RMB revaluation will serve China’s self-interest

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Abstract

China has operated its exchange rate regime as a de-facto peg to the dollar since the devaluation of August 1994. Given the stunning growth in foreign exchange reserves in 2003, this paper argues that the optimal currency adjustment is a one-time maxi revaluation of roughly 15% versus the U.S. dollar to a new fixed rate but to a modified anchor, that is, a trade-weighted currency basket. Once the currency was repegged and the new reference basket was implemented, any additional moves, such as widening the trading band, could be phased during a transition period of some years, providing a safe and effective path to a more flexible exchange rate regime in the medium to long term.

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1. Introduction

China has operated its exchange rate regime as a de-facto peg to the dollar (RMB 8.28/US$) since the devaluation of August 1994. A stable exchange rate regime has served China well, helping to provide a stable macroeconomic environment and thus facilitating China’s growth miracle over the past decade. In the wake of the Asian crisis, China’s commitment to a fixed exchange rate to the dollar was widely praised as a key anchor for the global financial system.

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Against this background, Chinese policymakers continue to reiterate their continued commitment to a stable exchange rate regime, defending this strategy as the most prudent policy course consistent with China’s self-interest and, in turn, the best interest of the global market.

We argue the opposite: that it is in China’s patent self-interest to revalue the RMB as part of a comprehensive strategy aimed initially at dampening hot money inflows and their related knock-on effects, including excessive money and bank loan growth, and eventually paving the way for an inevitable move to a flexible currency regime.

The optimal currency adjustment under the current conditions is a one-time maxi revaluation of roughly 15% versus the U.S. dollar to a new fixed rate but to a modified anchor, that is, a trade-weighted currency basket. Several economic models (see, e.g., Chang, in press; Goldstein, 2003) indicate the RMB is undervalued by 15–25%. An adjustment short of this range would beg further adjustments, thus causing more—not less—speculative pressure on the RMB. Pegging the RMB to another fixed rate that is roughly in line with market expectations of fair value would underscore Chinese policymaker’s commitment to a stable currency regime in the short term. By changing the currency reference to a basket of currencies from the U.S. dollar, our multipronged adjustment plan would break the ice for a transition to a more flexible exchange system in the medium to long term.

2. Increasing imbalances under rigid exchange rate

In 2003, foreign direct investment amounted to US$53.5 billion, while the trade surplus amounted to US$25.6 billion. Given the stunning growth in foreign exchange reserves in 2003, that is, US$161.9 billion, speculative hot money could easily have totaled US$50 billion—with the lion share coming in second half of the year (Chang, 2004).

Significant macroeconomic distortions resulted from this unexpected surge of hot money into China in 2003, including the explosive growth in foreign exchange reserves (+57% yoy), money supply (M2 + 19.6% yoy), bank loans (+21.3% yoy), and fixed asset investment (+30.5% yoy).

In the second half of 2003, Chinese policymakers began taking a host of specific measures aimed at limiting upward pressure on the currency and dampening nascent signs of overheating in the economy. However, none of the measures have had the desired effect, as evidenced by continued sharp gains thus far in 2004 regarding the key macro indicators listed above. In the first 3 months of 2004, foreign exchange reserves are up US$36.8 billion, averaging slightly more than a US$12 billion gain per month or US$144 billion at an annualized rate. Meanwhile, as of the end of March 2004, money supply (M2) is up 19.4%, bank loans are up 20.7%, and fixed asset investment is up 43% compared with a year earlier. All of the data are consistent with the hot money fueled numbers posted in 2003.

Short of a meaningful revaluation of the Chinese currency, we expect large hot money inflows into China to continue through 2004, as foreign capital naturally flows into such a fast growing and attractively large economy and speculative pressure on the Renminbi mounts, such that foreign exchange reserves, money supply, and bank lending are all likely to post similar gains to 2003.
While authorities have already cracked down on new loans to the hottest investment sectors in 2003, including auto manufacturing, building materials, and real estate development, and reiterated their commitment to monitoring loan growth in 2004 to make sure other sectors are not the target of excess lending bubbles, such a strategy is inherently flawed, as it relies on administration fiat to ensure fully commercialized (i.e., risk adjusted) lending decisions. Another round of bad loans and excess capacity is bound to appear in China’s economy, with a resulting deflationary effect given the enormous growth of credit in such a flawed financial sector.

