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China Economics

A Dialogue on the Renminbi

What's new: As the global economy starts to recover and the US dollar is subject to strong downward pressures, the currencies of a number of emerging market economies have faced significant appreciation pressures. In this context, speculation has recently intensified that a de-peg of Renminbi from US dollar is imminent.

Conclusions: We maintain our long-standing view that the current renminbi exchange rate arrangement will remain unchanged at least through mid-2010. While we believe an exit from the current regime of a *de facto* peg against the USD may occur in 2H10, any subsequent Renminbi appreciation against the US dollar is, in our view, likely to be modest and gradual.

Where we differ: The fact is that the Renminbi exchange rate is still a policy tool instead of a market-determined price variable. To gauge the potential policy shift on Renminbi, one should think more like a policymaker than a fund manager, in our view. To this effect, we highlight in this research note the *pros* and *cons* of a Renminbi de-peg and appreciation in the format of a hypothetical debate between a policy advisor who defends the *status quo* and a fund manager who argues that the current arrangement is unsustainable.

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A Dialogue on the Renminbi

Introduction

We highlight in this research note the *pros* and *cons* of Renminbi de-peg and appreciation in the format of a hypothetical debate between a policy advisor who defends the *status quo* and a fund manager who argues that the current arrangement is unsustainable¹.

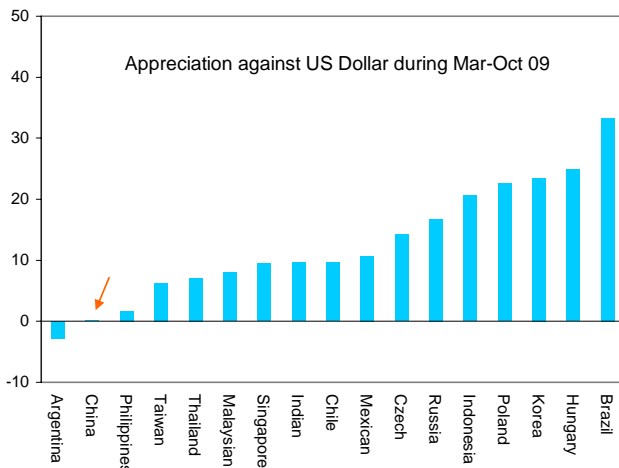
A Conversation on Renminbi

An overseas fund manager recently visited Beijing as part of his regular macro due diligence trip to China. He had a one-on-one meeting with an influential policy advisor from a local think tank, the purpose of which is to understand better the outlook for the Renminbi exchange rate. The following is a dialogue between the policy advisor (or 'Ms. P') and the fund manager (or 'Mr. M'):

Mr. M: Professor, thank you for sparing time to meet me. In the interest of time and if you do not mind, may I start with a question by showing you this chart below (Exhibit 1). The chart shows that since March this year, a number of currencies among emerging market (EM) economies have appreciated substantially against the USD. However, the Renminbi is among a handful of EM currencies that did not appreciate against the USD, making it one of the weakest currencies in the EM space. Shouldn't we expect the Renminbi to appreciate soon?

Exhibit 1

Renminbi: The Weakest EM Currency?



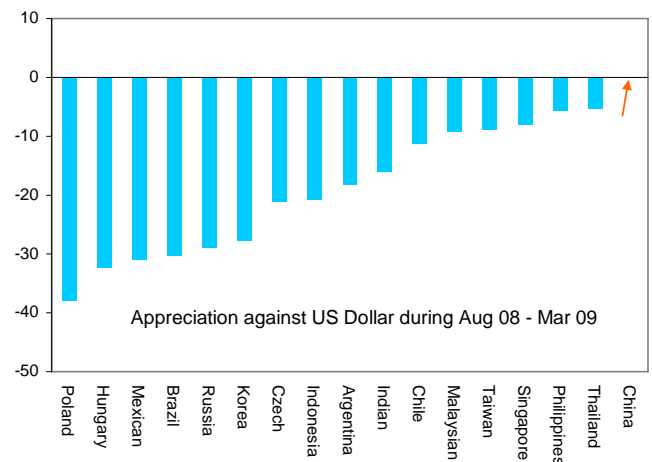
Source: CEIC, Morgan Stanley Research

¹ We are indebted to Stewart Newnham, Morgan Stanley Head of AxJ Currency Strategy, for valuable comments.

