁸

Nevertheless, once the labour migration from agriculture to industry is completed – marginal product of labour equates wage in agriculture – China will face significant upward pressure on its real exchange rate. This could happen in the next 15 to 20 years. As a result, an *ad hoc* adjustment in its exchange rate could destabilise China's labour market, in particular, and the economy, in general.

However, a rapid rise in current account surplus and associated reserves build-up pose mounting challenges for the Chinese central bank to keep its currency undervalued.

The basic premise of an undervalued currency is that the concerned monetary authority has to intervene in the foreign exchange market to postpone current consumption and delay inflation. As an intervener, the PBoC faces the challenge to sterilise the incipient increase in domestic money supply resulting from the large-scale purchase of foreign exchange. If it does not, the excess liquidity in the financial system eventually leads to inflation and currency appreciation. The PBoC generally banks on two instruments in pursuit of this goal: it raises reserve requirements against the deposits of commercial banks and issues renminbi-denominated bills and bonds. Both are implemented under China's highly repressed financial system.

However, there is a limit to sterilisation. Following the collapse in interest rates in the United States, the domestic short-term interest rate in China has begun to exceed the United States' rates. As a result, the spread between the cost of issuing sterilisation bills and the returns on foreign assets is increasing. The PBoC now relies more on the upward adjustment of bank reserves requirement than on central bank bills, thereby shifting part of the sterilisation cost from the central bank to commercial banks.

⁷ McKinsey Global Institute (2009), "Preparing for China's Urban Billion".

⁸ The Conference Board <<http://www.conference-board.org/>>.

However, there is no easy way out. Interest rates in China have to be kept low to avert capital flows (to avoid further sterilisation). Low lending rates⁹ generated a US\$1.3 trillion credit boom in 2009.¹⁰ Moreover, low or negative returns from savings rates¹¹ are prompting people to put their money in speculative investments, such as stocks and properties. The Shanghai Composite Index climbed 81 percent in 2009.¹² To cool down the property boom, the State Council in China has of late threatened to re-impose a sales tax on property sales.

Exchange Rates Determination: Beyond Economics

The values of exchange rates are not always determined by economic forces alone. History is full of such examples. Faced with sheer competition from Japan to a large extent and a hefty current account deficit, in 1985, the United States signed the Plaza Accord with Japan, West Germany, France and the United Kingdom that deliberately devalued the United States dollar's exchange rate. Japanese exports and economic growth were badly hit because the yen appreciated more than 50 percent. Many analysts believe that a super-strong Japanese currency is largely responsible for halting its unprecedented economic expansion since the 1950s, and the economy stagnated for a whole decade during the 1990s, known as the "lost decade of Japan".

Apart from Japan, the European experience could be another lesson for China as far as exchange rate determination is concerned. Faced with huge trade deficits and runaway inflation, partly due to the Vietnam War, the Richard Nixon administration unilaterally cancelled the direct convertibility of the United States dollar to gold, also known as the "Nixon Shock", which essentially ended the Bretton Woods system of international financial exchange. Europe's rather forced graduation from fixed to flexible exchange rates came at a high price. Within one or two years, its unit labour costs rose from 60 percent of the United States level to over 110 percent, and many experts believe that this virtually ended Europe's miracle.¹³

Today, China faces similar pressure from the West. The Exchange Rates and International Economic Policy Coordination Act of 1988 of the United States mandates the United States Secretary of Treasury to give a report every two years to Congress on foreign exchange rate policies of other countries that trade with the United States. It also mandates that the United States Treasury identify countries that are currency manipulators.¹⁴ China has not yet been officially accused of being a currency manipulator by the United States, but the trade lobbyists in Washington want retaliatory penalties against China. Although United States

⁹ For instance, in late December 2007, the one-year benchmark bank lending rate was 7.47 percent and the inflation rate (corporate goods price index) in the first quarter of 2008 was 9.3 percent – the net lending rate (1.8 percent) – underlies the excess demand for credit [Goldstein, M. and Lardy, N.R. (2009), "The future of China's exchange rate policy", *Policy Analyses in International Economics* 87, Peterson Institute for International Economics].

