BlackRock Global Watch
Chinese currency reform: a broader perspective

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By Ken Liow and Linda Glassborow
Investment Strategy – Scientific Active Equity (Aust)

On 19 June 2010, merely a week prior to the G-20 summit in Toronto, the People's Bank of China (PBoC) announced its decision to proceed further with reform of the Renminbi (RMB) exchange rate regime. The RMB would be permitted to vary, upwards and downwards, within a floating band of 0.5% around a reference basket of currencies. The specifics of the currency basket were not released.

Increasing vocal attention on the part of US legislators and Treasury officials had raised the prospect of China being declared a currency manipulator by the Obama regime in a regular Treasury review. This may have sparked the prospect of a round of protectionist measures with unknown downstream effects. In the event, the date of issuance (8 July 2010) passed without fanfare. In fact, the US has not cited a country for currency manipulation since 1994 – interestingly this last country was China.

Two widely known quips come to mind which go some way towards capturing background to the rancour over China's continued official reserve accumulation:

> ***"It's the economy, stupid"***
>
> – William Jefferson Clinton, President of the US 1993–2001
>
> ***"Never let a serious crisis go to waste"***
>
> – Rahm Emanuel, Chief of Staff to US President Obama 2009

As unemployment in the US remained stubbornly fixed at nearly 10%, despite a fiscal package that saw the federal deficit exceed USD 1 trillion and extremely accommodative monetary settings remaining, the US political calendar was firmly focused on upcoming mid-term elections in the US Congress. Although he emerged successfully from a bruising political battle on healthcare reform, President Obama, and the Democratic Party more generally, failed to staunch a decline in popularity. It seemed increasingly likely that the Democrats would lose control of the House of Representatives in the November elections.

As these developments unfolded, political affronts on the Chinese currency policy grew ever more shrill. Reports of yawning bilateral trade deficits, loss of US factory jobs and other similar material regularly secured headlines.

The announcement of currency reform helped to communicate China's intentions to the world at large and helped move the fixed peg against the US dollar from the headlines. However, many issues received scant attention or were portrayed for political impact.

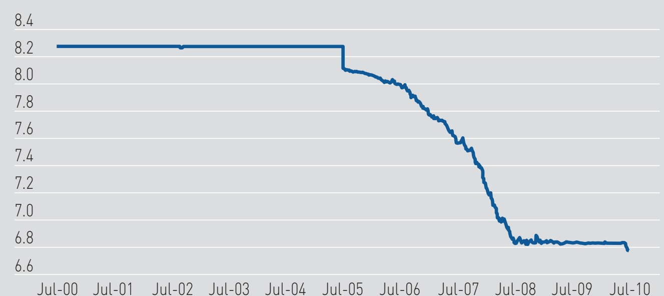
What is the likely impact of a rebalancing of China's trade balance? Why did China pursue such a policy in the first place? How is the peg managed and what can go wrong with this arrangement? Did the policy actually cost US jobs? In the coming pages, we provide a slightly deeper examination of the underlying issues.

A continuation of reform

China had long maintained a fixed peg to the USD at a rate of exchange approximating 8.28 RMB per US dollar. The numbers 8 and 2 have significance in Chinese culture. The number 8 is a homophone for "prosperity" and the number 2 is a homophone for the term "easy".

Commencing on 21 July 2005, the fixed peg was reformed. The rate of exchange against the USD gradually weakened as the RMB was permitted to appreciate in a steady fashion. The process was halted during the financial crisis in 2008, but resumed in June 2010 and has since continued its prior path. Refer Chart 1 below.

Chart 1: Chinese Renminbi per US Dollar



Source: WM/Reuters, FactSet

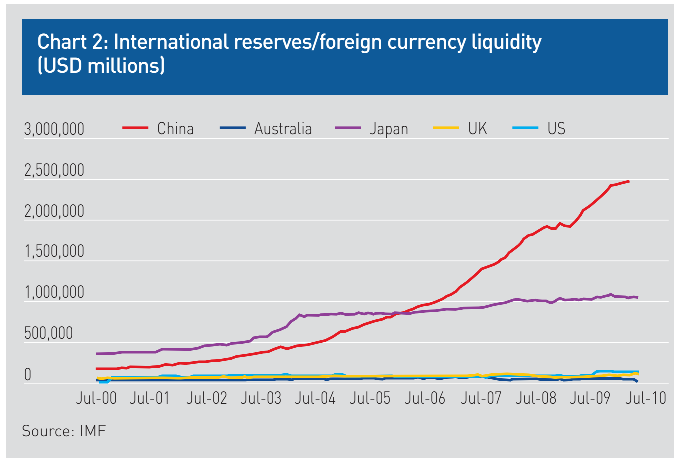
Managing exchange rates and foreign currency reserve accumulation

The PBoC maintains and manages the exchange rate by acquiring USD (and other currencies) from various points in the state banking system. The PBoC offers RMB denominated assets in exchange for these foreign currencies to facilitate transactions within China. The foreign currencies are then invested in foreign assets, mostly government bonds of various maturities.

