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APPRECIATION OF THE RENMINBI:
WHAT'S HAPPENED -- AND WHAT HASN'T



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The agreement creating the International Monetary Fund established as a central objective of the post-War international system the “continuing development of the orderly underlying conditions that are necessary for financial and economic stability.” To that end, IMF Article 4.1 obligates members to “avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.” That obligation lies at the heart of the six-year struggle between China and its trading partners. The IMF rule makes it clear that when trade flows and/or balance of payments become substantially unbalanced, governments are expected to allow exchange rates to *correct those imbalances*.

Three years ago, on July 21, 2005, China abandoned the hard peg of the renminbi to the dollar, making an initial revaluation of approximately 2 percent. Since then the RMB has gradually appreciated by means of a “dirty” float within a daily band of initially 0.3 and currently 0.5 percent.

Whether these measures have proved to be adequate in terms of the objectives of Article 4 can be gauged only by reference to objective data on the performance of the Chinese economy. This paper provides the latest available data from official Chinese sources on the results for the Chinese economy since July 2005 in terms of:

- the growth of China’s gross domestic product;
- the share of exports as a percentage of China’s GDP;
- the share of domestic consumption as a share of China’s GDP;
- consumer price inflation in China;
- China’s balance of trade with the rest of the world and with the United States; and
- holdings of official foreign exchange reserves by the Chinese government.

GDP Growth

For most of this decade, economists in China and throughout the world have fretted over the threat of overheating in the Chinese economy. A stronger currency over time would be expected to reduce that threat. While overall growth probably might not have to slow markedly if at all, the composition of this growth would be expected to change.

In the case of China, GDP growth has remained strong for the past three years. In fact, as shown in Table 1, since the appreciation process began, China’s real GDP has grown at a higher rate than it did just prior to July 2005.

Table 1

China Real GDP Growth

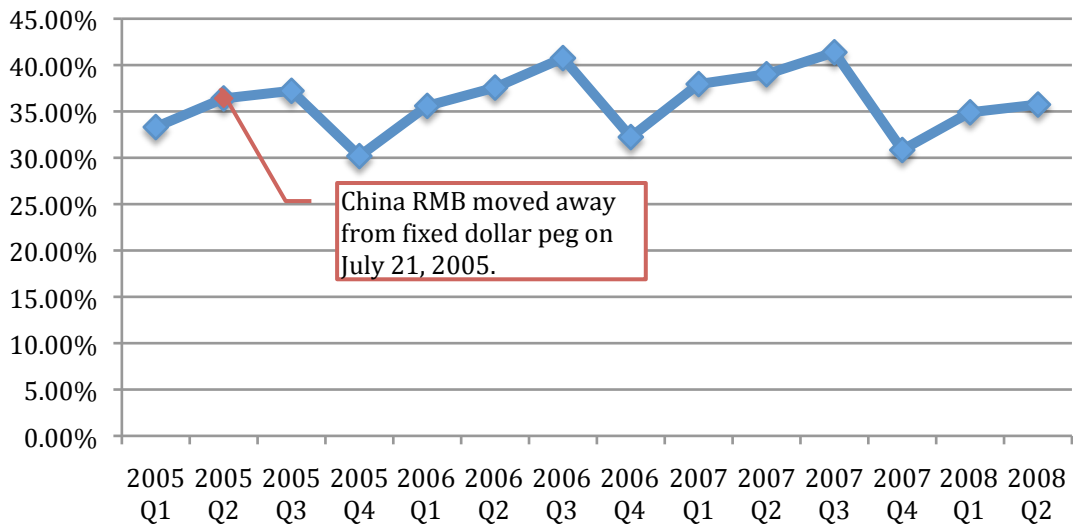
	2005	2006	2007	2008
Q1	10.50%	11.40%	11.70%	10.60%
Q1-Q2	10.50%	12.00%	12.20%	10.40%
Q1-Q3	10.40%	11.80%	12.20%	NA
Q1-Q4	10.40%	11.60%	11.90%	NA

