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INVESTIGATION INTO THE DEBATE OVER RMB REVALUATION

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I. INTRODUCTION

The purpose of this paper is to look into the present debate over whether or not the value of the Chinese Renminbi has been kept artificially low by the Chinese government, particularly in relation to the U.S. dollar, or if these claims are largely political posturing by those seeking to encourage domestic support by giving the illusion of being proactive. This has become an increasingly important issue with regards to bilateral trade talks between the two economic powerhouses and is being considered a major hurdle that must be overcome.



As the dust of the financial crisis and the ensuing crash of 2008 begins to settle, the international community has been in the beginning stages of pulling itself out of recession. The U.S. and China, having two of the largest economies in the world, will play major roles in this recovery, and the thirst of the American consumer for Chinese made products is of central significance to this and, in general, to global financial stability. Thus, resolving the problems of currency manipulation and maintaining the strength of this trade relationship will become increasingly important to the rest of the world as it begins to rebuild.

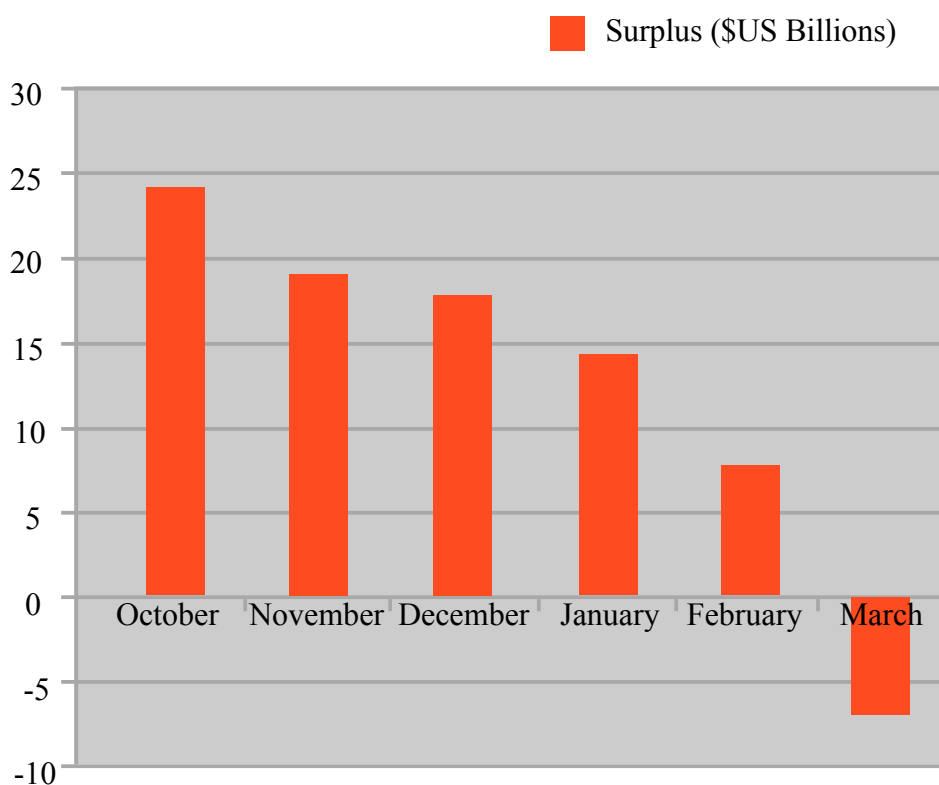
II. THE TRADE IMBALANCE

The accusation that the Chinese government has kept the value of the RMB artificially low has become a topic of much contention, particularly as countries around the world seek to rebuild their economies. For the United States (and the EU to an increasing extent), it is particularly important as it seeks for ways to balance a major trade deficit, that many claim is holding back economic recovery efforts. The argument typically made is that if the Chinese government were to allow their currency to appreciate to levels more freely dictated by the market (estimates range from 20%-25%), then it would make American goods relatively cheaper thus increasing exports for the U.S. The Chinese on the other hand maintain that this has very little to do with the trade imbalance, and that its first duty is to protect the interests of its own citizens, supporting industry through its monetary policy. Both arguments are valid to a certain extent, which has contributed to the issue becoming increasingly complex and controversial.