¹⁰ The Bloomberg <<http://www.bloomberg.com/apps/news?pid=20601080&sid=awonLXtlhUzE>>

¹¹ For example, in 2008, the real interest rate on a one-year deposit was 4.74 percent. [Goldstein, M. and Lardy, N.R. (2009), "The future of China's exchange rate policy", *Policy Analyses in International Economics* 87, Peterson Institute for International Economics].

¹² Ibid.

¹³ Collignon, S. (2009), "The answer to our problem with China is not revaluation – but Asian monetary cooperation", available at <<http://www.eurointelligence.com/article.581+M51507dd7967.0.html>>

¹⁴ Wilkins, T. (2009), "China currency report expected less gentle from Geithner", available at <<http://www.chinastakes.com/2009/4/China-Currency-Report-Expected-Less-Gentle-from-Geithner.html>>

President Barack Obama sought China's help to address the currency misalignment issue in his recent Asia tour, at the same time he took the position that United States-China relations go "far beyond any single issue".

Nevertheless, on currency issues Beijing's biggest collateral is none other than the Sino-US mutual economic dependence. China is the United States' largest foreign creditor, holding more than US\$800 billion of United States government debt. Moreover, the United States is China's main trading partner, and the latter is the former's second largest trading partner. However, the European Union is another entity which is more vocal than the United States because its currency, the Euro, is highly overvalued *vis-à-vis* the renminbi.

Apart from the trans-Atlantic economies, China's exchange rate policy is a major worry for its East Asian neighbours. Though China faces less political pressure from them, its pegged exchange rate threatens the sustainability of the East Asian production network. According to Willem Thorbecke of the Asian Development Bank, "as Asian economies do not only cooperate within production networks but also compete in third markets, China's exchange rate peg puts pressure on other countries in the region to prevent their exchange rates from appreciating."¹⁵ He believes that joint appreciations of the renminbi and other Asian currencies would prevent unpleasant outcomes such as "beggar-thy-neighbour" policies.

Implications for South Asia

South Asia is also not spared from the exchange rate movements of the key global currencies, including the renminbi. As major South Asian economies are members of the World Trade Organization, they are legally prohibited from providing direct subsidies to keep their exports competitive. That leaves them banking on currency undervaluation or improving productivity to remain competitive.

The region, more or less, follows the managed float exchange policies where the respective central banks intervene in the currency markets either to avert currency appreciation or to keep their currencies undervalued. Nevertheless, the degree and the type of intervention are not unique. As far as the Indian rupee is concerned, the Reserve Bank of India's recent challenge, particularly before the current financial crisis, has been arresting rupee appreciation in the wake of a rapid inflow of foreign capital. Nevertheless, the currency witnessed a free fall largely owing to the reversal of foreign institutional investment and the plunge in its export earnings following the crisis. In recent months, however, some external funds have returned to India and the Indian rupee experienced a modest appreciation against the United States dollar.

A favourable environment in its external sector¹⁶ has forced Bangladesh Bank, the central bank of Bangladesh, to intervene in the foreign exchange market to keep its currency undervalued or at least to block the appreciation of its currency. The Pakistani rupee and the

¹⁵ Thorbecke, W. (2009), "East Asian production networks, global imbalances, and exchange rate coordination", available at < http://www.econbrowser.com/archives/2009/10/east_asia_the_g.html>.

¹⁶ A rapid growth in inward remittances and a steady expansion of export sector have resulted in consistent current account surplus in Bangladesh.

Sri Lankan rupee witnessed a rapid depreciation *vis-à-vis* the United States dollar in the recent past due to adverse developments in their external sectors.¹⁷

The South Asian currencies generally target the United States dollar as far as their currency adjustments are concerned. As can be seen from Figure 2, all major South Asian currencies, with the exception of the Bangladeshi currency, witnessed significant depreciations against the United States dollar in recent years, particularly following the financial crisis. As the renminbi remained pegged *vis-à-vis* the United States dollar, particularly in 2009, the degree of depreciation between the Chinese currency and the South Asian ones virtually followed the pattern that one can observe as in the case of the United States dollar against major South Asian currencies.