Source: National Bureau of Statistics of China
<http://www.stats.gov.cn/tjsj/jidusj/>

Shortly after the initial revaluation, former Treasury Secretary John Snow argued in public that China’s economy had been misshapen by its undervalued currency. Unfortunately, there is not much evidence that the composition of China’s economy has changed since then, as might be expected to result from a substantial appreciation of the RMB. Table 2 shows that exports have continued to amount to about one-third or more the size of China’s GDP. Table 3 shows that domestic consumption has been falling as a percentage of GDP. Currently, consumption accounts for only 35 percent of China’s GDP, while investment continues to exceed 40 percent. In other words, despite the appreciation to date, China’s economic growth is still generated largely by exports and by domestic and foreign investment. While growing, domestic consumption continues to lag behind overall GDP growth.

Table 2

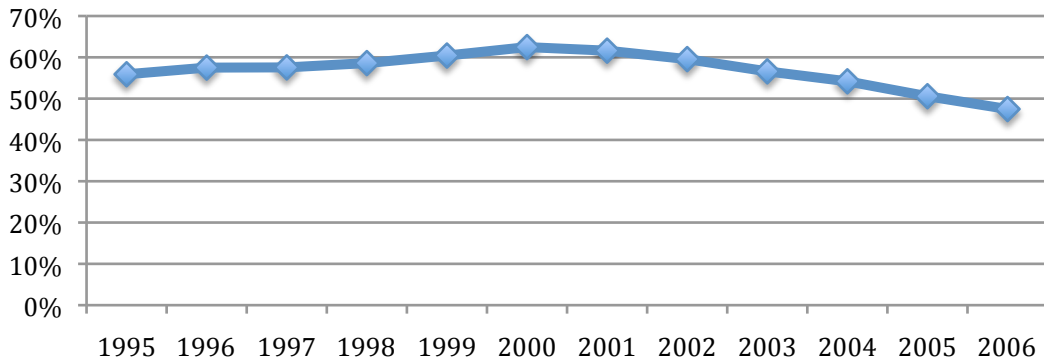
China Export/GDP Ratio



Source: China Customs Statistics
<http://www.chinacustomsstat.com/CustomsStat/hgtj/hgtjmain.aspx>

Table 3

China Final Consumption/GDP Ratio



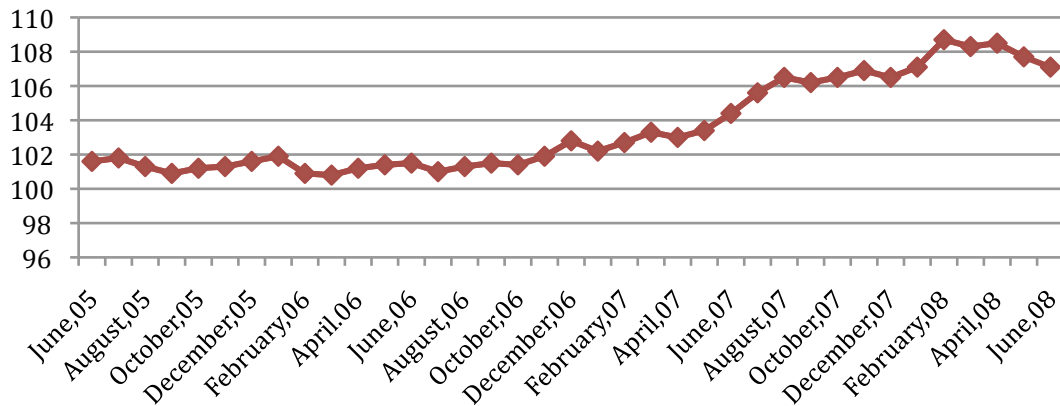
Source: World Development Index, World Bank
<http://go.worldbank.org/6HAYAHG8H0>

Inflation

China’s problems with inflationary pressures have been much in the news. By one count, the Chinese government has long maintained price controls of one type or another in 13 sectors, including certain agricultural products, energy, water, transportation, fertilizer and pharmaceuticals. Earlier this year, “temporary” price controls were imposed on grains, edible oils, milk, eggs, meat and liquefied natural gas. Nevertheless, as Table 4 shows, China’s consumer price inflation has been rising since the summer of 2005.