Maintaining or managing a currency peg with an under-developed banking system, as present in China, is challenging. Although the PBoC employs various tools to ration the creation of credit in the economy, the process of managing the money supply in such situations is subject to error. If the PBoC miscalculates and leaves too much RMB in the financial system, for example, asset bubbles may form over time.

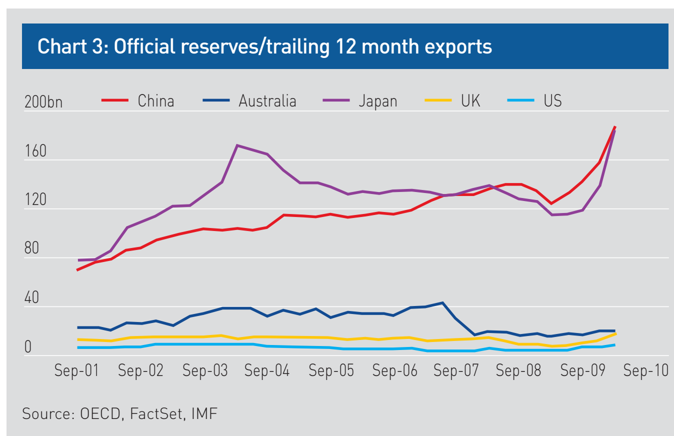
As a result of the actions to manage the exchange rate, and the extent of imbalance between the natural demand and supply of RMB, the PBoC has accumulated a vast foreign exchange reserve valued at USD 2.5 trillion as at June 2010. Whilst the precise composition of these reserves is a guarded secret, the value held in USD denominated securities was recently estimated at USD 1.2 trillion (Source: BCA Research). Charts 2 and 3 provide some comparisons of the size of the foreign exchange reserves relative to those held by other countries.

Chart 2: International reserves/foreign currency liquidity (USD millions)



Source: IMF

Chart 3: Official reserves/trailing 12 month exports



Source: OECD, FactSet, IMF

Following from the decision to further reform the currency regime, the PBoC will allow exchange between the RMB and foreign currencies to take place at different rates which will be affected by supply and demand factors, within a floating band. Importantly, the ability for the exchange rates to rise or fall in the new regime, in the short term at least, is intended to serve as a deterrent to currency speculators seeking risk free trades. As the exchange rates approach a level at which the demand for the currency is approximately balanced by supply, the accumulation of foreign reserves should slow.

US Treasury holdings and the economic "nuclear option"

Much news has also been made of China's holdings in US Treasury securities. China holds approximately 10% of the total issuance of US Treasury securities. This is clearly a material and substantive exposure. US Treasury assets constitute about a third of China's foreign reserves.

Concern has also been raised about the ability for China to exercise an economic "nuclear option" by adversely affecting the price of these securities through on-market sales in large volume. This would have flow-on effects to the pricing of debt in the US market and relative value of the USD. It would also destabilise the world debt markets more generally. Whilst Chinese monetary officials have repeatedly offered assurance that they would not pursue such strategies, the fear that such an option exists is a concern to US authorities.

Such fears were escalated by reports in former Treasury Secretary Hank Paulson's memoirs of the financial crisis that Russia had encouraged China to sell its holdings in US agency debt (that is, Fannie Mae and Freddie Mac debt) at the height of the debt crisis in 2008, in order to force an intervention by US authorities at a particularly inopportune time. China declined to pursue this option despite Russia's behest. However, it is clear that global strategic interests can be pursued through financial markets.

Some other features of China's holdings in USD denominated securities are under-reported. As China's trade becomes more diversified with increasing economic integration, it has diversified its FX reserves away from US assets. In 2003, USD denominated assets comprised 84% of its reserves. More recently, the proportion is estimated at close to 50%. Further, Japan is a similarly large foreign holder of USD government assets.

Rationale for managing the exchange rate

There are many countries whose currencies are pegged to the USD. Countries implement fixed exchange rate regimes for many reasons. However, key amongst these include: fostering the creation of an export capable industry; limiting sources of economic uncertainty and volatility; and helping countries anchor inflation expectations. Importantly, the US does not regard countries with fixed exchange rate regimes as currency "manipulators".