Having said this, the undervalued Chinese currency affects the South Asian economies in two ways. First, as all major South Asian countries' imports from China are much higher than their exports, the region, like many other countries, stands to benefit from an undervalued renminbi (through cheap import price). For instance, in 2008, China's exports to South Asia stood at US\$43.7 billion, whereas its imports from the region were US\$21.5 billion.¹⁸ Second, South Asia also competes with China in the global export markets and the undervalued renminbi could be one of the hurdles for them to be competitive in some low value-added products, which many South Asian economies specialise in.

However, as long as the South Asian currencies do not appreciate against their trading partners' currencies (including the renminbi) in real terms, their export competitiveness will not deteriorate as far as the exchange rate advantage is concerned. In other words, apart from the bilateral exchange rate, whether the South Asian economies in general could enjoy the advantage of their depreciated or undervalued currencies depends on other factors, most notably inflation rates in the region *vis-à-vis* their trading partners.

The movements of Real Effective Exchange Rates (REER) – the weighted average of a country's currency relative to a basket of other major currencies (key trading partners) adjusted for the effects of inflation – of South Asian currencies give us an indication of how competitive they are. Figure 3 shows that, in recent times, particularly in 2007-2009, compared to major South Asian currencies, except the Sri Lankan rupee, the renminbi experienced a real appreciation. The monthly REER data of China and India in Figure 4 shows that the Indian rupee underwent a significant depreciation in real terms, particularly following the financial crisis, and the renminbi experienced a marked appreciation. This is largely due to the reversal of foreign capital flows from the Indian capital market and a plunge in its exports income, and the rapid appreciation of the United States dollar (as did the renminbi) as funds returned to the United States in search of a safe haven.

As long as the South Asian currencies do not experience significant appreciation in real terms, the undervalued Chinese currency should not be a worry for the region. However, if the United States dollar undergoes rapid depreciation (along with the renminbi), this may be a cause for concern for South Asia. However, in the long-run, it is not merely the exchange rate but productivity that drives a country's exports competitiveness.

¹⁷ Apart from the global economic crisis, internal political conflicts in Pakistan and Sri Lanka weakened their external sectors, eventually affecting their currencies.

¹⁸ *The Direction of Trade Statistics*, International Monetary Fund.

The Way Forward

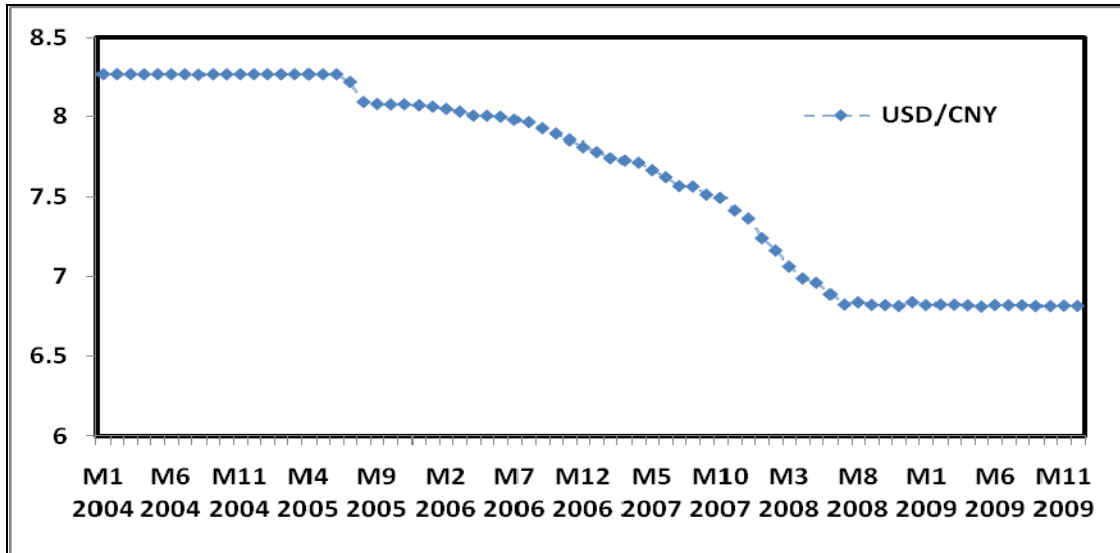
China's huge supply of labour gives it the upper hand, allowing it to delay an upward adjustment of its exchange rate by suppressing the prices of non-tradables. However, sterilisation and other monetary management issues are the key hurdles in pursuit of this goal. The net effects of its labour and financial market dynamics could lead to the upward revaluation of the renminbi, but the process may be much less steady than what the United States and other industrialised economies are demanding.

