Analysis on RMB Exchange Rate Policy

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Abstract

Based on this global environment, this essay will first present basic concepts of RMB exchange rate policy and its evolution history, then discuss some important challenges from the global perspective that the Chinese government meets in terms of the increasingly undervalued exchange rate, thirdly argue that China cannot take a substantial appreciation, Finally discuss whether China should take a gradual appreciation by comparing its advantages and disadvantages.

Key words: RMB, exchange rate policy, reform

1. Introduction

Although Chinese exchange rate regime has transferred to manage floating exchange rate system, there are many people arguing that the current exchange rate policy is not fair and scientific like leading to trade deficits and unemployment in other countries, and thus attempt to force China to substantially appreciate RMB by some measures. For example, Currency Reform for Fair Trade Act (H.R. 2378) was employed as a tool intending to put pressure on Chinese government to substantially appreciate RMB. It was passed by the US house on September 29, 2010 (China Daily, 2010). Meanwhile, Chinese government has its own reform agenda. For instance, on April 14, 2012, People's Bank of China has announced that since April 16, 2012, RMB's exchange rate is allowed to swing within a range of ±0.5% around the central parity set by PBC in 2007 to ±1%, at the same time, RMB had appreciated to RMB 6.2920 per dollar, the highest point since the reform. Plus, on April 18, 2017, the rate is RMB 6.8885 per dollar, which tell us that the big change of the RMB exchange rate.

2. Definition & History of RMB Exchange Rate Policy

2.1 An Overview of Basic Concepts

The exchange rate regime means one state manages its currency in correlation between other currencies and the foreign exchange market which is closely related to monetary policy. Generally speaking, they are dependent on many of the same factors.

There are some basic types of exchange rate regime. Firstly, it is floating exchange rate, where the market gives orders for movements in the exchange rate; secondly, a pegged float

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exchange rate, where a central bank keeps the rate from diverging too far from a target band or value; and thirdly, a fixed exchange rate, which ties the currency to another currency, mostly more widespread currencies such as the U.S. dollar or the euro or a basket of currencies (Wikipedia, 2012).

2.2 History of RMB Exchange Rate Policy

Chinese exchange rate regime has changed from centrally planning to market oriented one since the creation of RMB and it can be divided into four stages.

The first stage refers to the period of central planning in China before 1979. The foreign exchange management system pursued an import-substitution development strategy, under which the RMB exchange rate was fixed and overvalued. It resulted in huge losses from increased export costs when agricultural and industrial reform was introduced (Liew and Wu, 2007).

To reverse the above tendency, dual-track exchange rate system was established between 1979 and 1993. Generally speaking, RMB was always devalued based on economic fundamentals at that time (Wang, 2004). Since 1981, the dual-track system included an official exchange rate and an internal settlement rate. The former was depreciated by 93.3% until 1985, the latter fixed at RMB 2.8 per dollar played a major role (Guo and Han, 2004), and thus the regime can be categorized as a pegged system. However, it did not work well. In 1985, it transferred to another consisting of official exchange rate and the swap rate. At this stage, swap rates determined by the market imposed a crucial impact on foreign exchange trades, thus classified the regime as the managed floating one (Guo and Han, 2004).

At the end of 1993, when RMB’s official exchange rate and swap rate were unified at RMB 8.7 per dollar, official unified managed floating exchange rate regime based on market demand and supply was adopted (Lin and Schramm, 2003; Hu, 2010). Although the new regime allowed RMB’s exchange rate to float within some reasonable ranges, it was still under pegged system tying RMB to the US dollar. The reason is Bank of China practically controlled foreign exchange transactions and kept RMB per dollar constant (Lin and Schramm, 2003). During the 1997 Asian financial crisis, however, it was widely agreed that RMB’s exchange rate was only depreciated by RMB 0.01 per dollar which against the public expectation to have a large devaluation (Lin and Schramm, 2003). After that, the rate remained at RMB 8.28 per dollar until 2005 (Guo and Han, 2004).

With a view to improve the socialist market economy in China, and the pressure to depreciate RMB plus to be a free floating exchange rate regime, the above regime was transferred. It changed to managed floating exchange rate one in terms of market demand and supply with reference to a basket of currencies (including the US dollar, Euro, Japanese Yen as well as other countries’ currencies, rather than just the US dollar) since July 21, 2005. Under the new regime, RMB was appreciated by 2.1% to RMB 8.11 per dollar immediately and it seemed that it kept appreciating for a long time (Liew and Wu, 2007). To address the financial crisis,
although RMB’s appreciation was slowed down, China still committed to keep exchange rate constant while other countries depreciated their currency dramatically, which helped mitigate the negative impacts of crisis on the whole world (Hu, 2010). When global economy recovered on June 19, 2010, PBC announced to further reform to help exchange rate more flexible (Hu, 2010). On April 14, 2012, People's Bank of China has announced that since April 16, 2012, RMB’s exchange rate is allowed to swing within a range of ±0.5% around the central parity set by PBC in 2007 to ±1%. In addition, on April 14, 2012, RMB had appreciated to RMB 6.2920 per dollar, the highest point since the reform.

3. Challenge & Pressure of Undervalued RMB Exchange Rate

Nearly seven years have passed since China announced a number of changes to foreign exchange regime on July 21, 2005. During this period, the debate on the pros and cons of China’s exchange rate policy becomes more and more frequent. This part is to identify and discuss some important challenges that the Chinese government meets in terms of the increasingly undervalued exchange rate. with china’s economic development and especially its massive international trade surplus with the rest of the world, the RMB exchange rate policy making meets external pressures and domestic politics.