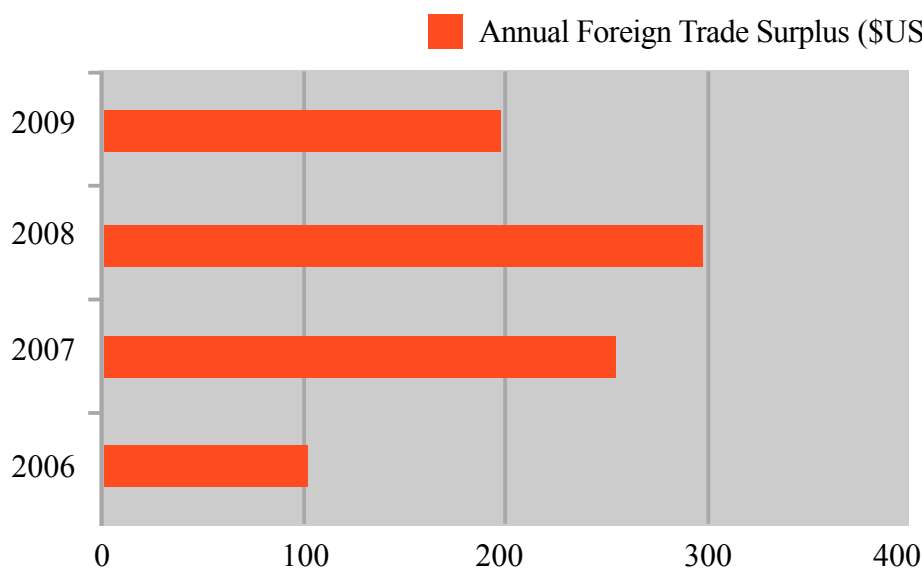
Thus, much of the debate over the value of the RMB centers around the massive trade surplus China holds over the United States and much of the rest of the world. Many ex-

perts believe that, from looking at the current data, it is still difficult to judge what the future will hold for China's trade surplus. It is however becoming clear that the comfortably large margins the country has enjoyed in recent years may not be sustainable for too much longer.

Chinese Trade Surplus (October '09-March '10)



Annual Foreign Trade Surplus From 2006-2009 (in \$US billion)



(As the pressure from CPI in May has eased, the RMB appreciation and increases to the interest are all likely to be delayed.)

We can see from this data that it may be the case that China's trade surplus could be shrinking. Though it is currently a time of extreme economic uncertainty and volatility, China's economy is clearly susceptible to a trade deficit (temporary as it may have been). As well, we can see that China's annual surplus peaked in 2008. This data would appear to begin to call into question the international claims of currency manipulation as being a major cause for the huge trade surpluses China has been enjoying. However, time will tell if this is simply as a result of the financial crisis or if it is in fact a reflection of changing, underlying fundamentals in the Chinese economy.

In reaction to the accusations of currency manipulation by the U.S., and much of the rest of the international community, Chinese economists point to massive expansionary fiscal and monetary policy by the U.S. federal government, part of a larger trend of fiscal irresponsibility, as a major cause for the trade and currency imbalances. The U.S. fiscal deficit in 2009 reached 1.42 trillion U.S. dollars, 9.9% of the GDP. Debt balance is currently more than US \$12 trillion, 84% of the U.S. GDP. They expect this deficit to grow, reaching 1.27 \$US trillion by 2011, fearing that, by 2015 the value of outstanding U.S. Treasury bonds will reach as high a 100% of GDP and that this will lead to a devaluating currency.

In addition, China's Commerce Ministry spokesman Yao Jian has noted that although China maintains a surplus in the trade of manufactured goods to the U.S., there has been little consideration for the existing surplus of trade in American services and American enterprises in China, thus making the claim that Sino-U.S. Trade is actually balanced when services are taken into account. He says that, from a global perspective, the main reason for trade imbalance lies in the relative absence of American financial responsibility and the difference in consumption and economic habits of the developed versus developing countries, largely a reflection of cultural differences. Yao also emphasized that China's surging exports in May 2010 were mainly as a result of last year's low starting point. Mr. Yao has said that this year's import growth will continue to increase, and thus the trade surplus size is expected to fall overall.

