Yuan on a short leash

China took the world by surprise on 21 July 2005 by revaluing its currency, which had remained pegged to the US dollar since 1994 at around 8.3 yuan to the greenback. Unlike the Malaysian ringgit, which was on a rigidly fixed exchange rate system, the Chinese yuan's fixture was somewhat less rigid in the sense that tiny variations were still possible within an extremely narrow band of 8.28-8.31 to the dollar.

The prevailing perception is that China is currently moving towards a freer exchange rate system, now that the yuan is allowed to appreciate. Upon close scrutiny, however, it appears that China has a long way to go in that direction. For one thing, the revaluation of the yuan has turned to be much smaller than anticipated. On 21 July, the yuan was revalued from a previous rate of 8.277 to 8.11 per dollar. Since then the yuan has edged up, albeit only marginally. It is yet to move below the level of 8.0 yuan/US dollar. For another, China has not abandoned the peg system altogether, as its so-called managed float is nothing but a crawling peg. China opted for a 3 basis-point trading band of 8.08-8.13. Some analysts expect the trading band to shift to 8.05-8.11in the foreseeable future.

While estimated undervaluation of the yuan had varied widely prior to the revaluation in the order of less than 20 per cent to over 30 per cent last year, the 2.1 per cent revaluation in July and the subsequent appreciation have been disappointingly dismal. One plausible explanation for this may well be the fact the US dollar had appreciated considerably since the beginning of the year. Still, the market is certainly not convinced that the yuan has arrived at fair value. Unless the currency is allowed to float freely, there is no way of finding out how the supply and demand equation would hold. There is little doubt that the yuan is still substantially undervalued.

Nevertheless, China's decision not to let the currency float freely is a wise move. A sharp appreciation would have caused serious adjustment problems for China's economy with much negative spillovers for other economies in the region. Understandably and consistently, China has always been very cautious in liberalisation. China's approach is to experiment on limited scale first, as was the case with the opening of China in1978. This line of reasoning suggests that China will allow greater appreciation if the small initial moves could produce positive results.

It is not clear if China's decision to revalue the yuan was for political or economic reasons. Arguably, it may well be a mixture of both. Some analysts believe that it was meant mainly to placate American pressure, while others see real benefits for China in the form of lower cost of imported inputs and greater monetary freedom. The fact however remains that the yuan's appreciation has thus far been too small to have a tangible impact. Interestingly, China's National Development and Reform Commission has suggested that the trading band be widened to 2 per cent from the current 0.3 per cent.

The chances are that the yuan will appreciate gradually over time. The fact that China is running a sizeable balance of payments (BOP) surplus to the tune of 12.5 per cent of gross domestic product (GDP) cannot suggest otherwise. What is more, China's foreign exchange reserves will continue to rise not only due to the country's huge BOP surplus but also due to the central bank's selling of the yuan in exchange for foreign currency to prevent the currency from rising. All this will, no doubt, continue to exert pressure on the yuan to appreciate further. The prognosis is that increased reserves will lead to increased money supply with inflationary consequences. It would be tempting to let interest rates rise under such circumstances, but this will add to the cost of sterilising foreign capital inflows. One way to contain this problem would be to allow the yuan to strengthen so that it would reduce the cost of imported inputs and stabilise prices.

Thus far, there is little sign of inflation in China, thanks partly to central bank controls on monetary expansion and credit growth and partly to improvements in domestic supply conditions. Meanwhile, China has been pursuing a prudent fiscal policy, keeping its fiscal deficit at 1.5 per cent of GDP in 2004 after running a small fiscal surplus in 2003. Sterilising the build-up in reserves has not been a problem for China, given the low interest rates at home relative to the returns on its reserves held in US treasury securities.

It is fair to surmise that China is not overheating, at least not for now. As mentioned, inflation remains subdued. Apparently, there are no worrisome asset bubbles. But there are other concerns, which include the fragile banking sector, debt-laden state-owned-enterprises, weak agriculture and growing property glut. The joker in the pack is the price of oil. If oil prices continue to rise beyond US$70 per barrel, it will take a toll, given China's growing demand for oil to fuel the manufacturing cylinder of its engine of growth. A stronger yuan can help cushion the impact.

All this does not mean that China is likely to let the yuan strengthen dramatically in the near term. One may safely rule out the possibility of any imminent revisions in China's exchange rate regime. All indications are that China will undertake further exchange rate liberalisation only on its own terms and at it own pace, even though the United States will continue to apply external pressure. Although the United States was pleased that China could take the first step by revaluing the yuan on 21 July, the move now looks like no big deal. Since revaluation, the yuan has stayed almost stationary, edging very marginally from 8.11 per dollar to 8.0954 per dollar, the highest as of end-August.

What China has adopted is a crawling peg system. Linking the exchange rate of yuan to a basket of currency does not mean that the yuan will reflect changes in the composite index of the currency basket, so long as China continues to impose limits on the trading of the yuan and restrict daily movements to no more than 0.3 per cent from the opening level. Strictly speaking, it is not even managed float. By "managed float" is meant ironing out short-term fluctuations through appropriate central bank interventions without interfering with long-term trends. Critics might rather call it "controlled float" as the currency is still tied albeit on a short leash, while cynics would brand it simply as "pseudo float". Unless and until the US dollar undergoes a major exchange rate correction, triggering drastic changes elsewhere, China's yuan is likely to remain significantly undervalued. It will probably take another 2-3 years before this scenario can unfold.

Much would depend on the sustainability of the US current account deficits. To be sure, a large appreciation of the yuan alone cannot solve the US current account deficit problem. One may even argue that while undervalued yuan could have contributed to the US bilateral trade deficit with China, it has little to do with the US trade imbalance overall. An appreciation of the yuan is likely to simply shift the sources of US imports from China to other countries without reducing the US trade gap. The latter is largely attributed to excessive spending and insufficient saving in the United States.

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