In September 2003, the central bank tightened monetary policy by raising the official required reserve ratio by 1%, from 6% to 7%, and again in April 2004, authorities raised reserve requirements by 0.5%, from 7% to 7.5%. This mild monetary tightening is unlikely to play a meaningful role in addressing macro imbalances being fueled by hot money inflows into China’s economy. Given the burden of large borrowing requirements needed to support critical fiscal spending initiatives, Chinese policymakers have little appetite for higher interest rates. Even if authorities decided to live with higher rates, it is unlikely that tighter money would help promote macroeconomic stability because the higher rates would attract more hot money inflows, which would tend to cancel the effect of tighter money.

3. Overstated risks and understated benefits from a maxi revaluation

Two major justifications that Chinese policymakers use to argue the unacceptably high risk of a currency adjustment include concerns that such a move would exacerbate deflationary pressures and undermine export competitiveness. Both concerns are overstated. The emergence of inflationary pressures appearing in the Chinese economy has more or less eliminated the deflation argument.

Concerns that a currency adjustment could produce an adverse effect on export competitiveness and thus exacerbate job losses and unemployment are similarly overblown, given the fact that half of Chinese imports are raw materials or intermediate goods used in the processing and manufacturing of exports. Cheaper prices of imported inputs facilitated by a currency appreciation would significantly offset the adverse effect of a stronger RMB on export prices. The net effect on China’s terms of trade from even the sort of maxi revaluation that we advocate would be modest.

The durability of the last maxi revaluation of the RMB in 1994—roughly 10 years ago and counting—highlights the folly of the argument that a large adjustment of the currency would risk destabilizing China’s financial sector and economy. Many of the same doom and gloom arguments about the potentially destabilizing effect of that roughly 30% devaluation proved just as false as they would today with a similarly sized appreciation (Zhou, 2003).

On the contrary, a significant revaluation of the RMB would provide an immediate boost to Chinese per capita incomes in U.S. dollar terms, providing more purchasing power to Chinese consumers, including rural consumers. The potential for a maxi
revaluation to boost Chinese living standards—even in rural areas—is enormously underappreciated.

We do not believe that China should adjust its currency on the basis of international pressure; however, there is no doubt a meaningful adjustment of the Chinese RMB versus the U.S. dollar would be welcomed by U.S. politicians and prominent labor groups and some industries who complain about cheap Chinese imports stealing jobs and business from America. In response to a move on the currency, China could expect reciprocal U.S. cooperation on other economic and diplomatic issues of vital importance to China.

4. Conclusion

Chinese policymakers have implemented several important current and capital account liberalization measures aimed at addressing emerging macroeconomic imbalances. However, there is no silver bullet in Chinese policymakers’ arsenal that will address the fundamental cause of those macro imbalances, that is, surging hot money inflows. No matter what policymakers do short of sufficiently revaluing the currency, net capital inflows and the large accumulation of international reserves will continue, thus fueling the continuation of emerging macroeconomic and financial sector imbalances.

Any incremental strategy aimed at moving the currency to a more flexible regime, whether it is moving the currency reference away from the U.S. dollar, widening the trading band, or implementing any one of countless alternatives to a fully flexible or pegged regime, risks inviting more, not less, hot money inflows into China, thus exacerbating the very macro imbalances that a flexible exchange rate is supposed to solve.

A one-time maxi revaluation would take speculative pressures out of the currency all at once, avoiding the risk of inviting a huge surge of speculative hot money of one sort or another into China and at the same time restoring policymakers’ flexibility in managing both fiscal and monetary policies. Once the currency was repegged and the new reference basket was implemented, any additional moves, such as widening the trading band, could be phased during a transition period of some years, providing a safe and effective path to a more flexible exchange rate regime.

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