Ms. P: I beg to disagree. Your observation is correct if one only focuses on the developments in the past 4-5 months. However, before I answer your question, I also would like to present a chart (Exhibit 2). This chart shows the change in the exchange rates of the same set of EM economies between September 2008—when the global financial crisis broke out—and March 2009 when the global economic and financial situation started to stabilize. This chart shows that the Renminbi was the strongest EM currency, because it was the only EM currency that did not depreciate against the US dollar in the wake of the global financial crisis.

Exhibit 2

Renminbi: The Strongest EM Currency?



Source: CEIC, Morgan Stanley Research

I recall that, back then, many market observers predicted that the Renminbi would depreciate against the US dollar by following the footsteps of other EM currencies. I believe that, had China allowed Renminbi depreciation, the depreciation pressures on other EM currencies would have been even stronger.

... large and persistent current account surpluses... suggest that the Renminbi is undervalued and should appreciate... This is International Economics 101...

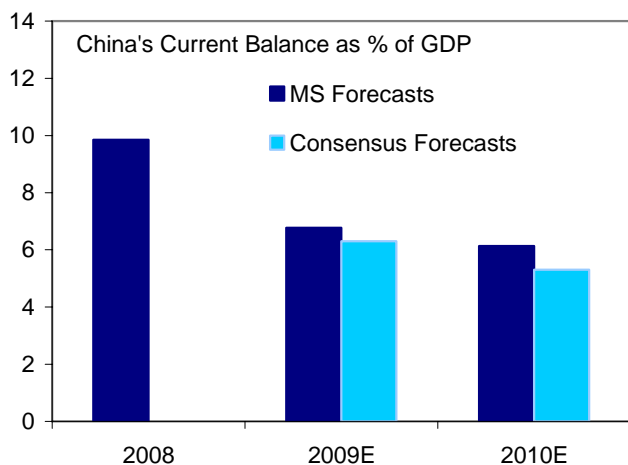
Your observation that the Renminbi is the weakest EM currency is valid only as far as the past 6-7 months is concerned. If we take a slightly longer view, examining the

cumulative performance since the crisis (i.e., August 2008), the Renminbi is still stronger than most other EM currencies.

Mr. M: These are fair points. However, when I suggest the Renminbi should appreciate, my arguments are based not only on the developments of the past few months but also the fact that China has, and is expected to continue to have, large and persistent current account surpluses, which suggest that the Renminbi is undervalued and should appreciate (Exhibit 3). This is International Economics 101, isn't it?

Exhibit 3

Large and Persistent Current Account Surpluses



Source: CEIC, Consensus Forecasts, Morgan Stanley Research

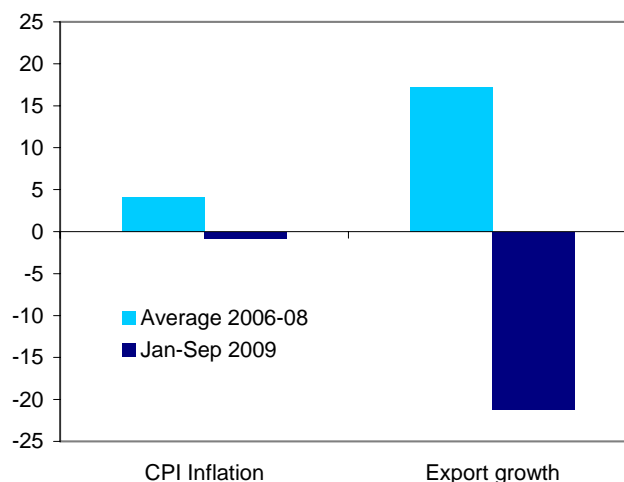
Ms. P: I do not disagree with you in principle. I think the large and persistent current account surpluses in China have reflected a structural saving-investment imbalance as well as an undervalued exchange rate. Renminbi appreciation should be part of the solution but not the only solution to reduce current account surpluses, especially given its structural nature. That said, from a policymaker's perspective, any macroeconomic policy decision needs to take into account both the cyclical and structural conditions of the economy. While Renminbi appreciation makes lots of sense in view of structurally high current account surpluses, the case for Renminbi appreciation is far from compelling from a cyclical point of view.

In theory, currency appreciation helps dampen export growth and contain inflation pressures. The reality is that the Chinese economy is currently suffering deflation and a sharp decline in exports (Exhibit 4). At the current juncture, it does not make any sense for the policymaker to take policy action that would serve to exacerbate either deflation or weak exports. This is Macroeconomic Policymaking 101, isn't it?

