The Dollar versus the Yuan: China's Renminbi Announcement: A Big Head Fake

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The Chinese central bank made a vague announcement about its currency policy on its website today, which the officialdom, on cue, treated as a major move (to wit: "China vows increased currency flexibility" at the Financial Times, "Chinese say they intend to free up their currency," Washington Post).)

As we describe below, this "announcement" is basically a non-statement to silence Westerners calling for a revaluation in the runup to the Toronto G-20 meeting later this month.

This is the full text of its English version:

> In view of the recent economic situation and financial market developments at home and abroad, and the balance of payments (BOP) situation in China, the People´s Bank of China has decided to proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility.
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> Starting from July 21, 2005, China has moved into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Since then, the reform of the RMB exchange rate regime has been making steady progress, producing the anticipated results and playing a positive role.
>
> When the current round of international financial crisis was at its worst, the exchange rate of a number of sovereign currencies to the U.S. dollar depreciated by varying margins. The stability of the RMB exchange rate has played an important role in mitigating the crisis´ impact, contributing significantly to Asian and global recovery, and demonstrating China´s efforts in promoting global rebalancing.
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> The global economy is gradually recovering. The recovery and upturn of the Chinese economy has become more solid with the enhanced economic stability. It is desirable to proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility.
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> In further proceeding with reform of the RMB exchange rate regime, continued emphasis would be placed to reflecting market supply and demand with reference to a basket of currencies. The exchange rate floating bands will remain the same as previously announced in the inter-bank foreign exchange market.
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> China´s external trade is steadily becoming more balanced. The ratio of current account surplus to GDP, after a notable reduction in 2009, has been declining since the beginning of 2010. With the BOP account moving closer to

> equilibrium, the basis for large-scale appreciation of the RMB exchange rate does not exist. The People´s Bank of China will further enable market to play a fundamental role in resource allocation, promote a more balanced BOP account, maintain the RMB exchange rate basically stable at an adaptive and equilibrium level, and achieve the macroeconomic and financial stability in China.

There are some real internal inconsistencies. While this does represent an announcement of an intent to liberalize, it lacks any particulars as to timing and mechanisms. Moreover, it specifically rejects the idea of widening the bands in which the RMB trades, which is the litmus test of a move to a market-based exchange rate (you'd expect gradual widening of the permitted band as a precursor to abandoning currency intervention).

Instead, what this appears to signal is a shift of the basis for managing the currency to:

1. Use of a basket of reference currencies, rather than just the dollar. China is contending that that is what it has been doing since 2005, but the language allows for the possibility for a change in the mix. Thus this signals China's intent to move away from a dollar reserve currency regime (it has taken other measures along these lines, for instance, encouraging invoicing in currencies other than the dollar). The problem is that a permitted trading band vs. a basket of currencies is what China supposedly implemented in 2007, and the results have looked an awful lot like a dirty float against the dollar.

2. Arguing for the balance of payments as the metric of the appropriateness of the exchange rates. China contends that because its balance of payments is improving (as in its trade surplus is weakening) it really does not need to do much (as in it has ruled out a meaningful revaluation). This is essentially an argument that the large trade deficit for March means critics need to lay off, a posture it took in April. The problem, however, was the March deficit appears to have been the result of one-off factors. China's exports in May were larger than expected, due to more robust export growth. And note Chinese officials had expected exports to rise 50% over 2009.

The fact is, as Michael Pettis pointed out in his latest post, no country in modern times has ever run a trade surplus as a percent of GDP as large as China does. That means even if it does decide to extricate itself from this position, it will want to do so gradually. As Pettis noted:

> As a share of global GDP China's recent trade surpluses (roughly 0.6-0.7% of global GDP) are easily the highest recorded in the last 100 years.
>
> This is all the more striking when you consider that the two previous record holders, the US in the late 1920s (with a trade surplus equal roughly to 0.4% of global GDP) and Japan in the late 1980s (0.5% of global GDP), were relatively much larger economies. The US represented more than 30% of global GDP in the late 1920s, and Japan represented 15% of global GDP in the late 1980s. By contrast China represents only 8% of global GDP today.