Table 4

China Consumer Price Index



Source: National Bureau of Statistics of China
<http://www.stats.gov.cn/english/statisticaldata/index.htm>

One reason for the so-far losing battle with inflation is that the renminbi has too little increased purchasing power to offset the rise in commodity prices such as oil and gas, iron ore, and other basic inputs for China’s manufacturing sector. China recently

complained in the World Trade Organization that the weakness of the dollar is an engine of inflation for food and commodity prices world-wide. However true that statement might be, the still weak renminbi compounds the problem by forcing Chinese importers to pay more in renminbi for the increased dollar prices that resulted in part from the weakness of the U.S. currency.

The weak RMB also feeds the problem of excessive credit expansion in China. Chinese banks are awash in cash. Nominal interest rates are low, and real interest rates turned negative as inflation has risen. The Chinese government has sought to tighten credit by raising reserve requirements for commercial banks 19 times since mid-2005. This year alone the reserve requirements have been raised by one-fifth to 17.5 percent. Nothing seems to work. Moreover, there is rising concern over the quality of loans. Credit checks are virtually unknown in China; personal and political connections guarantee access to cheap credit. This has caused some observers to caution that China has its own sub-prime crisis in the making.

Balance of Trade

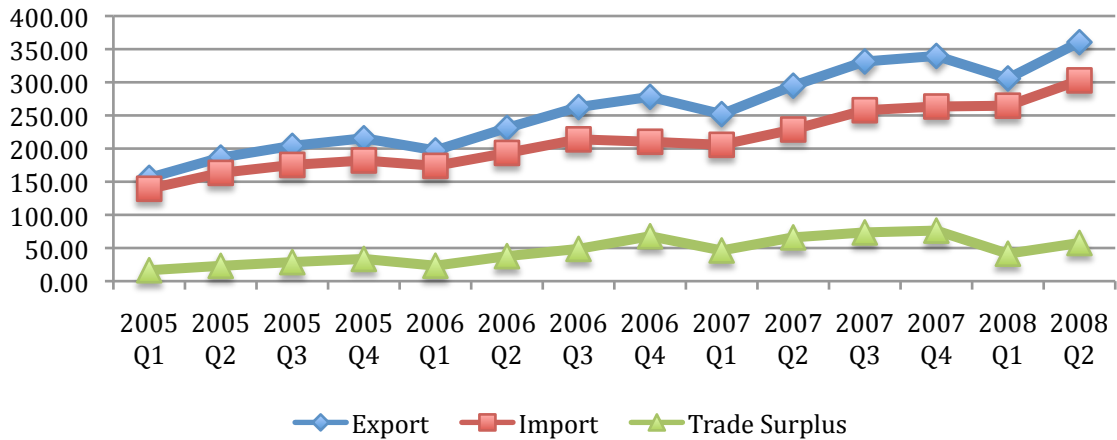
As the language of Article 4 clearly indicates, appreciation of a currency is supposed to reduce imbalances in trade flows, among other things. In the case of China, correction in the overall trade imbalance has been slow to appear in the statistics. Table 5 shows that, at least until the second quarter of 2008, China's overall trade surplus has continued to grow, with each new peak and each cyclical low point higher than the corresponding point in the previous annual cycle.

Note that the use of official Chinese trade data almost certainly understates the actual size of China's net exports with the world. Analysis conducted by the China Currency Coalition over a number of years supports the conclusion that Chinese data systematically overstate the value of China's imports and understate the value of its exports. This conclusion was derived by comparing the trade data submitted by China to the IMF with the comparable data submitted by its leading trade partners.

