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Renminbi Revaluation: Lessons and Experiences

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Executive Summary

Japan experienced sharp appreciations of the yen twice after World War II, the first followed by hyperinflation and the second by the “economic bubble” in the late 1980s. The country then underwent a long recession, the so-called “lost decade.” Some Chinese economists are worried that if the renminbi were sharply appreciated for a very short period of time, the PRC might follow the same path of recession that Japan experienced. To avoid such a path, can the PRC learn any possible lessons from Japan’s experiences?

1. Similarities and Differences Between the PRC and Japan

Japan's economic situation during the early 1970s and the mid-late 1980s somewhat resembles the PRC's recent economic situation. The US also suffered the collapse of a new economy bubble from 2001 until recently. This aggravated the so-called twin trade and fiscal deficits in the US economy and put a downward pressure on the value of the dollar. Domestically, since the PRC joined the WTO in December 2001 and started to gradually liberalize its capital account transactions, the country has registered an increasing trade surplus and accumulated a large amount of foreign reserves, though some efforts have been made to ease the appreciation pressure on the renminbi.

Three aspects of the situations faced by Japan differ importantly from that faced now by the PRC, making for more intense pressure for renminbi appreciation than that historically put on the yen. First, because the economies of the world are now more closely interlinked through trade, more FDI and international money flow now than when Japan faced the yen appreciations. Second, most major countries have now, in principle, completed liberalization on current and capital account transactions under a floating exchange regime and removed various external barriers. Third, unlike Japan during these periods, the PRC's capital account balance continues to register a large surplus.

The PRC currently faces two serious factors that did not exist in Japan. These may explain why the government is very careful about or strongly resists renminbi appreciation. One factor is the serious unemployment problem in rural areas and the mounting pressure to create employment opportunities in urban areas. The other relates to solving non-performing loans (NPL) in state-owned banks. The PRC government and four asset management companies have been trying to involve foreign investors in the liquidation and disposal of NPLs. A sharp appreciation of the renminbi would definitely discourage them from participating in the NPL disposal.

2. Impact on Macro Economy

Loose monetary policy was one of the underlying factors of the serious inflation Japan faced both after the early 1970s and in the mid-late 1980s. Also, policy change was not implemented in a timely fashion in either period. However, the impact of the currency appreciation on the economy tended to be overemphasized. Thanks to the appreciation of the yen, prices of raw materials declined and terms of trade were improved significantly, even benefiting Japanese industries. The international competitiveness of Japanese commodities was also unexpectedly high in terms of quality management. These unexpected benefits indicate the importance and difficulty of assessing the behavioral change and international competitiveness of enterprises and predicting the overall impact of currency fluctuation on the macro economy.

The PRC's currency was undervalued by an average of 17 percent in past years. Thus, the 2.1 percent revaluation of the currency announced in July 2005 is not sufficient to weaken the competitive power of the PRC economy and reduce the trade surplus against the US. The balance of trade may even continue expanding short term. The revaluation also has a limited impact on overall inflation. Considering the chain effects and accumulated effects of renminbi revaluation, the PRC economy could endure more extensive revaluations from the macro economic point of view. However, the PRC's main problems are not in the aggregate level, which is maintaining 9 percent growth, but in the structural or sectoral levels. The government is worrying most about the agricultural and automobile sectors, which may be easily affected by renminbi revaluation, and the unemployment problem induced by revaluation.

Currently FDI in the PRC is one of the major sources for absorbing excess labor and mitigating the unemployment problem. If the renminbi is sharply appreciated, the PRC's noncompetitive agriculture sector and SOEs will be affected and more excess labor will be created; FDI may somewhat decline due to the higher operating costs in the Mainland. Overall, prices have remained stable in the PRC. However, inflationary pressure, especially in terms of real estate price has been increasing in recent years and such a

trend may continue over the next few years. This pressure comes not only from the undervaluation of the renminbi, but from some other factors. Economically, to stabilize the renminbi exchange rate under the surplus in the current account, the PRC has to absorb U.S. dollars (USD) by issuing renminbi notes, which increases the money supply. Politically, the new PRC Administration differs from the old one in that it tends to accommodate all requests for development assistance from regional governments to address regional disparities. This additional funding to regional governments is also putting inflationary pressure on the economy as a whole.

3. Independent Monetary Policy and Capital Regulation

The events of both the early 1970s and mid-late 1980s raised the traditional question of a trilemma among the three economic goals: ensuring free international capital transactions, maintaining independence of the monetary policy, and keeping a pegged exchange rate regime. In the early 1970s, Japan tried to maintain a pegged exchange rate while allowing adjusted inflation to achieve external balance. In the mid-late 1980s, under the framework of international policy coordination put forward in the Plaza and Louvre Accords, readjusting or keeping exchange rates stable became a major goal of monetary policy. Differing views may exist about the goals of monetary policy, but in this case, when monetary policy lost its freedom, domestic equilibrium was sacrificed.

