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Depreciation of the Renminbi: A Boost to China's Economy

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Abstract: **Since the middle of the 1990s, China's economy has experienced spectacular growth in its exports. It enabled the country to maintain a highly favourable trade balance with the majority of its trading partners as well as substantial foreign exchange reserves. China has been accused by its trading partners of maintaining a depreciated currency in order to keep its exports high while maintaining cost competitiveness for its goods on the world market.**

By the middle of 2010, China was under increasing pressure from all sides to revalue its currency in order to reflect the true value of the Yuan in comparison to other currencies. China stayed silent on the subject, but economic analysts predicted that sooner or later it would have to give in to pressure. They added that a currency revaluation might not have an immediate impact.

Keywords: **Import, Export, USD, Yuan, Currency Valuation, Exchange Rate Management, Forex, Imports, Exports, Foreign Trade, Forex, Inflation, Trade Deficit, Nominal Effective Exchange Rates, Real Effective Exchange Rates, World Market.**

1. INTRODUCTION

In 2010, the charge that China was persistently undervaluing its currency, the Yuan, took centre stage in discussions about global economic policy. The Yuan has been devalued by as much as 22.5% by the middle of the 2000s. According to experts, the undervaluation of the Chinese Yuan was having an impact on other nations and was causing trade imbalances with China in many nations, particularly the United States. The Yuan was allegedly intentionally kept low to encourage exports, which resulted in enormous trade surpluses for China but bilateral trade deficits for the rest of the world, according to the United States, the European Union, and other trading partners of China. For instance, in 2009, China's exports to the United States were more than four times more than its purchases from that nation, resulting in a trade surplus of USD 198 billion with the rest of the world. China, meanwhile, insisted that its currency was not materially undervalued and that it was proceeding ahead with its currency reforms. The Chinese Central Bank, People's Bank of China (PBoC), stated, "China's central bank has decided to further promote the reform in the Yuan exchange rate mechanism, and strengthen the flexibility of the Yuan exchange rate."

Analysts have differing views on the issues brought on by the purported undervaluation of the Yuan by China's trading partners. Leading economist and Nobel Prize winner Paul Krugman made the case that maintaining this level of current account surplus has resulted in employment losses in its trade partners. He stated: "China's currency is tied by government policy at around 6.8 Yuan to the Dollar, unlike the Dollar, the Euro, or the Yen, whose values fluctuate freely. Chinese manufacturing has a significant cost advantage over its competitors at current exchange rate, resulting in massive trade surpluses." Western commentators said that China's cost advantages were promoting the offshoring of production to the nation, putting other firms out of business, leading to job losses, and distorting trade balances in western nations. Many Chinese officials and economists, however, contended that China was not to blame for the high unemployment rates and current account deficits that the US and other western nations were experiencing. Yiping Huang, a professor of economics at Peking University, China stated, "Indeed, the United States began to lose manufacturing jobs well before China emerged as the global manufacturing center earlier this decade. Indeed, America's current-account deficits started to expand rapidly in the late 1990s, but the surge of China's current-account surplus occurred after 2004. Blaming China for causing America's economic problems appears at odds with common sense." He added, "China, the United States, and other nations will need to cooperate and enact more thorough reform packages to address the issue of global imbalance, paying particular attention to both internal structural changes and the exchange rate system in each of their individual countries. It is probably futile and counterproductive to concentrate solely on the Yuan exchange rate problem. The Yuan gained 22% versus the dollar and 16% in real effective terms between mid-2005 and mid-2008. However, China's foreign imbalances were becoming worse and worse." Economists were analysing the harmful implications of the purported undervaluation of the Chinese currency and potential solutions to those effects in the middle of these divergent viewpoints.

