

China Burnishes Its Currency

On July 21, the People's Bank of China (PBOC) announced that it was replacing its currency peg to the U.S. dollar with a more flexible exchange rate regime. The announcement was long expected, though the precise timing took the financial markets and many in Washington by surprise. Early reaction was mixed, with many commentators welcoming the change in the currency regime but expressing disappointment with the small scale of the initial revaluation. While unlikely to have a substantial economic or political impact in the near term, the July 21 currency move is, in our view, a highly significant event in China's economic development and emergence as a global power.

Reaction in Washington

The Chinese Government had been under intense pressure for nearly two years to re-peg the renminbi (RMB) and/or to move to a more flexible currency trading system. Despite doubts among economists about the beneficial impact of an RMB revaluation on U.S. trade or employment, many in the U.S. Congress had fixed on this issue as a catch-all remedy for an array of grievances against China. Treasury Secretary John Snow, Federal Reserve Chairman Alan Greenspan, and economists at the International Monetary Fund had each independently urged the Chinese to move to a more flexible currency regime in which the RMB could move in response to market forces. They argued that this would give Beijing better tools to manage inflation at home, while contributing to smoother adjustment of imbalances in global trade and capital flows.

The July 21 announcement was greeted with a palpable sense of relief in Washington. Treasury Secretary Snow, feeling vindicated by his “quiet diplomacy” strategy, welcomed the move as likely to contribute to global financial stability. Fed Chairman Greenspan called it “a good first step,” as did prominent Congressional critics of Chinese currency policies such as Senator Charles Schumer of New York; others on Capitol Hill called it “promising.” The move seemed likely to relieve – temporarily at least – pressure for legislative action against Chinese currency practices.

Why Beijing Moved

While a number of considerations lay behind the decision to reform the currency system at this time, the most important may have been a shift in the balance of economic arguments within the Chinese Government.

New Regime: According to the PBOC statement of July 21, China will move immediately to a “managed floating exchange rate regime based on market supply and demand,” in which the RMB will be set with reference to a basket of major currencies rather than the dollar alone. The currency will be allowed to trade within a narrow 0.3 percent band in the course of each trading day. At the end of the trading day, the PBOC will announce the closing exchange rate, which will become the central parity for trading the following day. As part of the reform, the RMB was also revalued slightly (2.1 percent) from 8.28 to the dollar to 8.11. Other details of the new regime, such as currencies to be included in the basket, remain unclear.

China's economic policymakers, notably PBOC Governor Zhou Xiaochuan, had reportedly been arguing in internal policy debates for the past 2-3 years that a growing and modernizing China needs a more complete “toolkit” of economic policies to manage the domestic macroeconomy. It is widely believed that China's top political leadership, when considering these arguments, have been more concerned that any currency revaluation accompanying such a move to flexibility could slow China's export-led growth – thereby undermining a key pillar of the regime's legitimacy.

However, as many Western economists have pointed out, an excessively export-led growth strategy can be inappropriate for a developing country like China, insofar as it implies suppression of domestic consumption in favor of foreign demand. Revaluation of the RMB, by making dollar-denominated goods more affordable, raises household wealth across China. Seen in this light, the July 21 action appears to have been a significant statement by Beijing that it intends to seek more balanced growth between exports and imports, to benefit a wider group of stakeholders in China – although the limited size of the initial revaluation suggests that the authorities were not ready to let the pendulum swing too far immediately.

Foreign policy considerations appear to have been the other key driver of the currency move. For more than a decade, Beijing has been working to project an image of China as an engaged, responsible member of the global community. This effort has been most pronounced in the economic policy arena, where China has taken steps to bind itself into the global rules-based system, most notably by acceding to membership in the World Trade Organization in 2001, but also through less-publicized

moves such as submitting itself to a full review of its economic policies by the OECD, the club of advanced industrialized economies.

At the Group of Eight (G-8) Summit in Gleneagles, Scotland, in early July, Chinese President Hu Jintao called on the assembled group of eight developed and five developing country leaders to “commit ourselves to adopting effective fiscal and monetary policies, readjusting our economic structures and promoting balanced and sustained development of the world economy.” Against the backdrop of earlier G-8 calls for China to move toward a flexible exchange rate system, Hu’s statement appeared to be a public acknowledgement of what China needed to do to “join the club” of responsible global economic powers. (Indeed, the July 21 action has arguably moved China a step closer to membership in the G-8, or at least the Group of Seven assembly of finance ministers and central bankers.)

In addition to the broader economic and foreign policy considerations described above, narrower political considerations also appear to have influenced the timing of the Chinese currency move. Although Beijing has been at pains to avoid being seen as yielding to foreign pressure, the crescendo of noise in Washington apparently persuaded the Chinese Government that if it did *not* take some kind of action during the quiet summer period, it would invite serious economic friction with Washington in the fall. This would be particularly undesirable with Hu Jintao’s first visit to the United States as Chinese President scheduled for September, the success of which Beijing considers to be of paramount importance.

Outlook

In theory, if the authorities allowed the RMB to rise to the limit of its 0.3 percent trading band each day, the currency could appreciate by some 20 percent in less than four months. However, particularly given the non-transparency of the trading system, it would be relatively easy for the PBOC to manipulate the exchange rate at the end of each day (e.g., by conducting the final few trades of the day itself), thereby preventing the RMB from appreciating significantly, or at all. We expect the authorities will allow no more than a 5-7 percent appreciation over the next 12 months.

Indeed, the Chinese Government’s early public pronouncements were clearly designed to squelch market speculation of further appreciation in the near term. The PBOC issued a press release on July 26 in which it clarified that its earlier references to an “initial adjustment” of the RMB did not imply that further adjustments of the currency’s *value* were imminent; rather, the previous week’s move was the first step in gradual reform of the “exchange rate *formation mechanism*.”

Assuming limited additional appreciation of the RMB, the initial goodwill in the U.S. Congress in response to Beijing’s action is unlikely to last much beyond the summer break. Even Treasury Secretary Snow put Beijing on notice in his July 21 statement that he would monitor the new regime to ensure the RMB “moves to alignment with underlying market conditions.” Absent such a move, Treasury will face another difficult decision in mid-October when it prepares its next semiannual report to Congress on currency “manipulation.” In this situation, Senator Schumer can be expected to revive his punitive tariff bill, and other legislative remedies may receive serious consideration.

Even further appreciation of the RMB does not guarantee calm in U.S.-China economic relations. It is unlikely to have a meaningful impact on China’s large and growing trade surplus with the United States, nor will it do anything to address the raft of bilateral trade disputes over issues ranging from intellectual property rights to textiles. Thus the July 21 action has taken the immediate edge off but is unlikely to fundamentally alter the dynamics of bilateral economic relations for the foreseeable future.

When viewed from a longer-term perspective, however, the currency action marks an important watershed in the development of China’s domestic and international economic policies, aligning them more closely with the objectives and practices of the major industrialized economies.

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