Nevertheless, if China's exchange rate is to be determined by factors other than economic forces and if it finally undergoes Japan's experience owing to global politics, its three-decade economic march could face a major setback.

The very essence of Lenin's economic and political philosophy might have faded away, if not buried, following the fall of the Berlin Wall in the 1990s. However, his observations about currency are very much alive today.

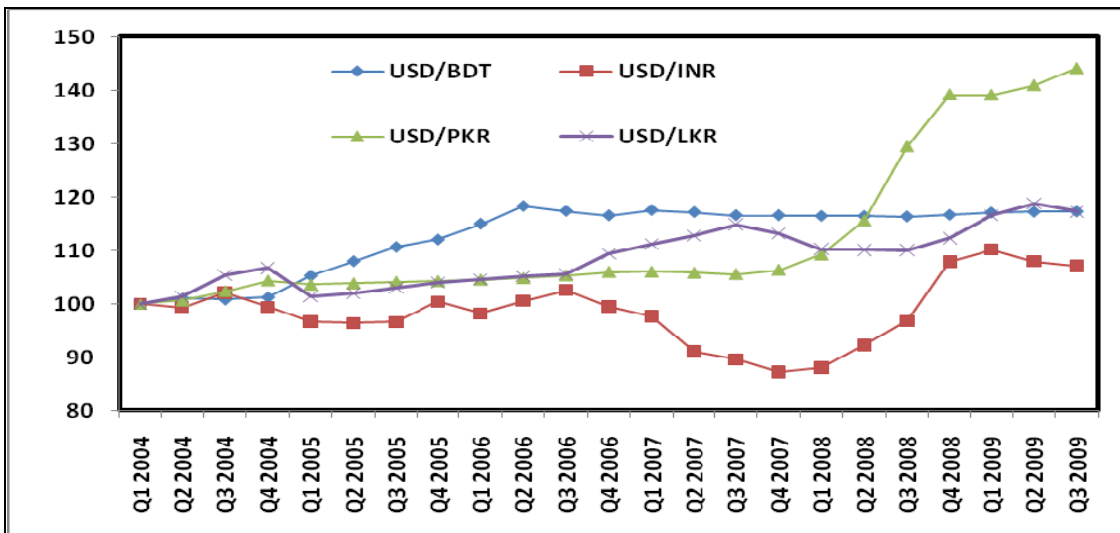
Appendix

Figure 1: United States Dollar to Chinese Renminbi Exchange Rates: M1:2004-M12:2009.



Source: Oanda (www.oanda.com).