Information

Late in the 1970s, China, which had a conventional, centrally planned economy and had little trade with the rest of the world, started implementing economic reforms. Starting with the gradual end of collectivised agriculture, the economic reforms subsequently included many other aspects of the economy, such as the exchange rate system, as well as the progressive liberalisation of pricing and fiscal decentralisation. China had fixed the Yuan at 2.46 to the USD ever since gaining independence in 1949. The Yuan progressively increased during the 1970s until it reached 1.50 Yuan per USD in 1980. The Chinese government, however, saw the need to increase the competitiveness of Chinese exports in the international markets throughout the 1980s while economic reforms were underway. The Yuan's value declined over time, hitting a low of 8.62 Yuan per USD in 1994 before marginally gaining to 8.27 Yuan per USD in 1997. According to economists, the Chinese government's decision to retain a peg of 8.27 Yuan per USD from 1997 to 2005 was due to expanding exports and the inflation in the current account balance that resulted from them during the late 1990s (Refer to Exhibit I and II for growth in exports and current account). China linked the Yuan to a basket of currencies in July 2005 and increased the value of its currency by 2.1% in relation to the US dollar. The Yuan rose more than 20% cumulatively versus the USD since the peg's removal in 2005, although it remained essentially tied after the start of the global financial crisis until June 2010.

Over time, the Yuan's value stayed steady when compared to the US dollar, but it changed significantly when compared to a basket of currencies. The Yuan increased by over 20% in the three years after 2005. As a result, China once more adopted the dollar peg in an effort to stop the Yuan's appreciation. As of 2010, there was a plus/minus 0.5% volatility between the Yuan and the USD. (Exhibit III the Yuan's movement both before and after the announcement that it was linked to a basket of currencies in July 2005.) A true relationship between the Yuan and the basket of currencies, according to economists, would have resulted in more stable fluctuations. China had maintained a Yuan/USD exchange rate of 6.83 since 2008 (Refer to Exhibit IV for the movement of Yuan). With the help of this peg, the country was able to maintain a 9% annual GDP growth rate (Refer to Exhibit V for China’s GDP growth) while still maintaining control over the formerly high inflation rate. (Refer to Exhibit VI for Inflation)

However, China was coming under increasing international pressure to devalue the Yuan. In June 2010, US Treasury Secretary, Timothy Geithner, said, "The distortions caused by China's exchange rate spread far beyond China's borders and are an impediment to the global rebalancing we need.” According to experts, the currency problem has put China and the United States on a ‘collision path.’ The probability of a collision course on China's currency peg and a larger trade divide between the world's top debtor and creditor nations has increased dramatically in recent months, according to renowned economist and New York University professor Nouriel Roubini. He said that there was a 50% probability that the United States will accuse China of manipulating its currency.

The People's Bank of China (PBoC) removed the Yuan's 23-month peg to the dollar in mid-June 2010, capitulating to external pressure in an effort to increase flexibility while maintaining the currency's stability. Since then, the Yuan's appreciation versus the dollar has reached 0.8%. The Yuan appreciated from 8.1943 to 6.8249 per USD between 2005 and 2009. The current account balance decreased as a result of the appreciation from $426.1 billion in 2008 to $297.1 billion in 2009. Exports decreased somewhat from $1.4307 trillion in 2008 to $1.201 trillion in 2009 as a result of the appreciating Yuan (Refer to Exhibit VII for China’s trade with the world). Some economists argued that it was China's undervalued Yuan which had induced export-led growth, resulting in a current account surplus, which in turn, had reduced China's vulnerability to external shocks. Other significant elements of the Chinese economy were impacted by the undervaluation of the Yuan in addition to export growth and current account balances.

The Yuan's depreciation and its implications for China

The appreciation of the USD caused the nominal effective exchange rate (NEER) to increase by over 40% between 1994 and the beginning of 2002 (Exhibit VIII shows REER and NEER nominal effective exchange rate for China from January 1994 to June 2010). Since 2002, the Yuan has lost about 10% of its value due to the weakening US dollar, albeit some of that loss has been somewhat mitigated by China's very low inflation rate. Only 2% had been lost in the real effective exchange rate (REER). The REER had risen about 50% by June 2010 compared to its early 1994 level.