Normally, the first quarter shows a substantial drop in China's trade surplus (as well as in GDP growth; see Table 1). This reflects the slowdown in economic activity during the extended Chinese New Year holiday as well as the effects of winter weather. This year's unusually harsh wintery conditions undoubtedly depressed production and trade figures. Nonetheless, it is striking that since the July 2005 revaluation, the overall trend in China's trade surplus has been higher, not lower. In fact, China's overall exports reached an all-time high in the second quarter of this year. Growing imports have narrowed the overall surplus, but it remains about double what it was prior to the change in the currency regime.

Table 5

China Trade Balance
Billions of USD



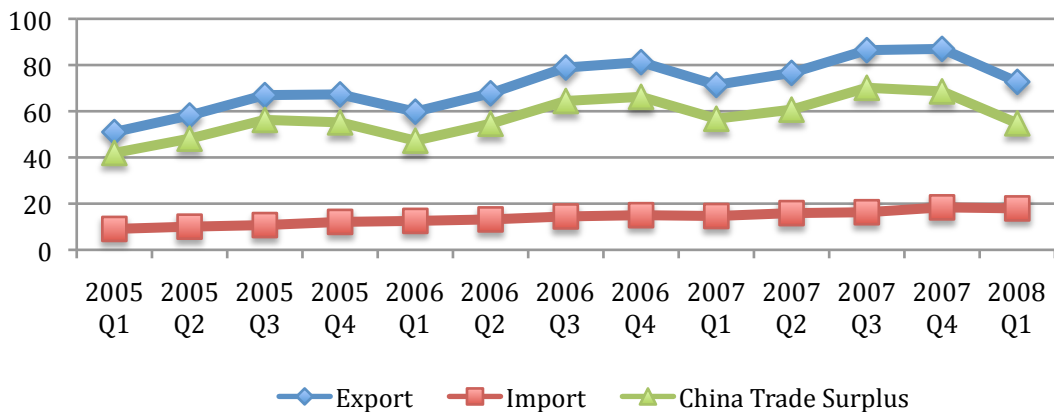
Source: China Customs Statistics

<http://www.chinacustomsstat.com/CustomsStat/hgtj/hgtjmain.aspx>

The overall trade balance, of course, is impacted by the dollar’s decline in value against the euro, the Canadian dollar, the British pound, and other freely floating currencies. Still effectively pegged to the dollar, the renminbi loses value against other currencies as the dollar sinks against them. Interestingly, China’s surplus with the United States has shown a pattern quite similar to the overall surplus (see Table 6). Note that until the first quarter of 2008, the pattern of higher peaks and higher troughs continued for bilateral trade as well as for China’s overall trade.

Table 6

China Trade Balance with The U.S.
Billions of USD



Source: U.S. Census Bureau Foreign Trade Statistics

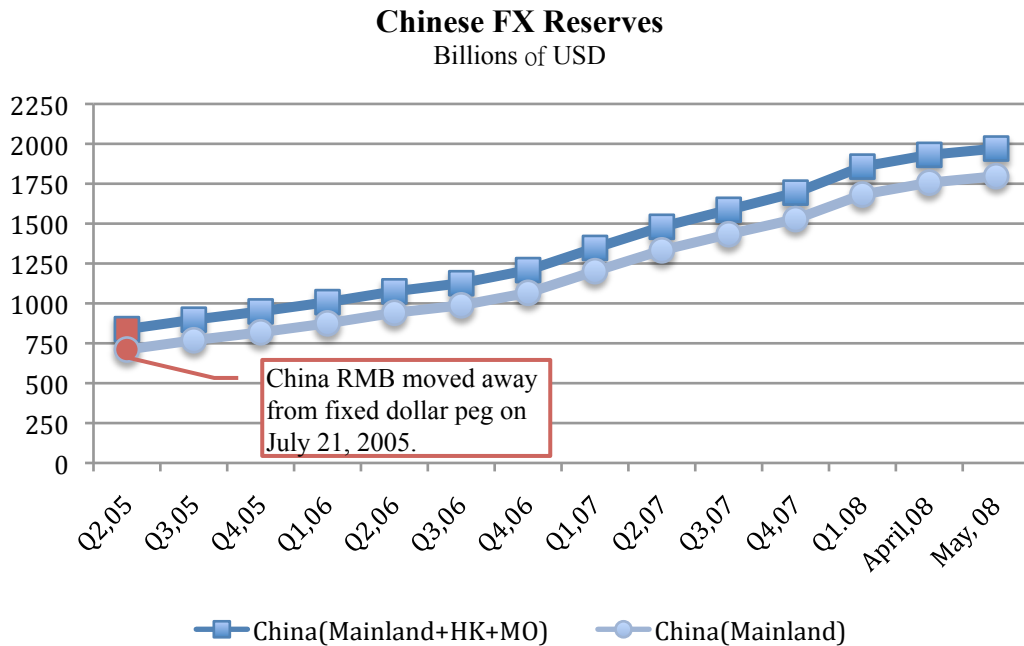
<http://www.census.gov/foreign-trade/balance/c5700.html>