We must take note that the trilemma argument generally applies to small-sized economies and cannot necessarily explain the situation in the PRC. The argument states that a small country cannot carry out an independent monetary policy and a fixed exchange rate policy while keeping free capital flow. At its early stage of economic reform, PRC was economically a small country. Monetary policy was regarded as an indication of sovereignty and had to be maintained. If the trilemma argument applied to the PRC, although its capital account transactions are not fully liberalized, a fixed exchange rate could not be kept for long, especially when facing a trade surplus.

The PRC can no longer be regarded as a small country; the US pressure on the renminbi exchange rate shows its economic significance. As a large economy, the PRC can carry out an independent monetary policy under a fixed exchange rate regime with regulated capital transactions. Thus, for the PRC internally, a fixed rate regime may not be a very serious problem, although it may result in external imbalance and incur foreign pressure. These imbalances are caused not only by the exchange rate, but also by other factors, such as the US war on terror and the collapse of the US bubble economy.

In fact, the current problem between the PRC and the US could be resolved through either external or domestic adjustment—adjusting the renminbi exchange rate is only one of the options available. Regarding regulations on capital transactions, the PRC is moving to lift regulations on capital outflow with the “Go Overseas” (*Zou chuqu*) policy, which is expected to mitigate appreciation pressure to some extent. However, there would be an increasing risk if the PRC further deregulated capital outflow while keeping a rigid exchange rate regime. This is the issue of policy sequencing. In the case of Japan, the move toward a floating exchange regime took place in tandem with the deregulation of capital account transactions.

4. External Imbalance and Exchange Rate Adjustment

Japan’s experience also indicates that external balance cannot be achieved only through exchange rate adjustment. Currency appreciation is generally expected to raise export prices in terms of USD, which cuts down price competitiveness and decreases export volume. However, in the mid-1980s, export prices in USD terms were raised by only 50 percent in terms of the percentage change of yen appreciation and the overall export volume was not much affected. The remaining 50 percent was absorbed by the streamlining efforts by the enterprises and the decline of the prices of imported raw materials.

Overall saving should be matched by overall investment, i.e. over saving in the domestic sector, should be offset by over investment in the external sector. The current I-S imbalance reflects a domestic I-S imbalance among the countries concerned. Since under a free international capital flow regime, the exchange rate itself is deeply affected by capital flow and interest rates, the adjustment role of exchange rates to current balance tends to be diminished. Therefore, focusing on the structural I-S imbalance of each country is essential to solve external imbalance problems. In the PRC context, the current surplus is roughly matched by huge over-saving in the household sector. Since exports by foreign-invested companies account for more than half of the PRC's total exports, exports may not be seriously affected by appreciation of the renminbi. Companies that import raw materials and intermediate goods from other countries could offset the impact of the increase in export prices by a decline in import prices.

5. Impact on Different Interest Groups

Different interest groups are affected differently by currency fluctuation and some groups have a bigger voice than others. Balancing interests is important, yet difficult. For Japan, doubtless the manufacturing industry sectors such as steel and machineries suffered from the appreciation of the yen, and they had more ability to influence policymaking. Meanwhile, non-manufacturing industries and consumers who must have benefited were not so politically influential, and their views were not reflected in the decision-making.

Who in the PRC benefits and who loses due to the appreciation of the renminbi? State-owned enterprises (SOEs) and state-owned banks (SOBs), having no international competitiveness, and other export industries including agriculture will definitely suffer. Foreign-invested companies in general will also suffer. This may affect FDI as a whole, but the effect should not be too serious—many foreign-invested companies are no longer looking only for cheap labor in the PRC, but are looking at the huge potential of the domestic market. Consumers may stand to benefit from renminbi appreciation. As for the political influence of each group, the SOEs and

SOBs may still have big voices but as the market economy matures and people become richer, private enterprises and households are gaining influence.

6. Long-term Impact of Currency Appreciation

We should watch not only the immediate impact of currency appreciation, but also its long-term effect on the economy. The sharp appreciation of the yen triggered upgrading or conversion of the industrial structure in both the 1970s and 1980s and made Japan a more advanced or high-value added economy. For the PRC, the appreciation of the renminbi or moving to a more flexible exchange rate regime should provide a good opportunity to move toward a more market-oriented economy. The renminbi is severely undervalued under a fixed exchange rate regime, which distorts resource allocations. Appreciation of the renminbi will help to correct the distortion. We estimate that the currency is undervalued by 17% in terms of the nominal exchange rate. The variation of other estimates, however, indicates the difficulty for a planned economy to reach consensus on the appropriate equilibrium level. The best answer is to pursue marketization, adopting a more flexible exchange rate regime and letting the market determine the equilibrium level. However, the exchange rate is much more volatile than goods prices, and its sometimes explosive behavior may bring about some economic and political uncertainty.

Considering the negative experiences of Japan and the PRC and the success of gradual reform, we think that the PRC should stay on the road toward a more flexible exchange rate regime with a gradualist principle and let the foreign exchange market explore its equilibrium level in two or three years. This should avoid causing too many shocks to the economy and give market participants more time to adjust their behavior and adapt to the new exchange rate. The principles of controllability, gradualism, and balance announced by the People's Bank of China, are therefore the right ones.