China had been reporting an annual current account surplus. Except for the time during the Asian financial crisis, when money fled the nation, the current account surplus had persisted since 1994. Net FDI inflow was one of the factors contributing to the current account surplus. Due to anticipation about the Yuan's potential to appreciate, foreign capital had been entering China at a very rapid rate. Additionally, trade analysts said that China's appeal as a location for foreign direct investments in export-oriented production facilities had increased as a result of the undervalued Yuan.

Analysts noted that China was increasing market share abroad at the expense of other countries, resulting in economic imbalances for those countries. The fact that China had managed to sustain a period of rapid growth, low inflation, and a stable financial system was also mentioned (Refer to Exhibit IX for growth in trade surplus). China's Yuan undervaluation led to an increase in its foreign exchange reserves as well as a trade surplus (and a trade deficit) with the United States (Refer to Exhibit X for growth in forex reserve). According to economists, the enormous foreign exchange reserves would have allowed the Yuan to float freely and increase in value over time. Due to stringent controls on capital inflows and outflows and the Yuan's partial non-convertibility on international markets, China was able to preserve significant foreign exchange reserves.

Global imbalances were also attributed to the devalued Yuan. The United States was reportedly the main victim of the undervaluation of the Yuan (Refer to Exhibit IX showing the deficit suffered by the United States in trade with China). A sizable chunk of the United States' overall deficit was due to its trade deficit with China. 2010 had the highest bilateral trade deficit between the United States and China since 2000 ($273 billion), an increase of about 20% over 2009. According to Thomas Lum and Dick K. Nanto (2007), "The possible problems or challenges raised by the United States strategy of economic engagement with China include adjusting to economic competition in sectors where China has a comparative advantage, responding to PRC (People's Republic of China) unfair trade practices, and the rise of an economically powerful China that is becoming more assertive in global affairs: (1) Imports from China may be entering in such increased quantities that they are a substantial cause of serious injury, or threat thereof, to competing United States industries; (2) Imports from China may be dumped, subsidized, or unfairly aided by government entities in China, which still wield considerable influence in the economy' (3) According to some economists and policymakers, the United States trade deficit with the PRX stems in large part from Beijing's policy of maintaining an undervalued currency; (4) China has a poor record of adopting or enforcing internationally recognised standards for working conditions and environmental regulation which, in addition to violating human rights and harming the environment, may prove PRC businesses with unfair competitive advantages; and (5) United States economic engagement with China arguably contributes to the legitimacy of the socialist government and the strengthening of China's military by facilitating general economic development."

Due to its trade deficit with other Asian economies, China's overall surplus was substantially lower than its surplus with the United States. According to many economists, for the US current account deficit to decrease to levels that are sustainable, the US REER must depreciate by at least 15% to 20%. The adjustment in the exchange rate was expected to help improve the global imbalances only if the savings and investment imbalances of the United States were addressed.

2. CONCLUSION

Even though China benefited from the undervalued Yuan, analysts warned that growth fostered by the undervalued Yuan could not always be beneficial. China could suffer considerable losses as a result of currency undervaluation; however, these losses might not have an immediate impact. First, a greater inflation rate could result from the devalued Yuan. The only process that can result in higher pricing in comparison to other trading partners is adjustment through the real exchange rate if the exchange rate does not increase in nominal terms.

Second, by keeping the Yuan undervalued, China may incur higher import expenses. A country's terms of trade would be higher if its currency was trading at a higher (undervalued) rate. According to statistics from the Chinese Customs, about half of the imports into China were for domestic use. Therefore, the opportunity cost of a higher exchange rate would be partially reflected in resisted current consumption and partially resisted domestic investment, which would result in reduced future consumption.

Furthermore, the significant stock of accumulated foreign reserves could potentially result in opportunity cost (as a result of the undervalued yuan). If not, the foreign reserves may have been used to pay off the US $443.2 billion in foreign debt as of the end of March 2010.