In the same post, he also rejected the idea that China's trade balance is moderating:

> In other words the cost of capital for China's already too-capital-intensive and overinvesting economy is declining, and so worsening the domestic imbalances, and all but assuring that China's trade surplus excluding Europe

will surge (and maybe even including Europe it will still rise). In fact one of the least surprising of the "surprises" of recent months was China's May trade figures. Here is what an article on Thursday in the South China Morning Post says:

> Mainland's exports rose 48.5 per cent in May from a year earlier and imports were up 48.3 per cent, the General Administration of Customs said on Thursday, giving the country a trade surplus of US$19.53 billion, up from just US$1.7 billion in April. The median forecast of 32 economists polled by Reuters was for exports to rise 32 per cent and imports to climb 45 per cent, with a projected trade surplus of US$8.8 billion.
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> Sources said on Wednesday that export growth was up about 50 per cent from a year ago, giving a boost to global financial markets as investors expressed relief that the country's fast growing economy did not appear to be juddering to a sharp halt.

Some surprise, although I should add that I have a worrying feeling that the subsequent applause by the global stock markets may have got it exactly backwards. Net exports had to surge after the temporary contraction earlier this year, and in fact if you exclude the impact of commodity stockpiling, which overstates outflows due to consumption imports and understates outflows due to investment, China's trade surplus would have probably been much higher. It is being artificially reduced by commodity stockpiling, which of course must be reversed at some point in the future. I expect that Chinese net exports will continue very strong this year, perhaps even taking into account the effect of the European crisis, which should be excluded from the number. And of course I expect US net imports, and with it US unemployment, will surge to politically unacceptable levels throughout this year and next, thanks in large part the European crisis and the unwillingness of anyone else to absorb it.

With this as background, there is a completely different way to read the China announcement. Start from the top:

> Starting from July 21, 2005, China has moved into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Since then, the reform of the RMB exchange rate regime has been making steady progress, producing the anticipated results and playing a positive role.
>
> When the current round of international financial crisis was at its worst, the exchange rate of a number of sovereign currencies to the U.S. dollar depreciated by varying margins. The stability of the RMB exchange rate has played an important role in mitigating the crisis´ impact, contributing significantly to Asian and global recovery, and demonstrating China´s efforts in promoting global rebalancing.

First, the "basket of currencies" talk is technically accurate but misleading. China allowed for a widening of the band against the dollar and a smidge of appreciation. And the talk on what happened during the crisis is more than a bit of a distortion. China is effectively contending that by keeping its dollar peg during the crisis (when the dollar was rising, which was to China's disadvantage) it was being a good soldier and "promoting global rebalancing". Huh? Although China's trade surplus shrank in early 2009, the big story of

trade during the crisis was: 1. Trade volumes plunged and 2. China's surplus in quite a few months was at record levels. Why? Pretty much every other trade surplus nation saw its surplus collapse (Japan in particular, as its yen soared) and China got a disproportionate share of what trade there was. Calling that an effort to promote global rebalancing is a serious distortion. (By the way, old Asia hands will recall the US unwittingly promoted this construction, that of keeping a dollar peg when other currencies were depreciating as being pro-stability, during the 1997 Asian crisis, when China no doubt considered devaluing the renminbi, but stood pat at the US's request).

So as I read this announcement, China has committed to do…..absolutely nothing. In fact, this language could just as easily be used to justify shifting its dirty float to be against the dollar (which is now comparatively strong and will continue to be so as long as the eurozone is on its austerity kick) to putting greater weight upon the euro in its basket, which would lead to a devaluation against the dollar. Note I am not saying that will happen, but the announcement does not preclude that idea if China's trade surplus were to deteriorate.

Notice the goals the PBoC commits itself to meet:

> ….further enable market to play a fundamental role in resource allocation, promote a more balanced BOP account, maintain the RMB exchange rate basically stable at an adaptive and equilibrium level, and achieve the macroeconomic and financial stability in China.