By setting an exchange rate at levels below a fundamental equilibrium, the nascent economy also has the opportunity to acquire a store of foreign exchange reserves to help it subsequently manage the effect of currency flows. With the Asian currency crisis of 1997 highlighting the magnitude of non-trade related currency flows which can sweep across a region following a loss of confidence, China would also draw comfort from the security that its FX reserves help protect against such events. Countries in the region recall with indignation the policy conditions and economic dislocation associated with IMF packages.

Keeping exchange rates fixed at low levels for an extended period can ultimately suppress domestic living standards by making the price of imported goods too high, and by developing an unbalanced economic structure.

How much do exports drive China's growth?

A common perception is that China's growth is driven by net exports. China's exchange rate is sometimes portrayed as being set at predatory levels in an effort to expand via a beggar-thy-neighbour strategy. In truth, China's growth is primarily driven by domestic demand, in the form of consumption and investment in capital stock. Whilst net exports contribute to growth, it could not be said to be the key driver. China's growth is derived primarily from domestic sources. Furthermore, the significant policy stimulus provided in 2009 led to a dramatic increase in capital formation, with an associated deterioration in the trade balance. Net exports actually detracted from growth in 2009. This is illustrated in Chart 4 below.

Chart 4: China's GDP growth by component

Source: CLSA Asia-Pacific Markets

How much is eliminating China's trade imbalance worth to the rest of the world?

An impression, commonly associated with the above, is that rebalancing of China's trade surplus would lead to materially improved growth in other countries. Chart 5 illustrates the monthly trade balance in USD.

Chart 5: China's foreign trade balance (total USD billions)

Source: National Bureau of Statistics of China, FactSet

If, for the purposes of this illustration, we assume that the trade imbalance can be taken as USD 20bn per month, this approximately equals 1.6% of US GDP if the entire benefit were to accrue there. Naturally, any such adjustment would not accrue entirely to the US. The IMF estimates that Gross World Output for 2010 will be USD 73.2 trillion on a Purchasing Power Parity (PPP) adjusted basis. China's trade imbalance equals approximately 0.3% of this figure. In other words, China's trade imbalance, whilst material, would not make wholesale change to the rest of the world's production profile even if it were to close in a single year.

Has China's currency policy cost US jobs?

With US unemployment at elevated levels, much has been made of China's role in this circumstance. Given the increasing extent to which manufacturing and assembly processes have relocated to China, it is asserted that this has cost US jobs.

A deeper examination by the non-partisan Congressional Research Service, whose results were published in December 2009, made the following points:

> "In the medium run, an undervalued RMB neither increases nor decreases aggregate demand in the United States. Rather, it leads to a compositional shift in US production, away from US exporters and import-competing firms toward the firms that benefit from Chinese capital flows. Thus, it is expected to have no medium or long-run effect on aggregate US employment or unemployment."

Clearly, the non-partisan view is at odds with populist claims on the employment effects of the RMB policy.

On the other hand, the US consumer has clearly benefitted from improved purchasing power as a result of the production of goods in China relative to other more expensive alternatives. The increasing efficiency of the production chains for Chinese manufactured consumer goods has also helped to keep inflation contained.

The bilateral trade deficit between China and the US

The bilateral trade deficit between the US and China was USD 266 billion in 2008. Whilst potentially alarming, the magnitude of the figure materially misleads an undiscriminating reader. In reviewing this figure, at least two features of China's exports need to be considered:

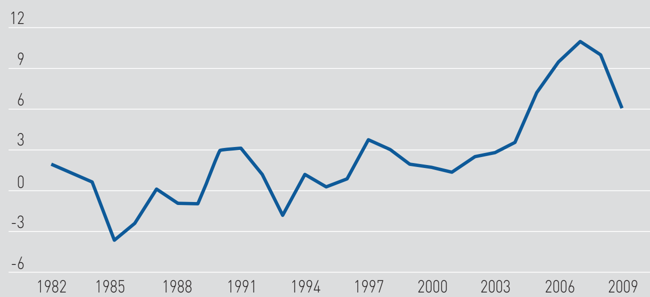
- Approximately 50% of the goods exported from China are simply processed in China. In other words, many of the underlying components of an export (say an iPod) were imported into China and merely assembled there prior to being exported. The value-add from the assembly of such goods is typically a very small fraction (approximately 5%) of the export value. A large trade deficit between China and the US is, therefore, effectively combining smaller trade deficits between several countries and the US.
- Part of the bilateral trade deficit arises because of deliberate decisions on the part of US firms to relocate a portion of the manufacturing process into China.