...it does not make any sense for the policymaker to take a policy action that would serve to exacerbating either deflation or weak exports... This is Macroeconomic Policymaking 101

Exhibit 4

CPI Deflation and Export Decline



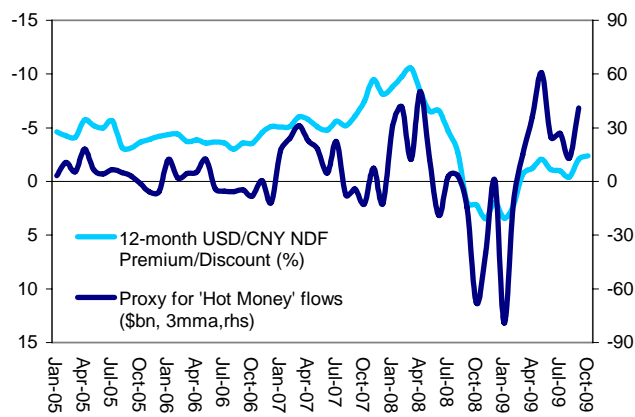
Source: CEIC, Morgan Stanley Research

Mr. M: I understand what you're saying, but the current situation is not sustainable. The conditions for a Renminbi appreciation will never be perfect; there will always be always some sort of downside. I am afraid that the longer the necessary adjustment is postponed, the stronger the appreciation pressures will be.

Ms. P: Exchange rate adjustment is important, but I caution against over-emphasizing its role in rebalancing the economy. The experience in 1H09 is a case in point. China registered a current account surplus of \$134bn in 1H09, a 30% decline compared to the level in same period in 2008. This is because while China's exports declined by 25%YoY in 1H09 due to a collapse in external demand, imports declined by only 21%YoY, reflecting relatively strong domestic demand underpinned by aggressive policy stimulus. Both Morgan Stanley and consensus forecasts expect the current account surplus to shrink further in 2010, as a result of stronger import than export growth due to robust domestic demand but a tepid recovery in external demand (Exhibit 3). If these forecasts were to materialize, it would suggest the underlying external imbalances are improving toward a more sustainable situation. Don't you agree?

Mr. M: Well, yes, but even according to these forecasts, China's current account surplus would still be over 5% of GDP in 2010. As long as a current account surplus of this magnitude persists, the expectation of Renminbi appreciation is bound to remain strong and will surely lead to significant 'hot money' inflows, which contribute to large and persistent FX reserve accumulation despite potentially narrowing current account surpluses (Exhibit 5). And large FX reserve accumulation will constitute a major challenge to monetary policy implementation, namely the loss of monetary policy independence. Aren't Chinese policymakers concerned?

Exhibit 5
'Hot Money' Inflows On Appreciation Expectations



Source: CEIC, Morgan Stanley Research

Ms. P: You are absolutely right on this point. In fact, I think this is by far the strongest argument for a flexible exchange rate arrangement in China, which is a pre-condition to independent monetary policy according to the theory of the 'Impossible Trinity'.

...while the Renminbi was allowed to appreciate...by over 20% between July 2005 – July 2008, it does not seem to me that the appreciation has brought about any genuine monetary policy independence...

Mr. M: I am glad we finally agree on something! Indeed, for such a large economy as China, independent monetary policy is critical to domestic macroeconomic and financial stability. Isn't this alone a sufficiently strong rationale for Renminbi appreciation?

Ms. P: This is indeed a theoretically sound argument, but it has proven to be very difficult to implement in practice. For instance,

while the Renminbi was allowed to appreciate against the US dollar by over 20% between July 2005 and July 2008, it does not seem to me that the appreciation brought about any genuine monetary policy independence during that period. On the contrary, I would argue that persistent FX reserve accumulation, in part driven by strong appreciation expectations, has further complicated monetary policy execution. Do you not agree?

...exchange rate is not just a relative price between tradable and non-tradable goods but a type of asset price, and it could easily overshoot, as every other asset price does.

Mr. M: True. But I think it is precisely because the Renminbi appreciation was too little and too slow to change expectations. A sufficiently large appreciation would generate two-way risks and therefore impart meaningful flexibility to the exchange rate.