3.1 Internal Challenge

An undervalued exchange rate and along with the foreign exchange reserves will be discussed. It leads to several economic challenges for the Chinese government. In this part, firstly, challenges for the independence of monetary policy will be discussed, then the rebalance of economic growth, thirdly the consistent efforts to reform the banking system of China, finally China’s external adjustment and its contribution to correcting global payments imbalances.

According to Anderson (2004) “China can run an independent monetary policy under any RMB regime.” It is just one of various thoughts and beliefs argue that China diverges substantially from the small open economy. The application of China’s monetary policy may obstructed by RMB undervalued exchange rate.

China has yet to transition to a more consumption-drive growth road. Indeed, growth has become even more unbalanced, which is shown in the declining consumption share of GDP. This is not just because the Chinese government has not undertaken sufficient exchange rate adjustment, but also has neglected to implement the fiscal and financial policies. There policies can be used for supporting the transition to more consumption driven growth (Lardy 2007).

To some extent, a more flexible and a more appreciated RMB exchange rate would affect the reform of banks positively and constructively. While in real, with the effects of further capital account liberalization, the outcome of currency reform has always been puzzled. Indeed, the banking system still has some urgent weaknesses and faces a number of challenges walking forward.
China’s own external adjustment can be guided positively by RMB exchange rate policy. From an international perspective, it has practical implication for the correction of global imbalances. But in real world, certain powerful country owes its own problem to the excuse that trouble is caused due to undervalued RMB exchange rate which will be talked about in details later subchapter.

3.2 External Pressure

According to Article 4 of the IMF Agreement and the New Decision of Bilateral Surveillance over Member’s Policies, when there is a large international payment surplus and deficit in a country caused by exchange rate manipulation, external instability or a crucial deviation of exchange rate, the country and other relevant countries have the responsibility to revise exchange rate to keep the balance of payment (Han, 2008). Many countries like the US consider their large trade deficits as important evidence that RMB is manipulated by Chinese government. In addition, Cline (2010) argued that undervalued RMB has played an important role in the US’s unemployment problem. However, others refute that the US trade deficits and unemployment problem are not caused by Chinese exchange rate. Some reports show that, the US trade deficits to China dropped by more than 400 million dollars while the unemployed increased dramatically by more than 1.5 million compared to the data in the previous year. There was hardly any change in Chinese exchange rate at the same period (He, 2010). Furthermore, people point out that the demographic dividend effect and the position China stand in the global industrial chain, rather than Chinese exchange rate, contribute to the trade deficits in other countries (Zhang, 2010; He, 2010; Changjiang Securities, 2010). Therefore, it can be definitely claimed that the US trade deficits and unemployment are not related to Chinese exchange rate. As a result, China does not have the responsibility to adjust it, not to mention taking a rapid and substantial appreciation.

4. Implication and Options of Future RMB Exchange Rate Policy

4.1 Substantial Appreciation

There are some people who hold the opinion that China should take a rapid substantial RMB appreciation. However, Chinese Premier Wen Jiaobao said on Europe-China summit in Brussels that if China appreciates RMB by 20 percent to 40 percent as some people requiring, many import related factories will shut down and the Chinese society will be in chaos, it is truly a disaster for the whole world (CBN, 2010). For instance, China Chamber of Commerce for Import and Export of Textiles claims a similar result. Through a pressure test directed towards the textile industry, with other variables fixed, which shows that China’s textile factories only have an average profit rate from 3 to 5 percent. These factories’ profits will decrease by 1 percent when RMB is appreciated by 1 percent (Zhang et al., 2011). Therefore the industry is vulnerable to RMB’s appreciation. In addition, the Relative Purchasing Power Parity theory demonstrates that the currency of a country with relative high inflation tends to depreciate (Eiteman et al, 2010). From this evidence, we can predict that China does not have the ability to perform a rapid substantial appreciation of RMB in the near future.
4.2 Gradual Appreciation

In terms of disadvantages of gradual appreciation of RMB, firstly, the certain appreciation expectation will make hot money problem more serious which China has already faced to. The difference between one year deposit rate in the US (0%) and that in China (3.5%), and the fact that China is less hit by the financial crisis. It has already attracted hot money into China. According to the price of one year NDF, RMB’s appreciation expectation is between 3% and 5%, definitely aggravating the hot money inflow (Zhang, 2010). The large amount of hot money can cause imported inflation, which will create assets bubble and damage China’s financial stability. During the process of gradual appreciation of RMB, another tough challenge that Chinese government facing is that how to minimize the unfavorable impacts it causes on the labor intensive industries. Whether Chinese government can solve the unemployment problem properly determines whether China can continuously maintain a harmonious society (Bi et al., 2009). Moreover, China will suffer a certain amount of loss when gradually appreciates RMB since China hold foreign exchange reserve of $3,181 billion. To prevent further dollar depreciation, China cannot decrease its dollar reserve by selling it (State Administration of Foreign Exchange, 2011)

5. Conclusion

Based on the above views and analysis, it is reasonably believed that although gradual RMB’s appreciation imposes negative impacts to some extent, the negative impacts are overwhelmed by the positive aspects. Measures can be taken by gradual appreciation like the economic structure reform and industry upgrade, increasing foreign investment and price advantage taken by Chinese citizens and industries. Thus, gradual appreciation of RMB has become an imperative in China.

References