Yao Jian pointed to the fact that China's growth rate of imports in the first five months of 2010 has been nearly twice that of exports. China provides an important export market for Japan, Korea, Australia, and Brazil among other countries. Although it maintains a surplus with the United States, European Union, India and other trading partners, import growth rate has continued to accelerate significantly.

From the Chinese perspective in evaluating which course to pursue, U.S. dollar depreciation has in contrast become a cause for concern. Due to their large re-

serves of U.S. dollars and debt, depreciation of the dollar (and the RMB relative appreciation) results in major capital losses in its foreign exchange reserves. From the period between 2002 and 2009 the dollar has been devalued 41% according to the U.S. dollar Index.

III. THE DOWNSIDE OF APPRECIATION

An appreciation in the RMB could also mean additional problems for the U.S. As reported by Xinhua Net, U.S. Congressman David Wu (D-Oregon), the newly appointed member to the House Committee on Foreign Affairs, has noted that an appreciation in the RMB would add upward pressure on inflation in the U.S., adding to the already unprecedented size of the public debt. The effects on the Chinese are even more significant, as any appreciation of the currency resulting in decreased exports would have a detrimental effect on jobs at a time where unemployment is already dangerously high.

One of the industries most exposed to these risks in China is the textile industry. The Vice President of the China Textile Industry Association Chen Shujin noted that the industry's profit margins are typically only about 4%. As a result of these slim margins, any textile manufacturers relying heavily on exports will most likely go bankrupt as a result of any significant revaluation of the currency. According to estimates by the China Textile Industry Association, every decrease in 1 billion dollars of exports will result in thousands of additional unemployed. Rep. Wu has suggested as an alternative however- that China pursue a strategy that further aims to alter the mind-set of the Chinese consumer and to increase consumer awareness within its population. By increasing domestic demand, the Chinese could decrease their reliance on exports to foreign countries. He notes that not only will this help cushion the unemployment blow but it could also improve the trade deficit between the United States and China.

IV. INTERNATIONAL PRESSURE AND CHINA'S MONETARY POLICY

With the upcoming G20 summit and the 2010 midterm elections in the U.S. on the horizon however, the tone of the U.S. government has become increasingly hostile, with voices demanding U.S. retaliation to Chinese currency manipulations becoming louder and more common. One major initiative included pursuing multi-lateral trade pressure, asking India and other major trading partners to similarly

increase pressure on China. On June 11, Europe also began to voice concerns of manipulation by the Chinese government, citing its "rigid current exchange rate policy." European Central Bank executive board member Lorenzo Bini Smaghi has been quoted as saying that if the U.S. and Europe can cooperate in this matter, hopes of Chinese exchange rate reform may actually be within reach. Similarly, U.S. Treasury Secretary Timothy Geithner made the accusation that China's failure to revalue its currency is acting as a major obstacle to global economic recovery. He also advised that the U.S. make sure they are using all effective ways to encourage China to take action, citing the importance of the upcoming G-20 summit. Thus, it is starting to look increasingly as if Europe and the United States may start acting together towards applying additional pressure on China on this issue, which could make it increasingly difficult for China to avoid making any changes.

Recently Chinese President Hu Jintao, when meeting with U.S. President Obama in Washington in April 2010, stressed the point that China will continue to "controllably, progressively, and steadily" pursue RMB exchange rate reform. However, the pace of this initiative will depend on China's economic and social development. The Chinese government insists that it will not pursue rapid reform simply in response to external pressure, as its number one concern is the welfare of its people. The current reform is built around a strategy of incremental policy maneuvers. In fact, since 2005, the RMB exchange rate has appreciated 21%. However, the goal for China in pursuing such reform is ultimately to maintain monetary sovereignty.