Official Reserves

Probably the least ambiguous measure of the impact of the appreciation of a currency are changes in the level of official foreign exchange reserves. Redressing the build-up of excessive reserves is one of the explicit means by which IMF Article 4 aims to promote order and stability in the global economy. While there is no firmly agreed target, most economists recommend that a country maintain enough reserves to cover the cost of 3-4 months' imports. At China's recent rate of imports, that would amount to 250 – 300 billion dollars' worth of reserves. When China began the process of appreciation of the renminbi, its reserves were already two to three times that benchmark.

In fact, ever since China has been amassing reserves at a rate and to levels never seen before in any country. Table 7 shows that the level of reserves has risen steadily; in fact in 2007-8, the rate of increase has shifted into high gear. China's foreign reserves today are conservatively estimated at two trillion dollars – and may in fact be considerably higher, as explained below. This is hardly what would have been expected given the more rapid nominal appreciation in the most recent period, major purchases by Chinese investors in natural resource deposits and other overseas assets, and the rising cost of energy and other imported commodities.

Table 7



Source: People's Bank of China-Statistics
<http://www.pbc.gov.cn/diaochatongji/tongjishuju>

Obviously, the trade imbalance does not fully account for this strong surge in reserves. Adding in China's continued strong inflow of foreign direct investment (FDI) -- \$75 billion in 2007 -- does not fully explain it, either. Thus, by subtraction, some observers deduce that "hot money," speculative international flows, is the most destabilizing factor.

By one estimate published in the *Financial Times* on July 14, 2008, the trade surplus, FDI and interest on reserves account for only 39 percent of the increase in China's reserves from January through May of this year. *The Economist* estimated on June 26 that hot money accounted for \$170 billion in new reserves in the first five months of 2008. This means that speculators are betting that China's inflation and the threat of financial instability will force a much greater appreciation sooner rather than later.

Whatever the full explanation, the plain fact is that China's reserves are spiraling upward at a time when a substantial appreciation ought to be moderating their growth and eventually reducing them (see Table 8). Mainland China now holds \$1.8 trillion dollars worth of reserves, more than double the pre-revaluation level. In other words, over the 35 months from July 2005 through June 2008, China's reserves increased in net terms by more than a billion dollars a day or about \$35 billion per month.