Ms. P: How much does the Renminbi need to appreciate in order to generate two-way risks in the short run—10%, 30% or 50%? Does anyone really know? As an expert in the internal capital market, do you believe a 10% one-off revaluation of the Renminbi could bring about meaningful two-way risks? Even if you can make a case that a 30% one-off revaluation will do the trick, do you think Chinese authorities—who are known for their hallmark gradualist approach reform—would take such a risk, given that a 30% revaluation of the exchange rate could potentially put many Chinese exporters out of business overnight? Also bear in mind that the exchange rate is not just a relative price between tradable and non-tradable goods but a type of asset price, and it could easily overshoot, as every other asset price does.

...government is not able to avoid an inevitable market-driven adjustment. One cannot control everything. Something has to give.

Mr. M: Your arguments make sense. However, as a market participant, I strongly believe that government is unable to avoid a market-driven adjustment. It is inevitable. One cannot control everything. Something has to give. You seem to be

suggesting the 'law of gravity' does not apply to China. Am I missing something here?

Ms. P: Yes, something is indeed missing in our discussion, which has so far focused on the role of Renminbi nominal exchange rate. In theory, when a currency is considered to be undervalued and needs to appreciate, the exchange rate concept here is the real exchange rate, namely the nominal exchange rate between two currencies adjusted for the inflation rate differentials between the two economies. In practice, country A's real exchange rate is estimated by calculating its real effective exchange rate (REER) which is defined as the trade-weighted nominal exchange rate against a currency basket—also called the nominal effective exchange rate (NEER)—adjusted for the inflation rate differentials between country A and its trading partner economies. A real appreciation of country A's exchange rate can be achieved through the nominal appreciation of country A's currency or by a higher inflation rate in country A than in its trading partner countries, or a combination of both.

I agree with you that 'something has to give'. In this context, the 'something' would be higher domestic inflation rate in China relative to other trading partner countries if the appreciation of Renminbi nominal exchange rate is slow.

Mr. M: Higher inflation in China? But China is suffering deflation now? It may take another 12 to 18 months before inflationary pressure emerges in China. Relying on higher inflation as part of the solution will be a long process.

While this relative price normalization will likely cause broad-based inflation...this type of inflation is what China needs...

Ms. P: This is where the point about cyclical vs. structural conditions of the economy that I made earlier becomes relevant again. Renminbi appreciation in real terms is justified over the medium term, namely if appreciation of the nominal exchange rate is slow, inflation pressures will eventually show. In fact, I would advise that, in view of the high level of growth in China, the norm for annual inflation rate in China should be in the range of 4-6% instead of the 2-3% to which many Chinese seem to have become used. However, the current cyclical condition of the economy dictates that there are deflationary pressures.

Mr. M: I think the relatively low inflation in China largely reflects strong supply capacity and thus fierce competition in the downstream manufacturing sector. I doubt this situation will change any time soon.

Ms. P: It also has to do with the low price of energy and natural resources, as well as low environmental costs. Deregulating these prices and making them reflect their true opportunity costs are the key. More generally, China needs to rationalize the relative price structure between energy and raw materials on the one hand and downstream manufactured goods on the other hand. While this relative price normalization is likely to cause broad-based inflation, I believe that this type of inflation is what China needs and, when it materializes, should be tolerated.

Mr. M: Inflationary pressures seem already to have been reflected in the upward pressures on asset prices.

...most of the points...are out of consideration of designing a course of policy action that serves the best interests of the Chinese economy itself.

Ms. P: The post-crisis asset price reflation is a global phenomenon. Indeed, preventing an asset price bubble will perhaps be of high policy priority. But conventional monetary policy tools are ill-suited for this task. I suggest that 'containing financial leverage' in the system be made a key policy objective with a view to minimizing systematic risks in the event of a bursting of the asset price bubble. This will entail strict mortgage rules for homebuyers, strict restrictions on margin trading in stock market, strict capital adequacy requirements for banks, asymmetric liberalization of external capital account controls that induce capital outflows and discourage capital inflows, and preventing a one-way bet on Renminbi exchange rate that would induce hot money inflows.