China's Central Bank has recently released its first quarter monetary policy report. In it is mentioned that the RMB exchange rate mechanism will continue its function of tracking "the supply and demand within the market with reference to a basket of currencies to regulate and manage a floating exchange rate system."¹ Mizuho Securities Asia chief economist for Greater China Shen Jianguang thinks this indicates that despite the recent international pressure for RMB appreciation, in the short term, there is not much room left in the market for much additional upward motion.

¹ YiXiaoShao, "〔人民币汇率〕一旦升值,中国纺织品出口企业将大量破产--协会副会长," March 29, 2010 Reuters, 编辑 Shu-zhenYang, <cn.reuters.com>.

V. RECENT DEVELOPMENTS

Signaling Possible RMB Appreciation

The New York Times on June 19 reported that China's central bank had signaled on Saturday evening that it may soon begin to allow for further flexibility in the valuation of its currency. The Times noted that this "could deflect growing international criticism of its economic policies and defuse one of the greatest sources of tension between Beijing and Washington, which was the clearest sign yet that the country would allow its currency to appreciate gradually against the dollar." This is a very timely announcement as world leaders will soon be meeting for the G20 summit in Toronto. Though this doesn't represent any tangible progress in the form of actual policy reform on the part of the Chinese, it does give hope that the international pressure being placed on the Chinese maybe be having an impact. The New York Times further reported that there was still a nationalistic undertone to the Chinese's currency discussions: "Cui Tiankai, a vice foreign minister, said on Friday that the value of the RMB was not a subject for global discussion, the latest in a series of remarks by Chinese officials indicating strong nationalistic sensitivities about currency policy." This still prevalent sentiment in China may signal that any significant changes in Chinese monetary policy may still be a long way off.

Export Tax Rebate Scale Backs

Ministry of Commerce spokesperson Yao Jian announced at a press conference on June 12 that the government will be drastically changing direction with regards to its export tax rebate policy. Beginning in July, a new wave of scale backs will be introduced affecting around 3,000 different products being exported out of China. These include zinc and tin products, pipes, foils, steel plates and rods, and galvanized metal products. Also on the list were many textiles, shoes, silver powder, certain alcohols, corn starch, some pesticides, pharmaceuticals, chemical products, certain plastics, rubber, and glass. Of the extensive list of products that will be affected, the steel industry will bear the brunt. In the 406 tax items covering steel, there are more than 40 different categories of steel products, including hot-rolled coil, plates, strips, and large H-shaped and angled steel.

International pressure in reaction to China's large trade surplus may largely be responsible for this sudden change of policy, as calls for an appreciation of the yuan and reactionary, protectionist trade policies abroad have been increasing over the past year. However, the Chinese government insists that its sole aim is simply to maintain trade stability. Also among the motivations are to decrease greenhouse gas emissions from the higher energy consumption industries (such as steel) as well as to avoid the potential over-heating of the Chinese economy reacting to the

4 trillion RMB stimulus that has been pumped into the economy in reaction to the global economic downturn.

To read more on China's export tax rebate policy, read the CPG white paper on the subject, which covers these recent changes in more depth as well as the history of these policies and their implementation in China.

VI. CONCLUSION

Though there may be no definite end in sight to this debate, it is clear that the arguments of both sides carry their share of validity. What the end result of this trade and currency fight will be however is still unknown. It is very likely that China will maintain its strong stance in resisting Western demands for further RMB appreciation. How international governmental and financial bodies emerge from the financial meltdown in 2008 and the current European debt crisis will have a major impact on how this debate will play out. There have been claims by economists that since the debt crisis in Europe has erupted, the stable rate of the RMB against the dollar has actually played a role in maintaining relative global stability for international financial institutions, acting as a firewall against the spread of financial risk, adding a welcome level of predictability in a global financial climate that is sorely lacking in it.

Currently however, uncertainty still largely abounds around the future of markets around the world, and the RMB has proven to be a convenient scapegoat for politicians seeking to appear proactive in their fight to boost their economies. Thus, if current headlines prove any indication, as long as this uncertainty remains, the pressure will continue to be put on China to revalue its currency in order to ease penetration of foreign firms into the vast Chinese market, while helping to boost domestic production by making Chinese goods relatively more expensive.

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