Within this context, the raw bilateral trade figures appear less dramatic.

Rebalancing China's economy

Reviews of global economic conditions routinely call for countries with substantial current account surpluses to rebalance their economies towards domestic consumption. This is merely a thinly veiled call to the Chinese leadership to stimulate internal consumer demand as a source of economic growth. To be sure, China has a large and growing current account surplus (see Chart 6) that will only invite trade retaliation at some point.

Chart 6: China's current account as a percentage of GDP



Source: IMF, FactSet

In 2008, household expenditure comprised a relatively low 36% of China's GDP. In contrast, household expenditure made up 71% of the US GDP in 2009 and 56% of Australian GDP in 2009. Such figures contrasting the composition of GDP highlight the potential for China's enlarging consumer class to carry growth forward.

However, the ability to do so effectively requires much more than simply modifying the exchange rate regime. For a start, the Chinese populace has a very high savings rate. Much of this is of a precautionary nature, given the lack of an effective medical insurance regime and pension system. Further, as reported by the McKinsey Global Institute, 97% of Chinese parents believe their children will attend college and save accordingly. Substantial savings are not conducive to the establishment of an economy which is driven by domestic private household consumption. Hence, the ambitions of the Chinese populace and lack of a well developed social infrastructure will imply that savings will remain high for the medium term and act as a natural constraint to economic rebalancing towards domestic household consumption.

The Plaza Accord...an example from history

The efforts to redress the trade balance with China via currency exchange reform have an interesting and related precedent. On 22 September 1985, the finance ministers from the US, Japan, West Germany, France and the UK announced the Plaza Accord. One of the key aims of the Accord was to reduce the current account deficit and recessionary conditions then prevalent in the US, following a wrenching contraction at the hands of Federal Reserve Governor, Paul Volcker. The Accord drew on the mechanism of exchange rates, more specifically a devaluation of the USD, to achieve these aims.

The Accord failed to address the US trade deficit with Japan, one of the primary objectives. Additionally, monetary conditions in Japan were loosened dramatically to compensate for the contractionary effects. This unleashed a substantial asset bubble in Japanese property markets and encouraged capital investments overseas that were subsequently found wanting. The Japanese banking system suffered from the after-effects of asset price contraction and the economy continues to labour under deflationary conditions and stagnant growth.

One key difference between Japan's situation and that of China is that China's leadership controls the banking system directly. China is in a better position to control credit growth. However, this shifts part of the burden of making capital allocation decisions to the leadership and away from the individual investor. It is unclear which is actually better placed to avoid unexpected and adverse outcomes.

Impact on Australia

The continued reform to the Chinese RMB exchange regime is likely to be broadly favourable for Australia's economy. This will mostly accrue to Chinese acquisitions of domestic bulk commodity exports via volume and terms of trade improvements. In an associated development, an upward revision to the RMB will also put upward pressure on the exchange rates for the Yen and other Asian currencies. In the case of Japan, a major bulk export destination, Australia can be expected to benefit from improved demand for coal and other materials.

Offsetting these effects to some lesser degree is the fact that Australia is a net importer of goods from the ASEAN nations, whose exchange rates will face upward pressure. Rising exchange rates will have an inflationary impact in relation to final consumption goods imported from the region.

Summary

The Chinese leadership is aware that running high current account surpluses with the rest of the world is not a sustainable proposition. Painful historical recollections of the Opium Wars of the 19th Century and British dismemberment of the Chinese national territory remain a source of national hurt. One of the underlying causes of this conflict was a significant imbalance of trade in favour of China.

The move to continue to reform the exchange rate regime, effectively electing to continue a process that had commenced in 2005, has been welcomed by the international community. Throughout the period that the regime had been halted, increasingly vociferous calls from various US officials, reported widely in the media, served to distort beliefs about the likely impact of China's currency policy on the US economy and wider global economy more generally. The incentive to do so can be understood in the context of a political imperative in the aftermath of a significant deterioration of employment.

China's emergence in the world economy will bring structural changes and challenges. The emergence of new powers on the global stage has not occurred peacefully in our history. It remains to be seen how the world adjusts. However, in the context of a grand strategy where the US, Europe, Japan and China are key players, we should expect areas of friction to continue to arise. The currency regime is but one element in a wider tapestry.

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Telephone: 1300 366 101
Email: adviserservices.aus@blackrock.com
www.blackrock.com/au

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