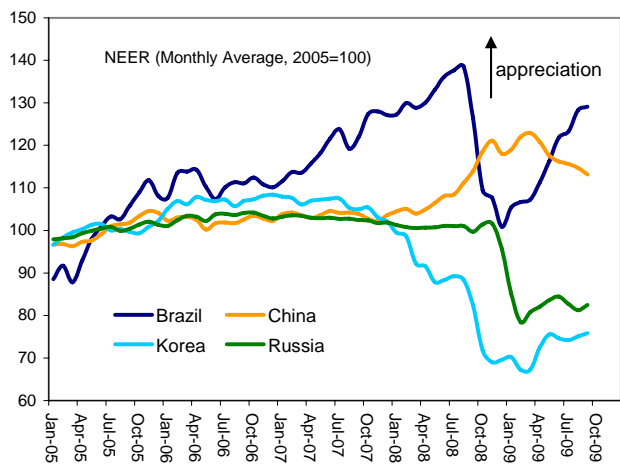
Mr. M: Professor, I appreciate the discussion and your answers to my questions. After hearing what you have to say, I now have a better understanding of the arguments in favor of the *status quo*. And I do see the validity of many of your arguments. At the same time, it seems to me that most of the points you have made are out of consideration of designing a course of policy action that serves the best interest of the Chinese economy itself. However, when it comes to exchange rates, it always involves more than one party. Other countries that are negatively impacted by China's exchange rate policy would complain and call on China to change its current practice.

Won't these international peer pressures change the mind of Chinese policy makers?

Ms. P: A strong Chinese economy should help the global economic recovery. While I do not work for the government, I know the Chinese government's position on this issue is that the choice of exchange rate regime is in the domain of a country's sovereign decision. That said, you seem to be suggesting that there are now strong and broad-based international pressures on China to change its exchange rate policy. This is not my impression, however. For instance, while the last G7 statement singled out the Renminbi and called for its appreciation, as it did in the past, recent statements issued by G20 have been completely silent on the exchange rate issue, let alone singling out the Renminbi. As you know, the G20 has now replaced the G7 as the main international forum for discussing global policy coordination among major economies. Take a look at the recent trends of trade-weighted exchange rates (or NEER) for Russia, Brazil, and Korea and compare them to that for China, you should understand why G20's position on this issue is much softer (Exhibit 6).

...the recent statements issued by G20 have been completely silent on the exchange rate issue, let alone singling out Renminbi

Exhibit 6
Put 'Lack of Renminbi Appreciation' in Context



Source: BIS, Morgan Stanley Research

As the expert, please correct me if I am wrong. I do not even think it is in the interest of the US to put pressure on China to allow the Renminbi to de-peg from and appreciate against the US dollar at the current juncture when the US dollar is already

under enormous downward pressure. Wouldn't the perception that 'even the Chinese are starting to abandon the US dollar' cause more US dollar selling in the FX market?

Mr. M: Interesting observations. On your last point, the current views of the market seem divided: while some share your view, others actually believe that a strong Renminbi will eventually help strengthen US dollar.

Well, professor, I really appreciate your time and I certainly enjoyed the discussion and have learnt a lot. I hope to stay in touch. Please do let me know if you change your view.

Ms. P: I also greatly appreciate your sharing your view from your perspective of an international capital market participant. Understanding of the market is critical to formulating good policies. Best of luck with your investments.

Our Takeaways from This Dialogue

First, given the fact that the Renminbi exchange rate is still a policy tool instead of a market-determined price variable, one needs to think more like a policymaker than a hedge fund manager to gauge the likelihood of a potential policy shift on Renminbi.

Second, we maintain our long-standing view that the current renminbi exchange rate arrangement will remain unchanged at least through mid-2010. While an exit from the current regime of a *de facto* peg against the USD may occur in 2H10, any subsequent Renminbi appreciation against the US dollar will likely be modest and gradual.

Third, as we had predicted earlier, the relevant debate and speculation as to what would be an exit strategy for the renminbi has indeed emerged sooner rather than later. However, we continue to believe that an actual decision - be it an exit strategy or maintaining the status quo - is unlikely to be made and implemented until after the middle of next year.

Fourth, looking ahead, China is likely to repeat a situation similar to that during 2005-2008, featuring strong expectations of renminbi appreciation, 'hot money' inflows, abundant external-surplus-driven liquidity (as opposed to the current abundant liquidity due to loose monetary policy), and the attendant upward pressures on asset prices.

Last but not the least, we expect that the current policy stance will remain broadly unchanged toward year-end and turn

neutral at the beginning of 2010 as the pace of new bank lending creation normalizes from about Rmb10tn in 2009 to Rmb7-8tn in 2010. Policy tightening in the form of RRR hike, base interest rate hike, or Renminbi appreciation is unlikely before mid-2010. If, however, excess liquidity stemming from large external balance of payment surpluses were to emerge earlier than expected, we would not rule out the possibility of the RRR hike cycle could start as early as beginning of 2Q10.

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