China's capital and current account flow imbalance was extremely large. The majority of research concluded that a real Chinese currency appreciation of between 15% and 30% could be necessary to establish a real macroeconomic balance in the medium term, while the precise amount depended on the equilibrium exchange rate model used.

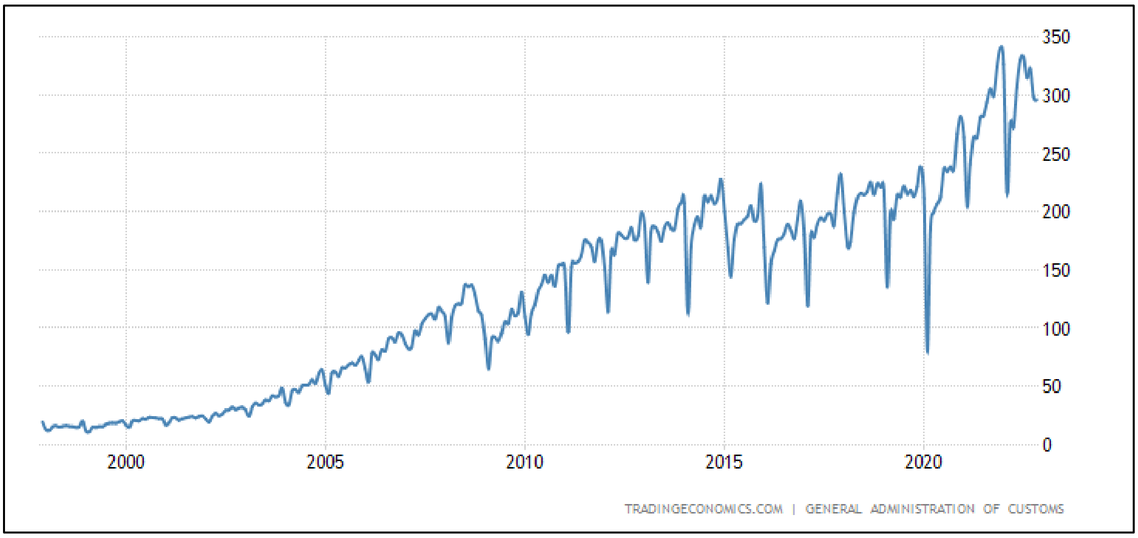
One of the topics that generated a lot of discussion was the Yuan's contribution to the external balance of the United States. However, many analysts believed that the Yuan's appreciation would only slightly increase the dollar's decline, which may be necessary to reduce the United States' current account deficit to a manageable level.

For China to move to a more flexible exchange rate regime would be a gradual and slow process. This movement toward a flexible system was constrained by the country's weak and underdeveloped banking system. So, a flexible rate regime had to be preceded by a sound financial system so that there would be no major destabilizations in the Chinese economy. This was due to the fact that Chinese banks had a net surplus of foreign assets, and an increase in the value of the Yuan would negatively impact their balance sheets. Additionally, it was believed that Chinese banks lacked the necessary expertise to manage the foreign exchange risk. Therefore, this must have happened gradually.

Exhibit I

Exports of China

(in USD billion)