Table 8

Top 16 Foreign Exchange Reserves Holders

Billions of USD

	Q2, 05	Q4, 05	Q2, 06	Q4, 06	Q2, 07	Q4, 07	Q1, 08	April, 08	May, 08
China	838.7	949.8	1075.6	1208.7	1480.1	1694.2	1857.3	1931.0	1970.5
Mainland	711.0	818.9	941.1	1066.3	1332.6	1528.2	1682.2	1756.6	1797.0
Hong Kong	122.0	124.3	126.6	133.2	136.3	152.7	160.8	159.9	159.0
Macau	5.7	6.7	7.9	9.1	11.1	13.2	14.3	14.5	14.5
Japan	843.5	846.9	864.9	895.3	913.6	973.4	1015.6	1003.8	997.0
Russia	151.6	182.2	250.6	303.7	405.8	476.4	507.0	534.4	547.4
India	138.4	142.8	162.9	177.3	213.4	275.3	309.7	314.2	316.2
Taiwan	253.6	253.3	260.4	266.1	266.1	270.3	289.4	289.4	290.1
South Korea	205.0	210.4	224.4	239.0	250.7	262.2	264.2	260.5	258.2
Brazil	59.9	53.8	62.7	85.8	147.1	180.3	195.2	195.8	197.9
Singapore	114.9	116.2	128.3	136.3	144.1	163.0	177.5	175.8	175.8
Germany	95.2	101.7	109.2	111.6	114.6	136.2	150.4	144.0	143.3
Algeria	NA	NA	NA	NA	NA	NA	126.9	NA	NA
France	73.4	74.4	86.0	98.3	98.7	115.7	127.1	120.4	NA
Malaysia	74.8	70.2	78.8	82.5	98.4	101.3	120.3	124.1	125.2
Thailand	48.4	52.1	58.1	67.0	73.0	87.5	110.0	109.8	110.1
Italy	60.5	66.0	74.2	75.8	80.8	94.3	103.1	100.8	NA
U.K.	80.2	79.2	79.4	85.6	95.5	97.3	100.0	94.4	89.2
Mexico	65.6	74.1	84.9	76.3	77.9	87.2	91.1	92.8	NA
TOTAL¹	3103.6	3273.0	3600.2	3909.3	4459.7	5014.6	5417.7	5491.1	NA

¹Algeria is excluded from the total for all periods.

Source:

IMF Special Data Dissemination Standard

<http://dsbb.imf.org/Applications/web/reservestemplate/>

(IMF DSBB-SDDS with links to countries' websites containing data on international reserves)

People's Bank of China-Statistics

<http://www.pbc.gov.cn/diaochatongji/tongjishuju>

Monetary Authority of Macao-Statistics

http://www.amcm.gov.mo/economic_statistics/economic.htm

Central Bank of Taiwan

<http://www.cbc.gov.tw/EngHome/eeconomic/statistics/monthly.asp>

The actual situation is made worse when the reserves held by Hong Kong and Macau are included. They bring China's effective reserves to \$1.97 trillion in May; by now, China's collective reserves almost surely have passed two trillion dollars.

Finally, unlike some other countries, China does not include in its official reserves the financial assets held by sovereign wealth funds. That means that, without the creation of the China Investment Corporation in September 2007, China's official reserves would have been \$200 billion higher than reported. Some observers believe that other Chinese institutions are also accumulating reserves that don't appear in the official statistics.

Matters are made far worse by the fact that China is just one of a number of leading countries that are amassing reserves at breath-taking rates. Table 8 shows that the leading 16 holders of foreign exchange reserves have experienced a combined growth in excess of 70 percent since July 2005. The combined additional reserves in their hands now amount to 2.4 trillion dollars more than when China was first persuaded to revalue. That substantial and growing overhang of dollars is a sure sign, and in part a cause, of the growing instability in the world economy.

Conclusion

Since 2005, the US Treasury and others have said repeatedly that China's appreciation was moving toward the equilibrium target but not fast enough. To the contrary, these data depict an alarming situation that is worsening, in some ways rapidly. It is undoubtedly true that, absent the real appreciation that has taken place since July 2005, things would be that much more dire. Nonetheless, it seems incontrovertible that the initial revaluation and the subsequent appreciation of the renminbi over the past 36 months have been grossly inadequate. The "intended consequences" of a revaluation – more consumption-led growth, lower inflation, reduced trade imbalances – have not yet materialized. The unbridled growth in reserves, in particular, poses a threat to the IMF's objective of "continuing development of the orderly underlying conditions that are necessary for financial and economic stability."

Not just the value of the renminbi, but that of all managed currencies, needs to be adjusted promptly and effectively. Once that is accomplished, the market would ensure an adjustment in other, freely floating currencies. Given the magnitude of the imbalances, there may not be much time left to avoid a hard landing for the world economy.