Yves here. Note the contradictions: you can't have the market play a "fundamental role" in setting FX rates, and "maintain the RMB exchange rate basically stable." And China is not going to make any moves that compromise "macroeconomic and financial stability in China."

I'm not the only observer to read this announcement cynically. From the Wall Street Journal:

> Beijing's move may not, however, result in a large appreciation of the yuan. Cornell University economist Eswar Prasad, former head of the International Monetary Fund's China division, cautioned that Beijing is returning to a policy of linking the yuan to a basket of currencies, without identifying the composition of the basket.
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> About a quarter of China's trade is in euros, a currency that has been in a steep slide against the dollar recently. If the euro composes a large share of China's invisible basket, the yuan could actually weaken relative to the dollar, Mr. Prasad warned.
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> "If the world now says, 'Let your currency float against the dollar,' the Chinese could say, 'Do you really want it to depreciate?' " Mr. Prasad said, describing Beijing's move as "canny."
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> Mr. Prasad said China's main concession was therefore not the content of its new policy, a return to the one that was in place before the global financial crisis. Rather, Beijing's principal shift was in the timing, offering at least a symbolic gesture ahead of the summit in Toronto next weekend of leaders from the Group of 20 major industrialized and emerging economies.
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> "They've actually accomplished two significant objectives," Mr. Prasad said. "They"re taking away the political heat, but without significantly affecting their export competitiveness."

So what does this announcement really achieve? Buy time. As we noted, there was a firestorm of criticism in Washington over the sharp rise in Chinese exports in May. This announcement comes right before the G20 meeting, where China was sure to come under attack if nothing appeared to have changed. The Administration really does not want a row with China right now; Geithner was clearly reluctant to brand China a currency manipulator (as he was being pushed to do by Congress in April, when China miraculously announced a trade deficit right before the required Treasury semi-annual window) and now has even less reason to want to, given that we are looking for China's support in the row between North and South Korea over North Korea's alleged sinking of a South Korean warship and in sanctions against Iran.

So not surprisingly, the Administration is playing along and touting this non-commitment as meaningful. From Bloomberg:

> Geithner, in a statement, praised China's decision and added that "vigorous implementation would make a positive contribution to strong and balanced global growth." The Obama administration received advance notice of the announcement, U.S. officials said.

And analysts are also talking China's book while pointing out that this takes the heat off China for now:

> "It makes it a lot more difficult for Washington and Congress to do China bashing," {Goldman Sachs Group Inc. Chief Global Economist Jim] O'Neill said. "The Chinese are increasingly confident they can make this adjustment to a domestic-driven economy rather than the one relying on exporting low-value-added stuff to the rest of the world."

But as Pettis pointed out, China has been increasingly reliant on investment as a source of growth, simply unheard of levels relative to GDP. And he points out another not widely recognized fact: this actually impedes the process of shifting to more consumption, which is necessary for China to become less export oriented (ie, it has plenty of opportunity to sell goods internally if it can increase income levels and consumption rates over time);

> More importantly, China's financial repression is also at the heart of the imbalance in the Chinese economy. By transferring large amounts of wealth from the household sector to net borrowers (perhaps as much as 5-10% of GDP annually, as I explain in an earlier entry), it creates the large growth differential between national GDP and household income that is at the root of China's very high savings and very low consumption levels.
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> I should add that if much of this investment is non-economic, as I believe it is, this will exacerbate even further the differential. Why? Because the total economic cost of the investment (which must include the real debt forgiveness implied by excessively low interest rates), and which will be borne over the future as the cost are amortized in the form of debt repayment, exceeds the total economic value of the investment (which must include externalities), which will accrue upfront. This means that we get more investment-driven growth today and less consumption-driven growth tomorrow.

The Chinese officialdom clearly can, at any point, announce and implement policies to move

the RMB either higher relative to other currencies and/or allow wider trading bands as a way to move towards a less controlled currency regime. But I don't see any reason to expect it to happen until China gets more pushback from its trading partners. Their enthusiastic responses to this noncommittal announcement seem likely to insure that has been kicked down the road until China's continuing trade surpluses force politicians to turn the heat back on.

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