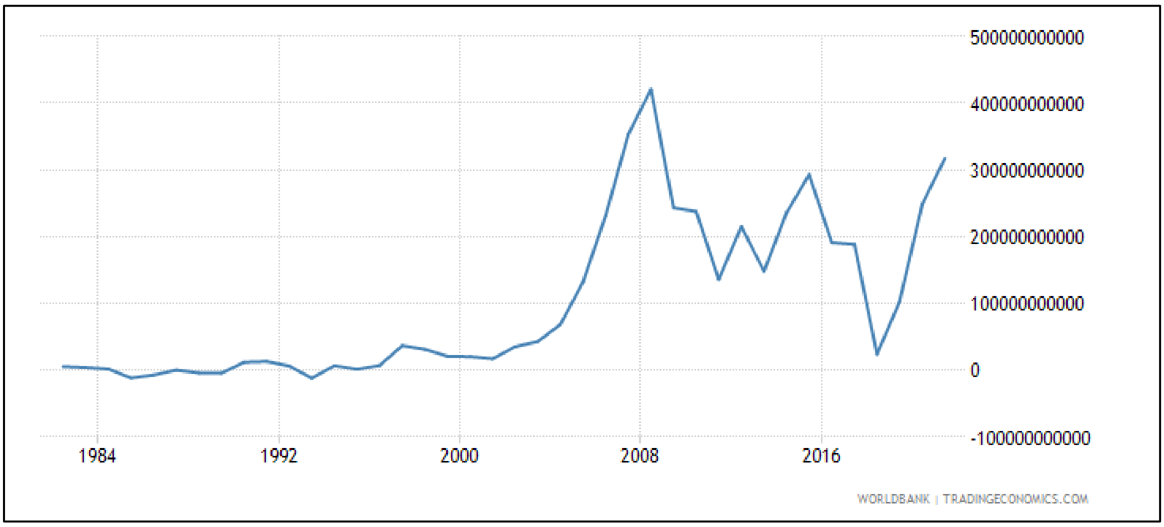


Source: TRADING ECONOMICS | 20 million INDICATORS FROM 196 COUNTRIES

Exhibit II

Current Account Balance of China

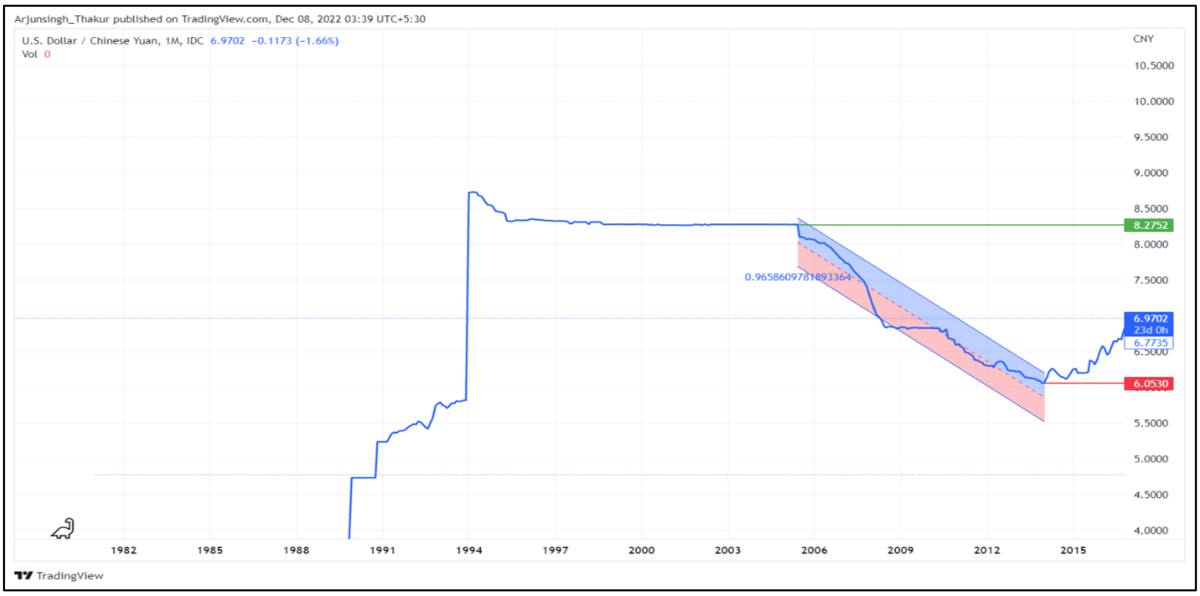
(in USD)