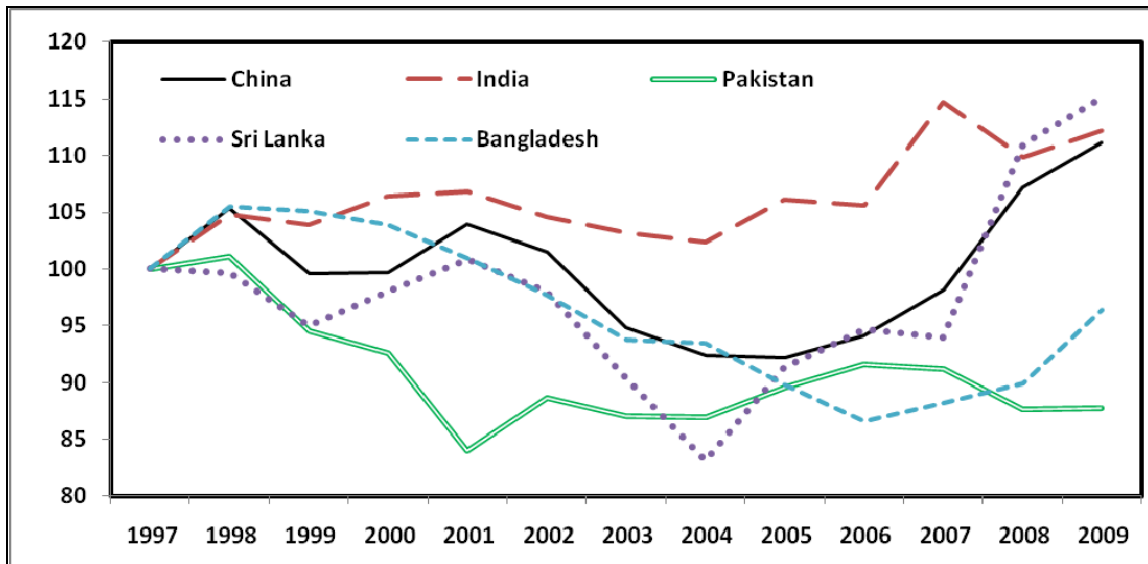
Figure 2: Exchange Rates Movement of Major South Asian Currencies vis-à-vis United States Dollar



Note: BDT= Bangladesh Tak, INR= Indian rupee, PKR= Paksitani rupee, LKR= Sri Lankan Rupee.

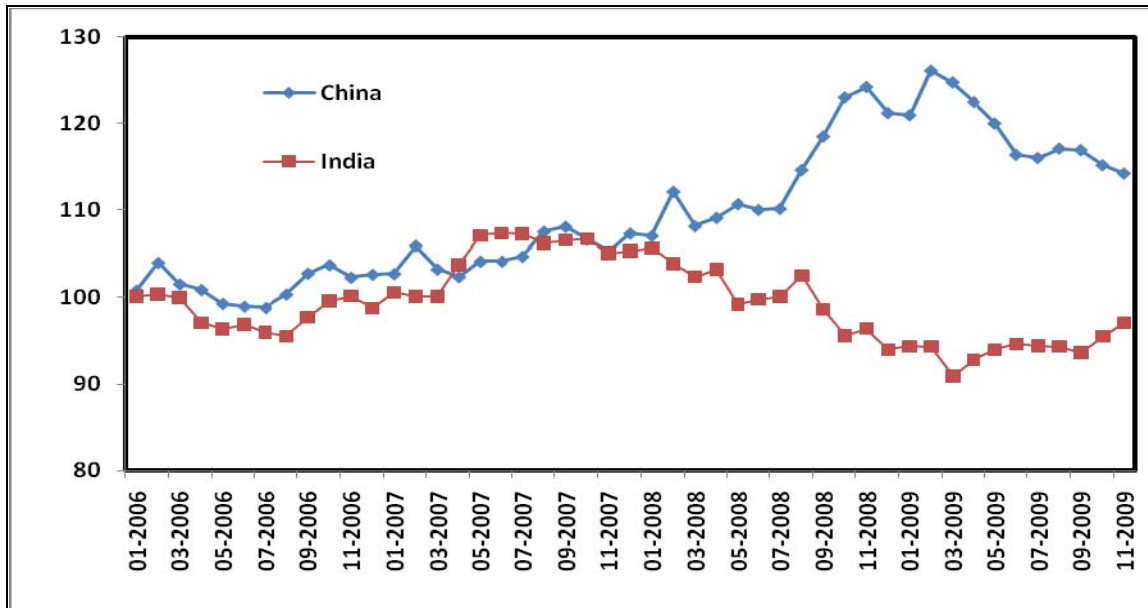
Source: Asia Regional Integration Center.

Figure 3: Real Effective Exchange Rate Indices of China and Major South Asian Currencies: 1997-2009



Source: Economist Intelligence Unit.

Figure 4: Real Effective Exchange Rates Indices of China and India: M1:2006 M11:2009



Source: Bank for International Settlements.