Source: TRADING ECONOMICS | 20 million INDICATORS FROM 196 COUNTRIES

Exhibit III

Yuan per USD



Source: www.tradingview.com

Exhibit IV

Movement of Yuan

Time	Yuan per SDR (End of the Period)	Yuan per USD (End of the Period)
1999	11.3505	8.2793
2000	10.7859	8.2781
2001	10.3923	8.2766
2002	11.2123	8.2773
2003	12.2989	8.2767
2004	12.8535	8.2765
2005	11.5345	2.0702
2006	11.7474	7.8087
2007	11.5302	7.3046
2008	10.5271	6.8346
2009	10.7045	6.8282
2010	10.1992	6.6227

Source: The People's Bank of China (PBoC), 中国人民银行 (pbc.gov.cn)

Exhibit V

China's Real Growth Rate

Year	GDP Growth Rate
2002	8.00%
2003	9.10%
2004	9.10%
2005	10.2%
2006	10.7%
2007	11.9%
2008	9.00%
2009	9.10%
2010	10.3%

Source: "China GDP – Real Growth Rate," IndexMundi - Country Facts

Exhibit VI

Inflation Rate in China

Year	Inflation Rate (Consumer Prices %)
2000	-1.3
2001	0.4
2002	-0.8
2003	-0.8
2004	1.2
2005	4.1
2006	1.8
2007	1.5
2008	4.8
2009	5.9

Source: "China Inflation Rate (consumer prices)," IndexMundi - Country Facts

Exhibit VII

China's Trade with the World (US$ billion)

Year	Exports	% Change	Imports	% Change
2002	325.6		295.3	
2003	436.1	33.94	397.4	34.58
2004	583.1	33.71	552.4	39.00
2005	752.2	29.00	631.8	14.37
2006	974.0	29.49	777.9	23.12
2007	1220	25.26	904.6	16.29
2008	1435	17.62	1074	18.73
2009	1204	-16.10	954.3	-11.15
2010	1506	25.08	1307	36.96

Source: IndexMundi - Country Facts

Exhibit VIII

Movement of REER and NEER

Time	NEER	REER
1994	84.70	88.59
1995	86.47	95.19
1996	90.83	103.6
1997	104.4	116.1
1998	102.5	109.6
1999	102.7	106.8
2000	109.5	113.0
2001	114.5	116.4
2002	109.9	108.8
2003	101.2	101.8
2004	96.36	96.95
2005	104.1	103.8
2006	102.2	102.7
2007	103.6	107.3
2008	118.1	121.2
2009	111.7	115.1
2010	117.4	118.8

Source: "BIS Effective Exchange Rates," Bank for International Settlements (bis.org)

Exhibit IX

US Foreign Trade with China

Year	Exports	Imports	Balance
1999	13,111.10	81,788.20	-68,677.10
2000	16,185.20	100,018.2	-83,833.00
2001	19.182.30	102,278.4	-83,096.10
2002	22,127.50	125,192.6	-103,064.9
2003	28,367.90	152,436.1	-124,068.2
2004	34,427.80	196,682.0	-162,254.3
2005	41,192.00	243,270.1	-202,278.1
2006	53,673.00	287,774.4	-234,101.3
2007	62,936.90	321,443.9	-258,506.0
2008	69,732.80	337,772.6	-268,039.8
2009	69,496.70	296,373.9	-226,877.2
2010	91,878.30	364,943.8	-273,065.5

NOTE: All figures are in millions of U.S. dollars on a nominal basis, not seasonally adjusted unless otherwise specified.

Source: "Trade in Goods with China," Census.gov

Exhibit X

China's Foreign Reserves

Time	Foreign Reserves (US$ billions)
Jun, 2009	2,131.60
Jul, 2009	2,174.60
Aug, 2009	2,210.80
Sep, 2009	2,272.60
Oct, 2009	2,328.30
Nov, 2009	2,388.80
Dec, 2009	2,399.20
Jan, 2010	2,415.20
Feb, 2010	2,424.60
Mar, 2010	2,447.10
Apr, 2010	2,490.50
May, 2010	2,439.50
Jun, 2010	2,454.30

Source: "China's Foreign Exchange Reserves, 1977-2011," China Ability – money & wealth (chinability.com)

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