Introduction

Looking back at Japan's history, the country experienced sharp appreciations of the yen twice after World War II, the first followed by hyperinflation and the second by the "economic bubble." After the economic bubble in the late 1980s, Japan underwent a long recession, the so-called "lost decade."

Many Chinese economists are worried that if the renminbi were sharply appreciated for a very short period of time, the PRC might follow the same path of recession that Japan experienced in the past. Local Chinese people say, "一些經濟學者認為中國人民幣如果迅速升值、會重走日本經濟不景氣的老路子"。["Some economists are worried that if renminbi sharply appreciates, PRC economy might follow the same old path of stagnation as Japan experienced in the past."]

To avoid such a path, can the PRC learn any lessons from Japan's experiences?

1. Developments in Early 1970s

On August 15, 1971, US President Richard Nixon announced a new economic policy that consisted of nine economic measures. The purpose of this policy was three-fold: to curb inflationary pressure, to stimulate economic activities and increase employment opportunities, and to address the balance of payment (BOP). In particular, in connection with BOP policy, the US declared the temporary suspension of the convertibility of the US dollar (USD) to gold. That this is called the "Nixon Shock" in Japan shows how shocked the country was by this announcement and the following sharp appreciation of the Japanese yen.

The suspension of the USD's convertibility to gold was a natural consequence of several developments that necessitated a defense of the currency. After World War II, the world economy had been primarily led by the US. However, after the mid-1950s, the situation gradually changed. Japan and the European countries started to recover and even catch up with the US. Meanwhile, the US was bogged down with the Vietnam War in the late

1960s; the increase in military expenditures put an enormous pressure on the US economy. The US was also suffering from serious labor disputes. The relative international competitiveness of the US economy in relation to Japan and the European nations thus declined, taking with it the people's confidence in the USD.

Immediately after the US announcement, while European countries closed their foreign exchange markets, Japan kept its market open and tried to maintain a pegged rate system. During the following two weeks, Japan, facing mounting selling pressure of the USD, kept buying dollars, reaching an amount equivalent to 2 trillion yen (or 5.2 billion USD at that time). This amount was also almost equal to the total Bank of Japan lending outstanding to the commercial banks at that time. However, even such large-scale intervention did not achieve the intended goal and in the end major countries including Japan decided to abandon the fixed exchange rate system on August 30. Due to the intervention in the market during these two weeks, the Japanese commercial banks were left with excessive yen liquidity, so the Bank of Japan exceptionally issued promissory notes in the market and tried to absorb the excessive liquidity.

In December 1971, the G-10 Finance Ministers met at the Smithsonian Museum in Washington, DC and agreed to readjust the exchange rates and resume a fixed exchange system. Under the Smithsonian Agreement, the value of gold increased from 35 to 38 USD per ounce, a 7.89 percent increase. At the same time, all of the major currencies appreciated significantly in relation to the USD; in particular the Japanese yen appreciated from the previous fixed rate of 360 yen to 308 yen to the dollar, a 16.88 percent increase. This was the highest among the major currencies. In addition, a more flexible wide band was adopted under the Smithsonian Agreement. Under the past fixed rate regime, currencies were allowed to fluctuate only within a very narrow range of plus or minus 1.5 percent. This range was widened to 2.25 percent each way under the Smithsonian Agreement.

However, even after the agreement at the Smithsonian, the confidence in the USD was not fully restored: speculation on the possibility of further readjustment prevailed in the market and the selling pressure on the USD

continued. Finally, in February and March 1973, Japan and other European nations decided to give up the fixed rate system and eventually the fixed rate regime completely came to an end. As of early 1973, the Japanese yen had appreciated to around 260 yen per dollar.

Japan's economy had been experiencing a relatively long period of buoyancy since the mid-1960s. To avoid overheating the economy, the Japanese monetary authority started to adopt a tight monetary policy in 1969. With the slowdown of the Japanese economy, the trade surplus increased. In addition, low interest rates in the US led to an increase in capital inflow to Japan through foreign investment in Japanese securities. The short-term volatile capital inflow to Japan also contributed to widening Japan's BOP imbalance and accumulating foreign reserves.

In early 1971 Japan's economy had shown signs of recovery, but the "Nixon Shock" and the following Smithsonian Agreement completely reversed entrepreneurs' sentiments from optimism to pessimism and significantly cut down exports. The Economic White Paper of the Japanese Government at that time correctly mentioned that the radical adjustment of foreign exchange rates in the early 1970s would provide Japan with an important turning point to change its economic growth path. In other words, Japan was no longer able to rely solely on the increase in exports to get out of recession.

2. Developments in Mid-late 1980s

The second sharp appreciation of yen in a very short period of time happened from the mid- to late 1980s. After the Reagan Administration took power in the US in the early 1980s, the American economy showed a buoyant cycle, which led to strong domestic demand and increasing imports from overseas. This, in turn, aggravated US trade deficits and American protectionist sentiments were intensified. On the other hand, inflationary pressure as well as fiscal deficits raised the US interest rates, keeping the value of the USD high.

Under the Plaza Accord in September 1985, the G-5 countries agreed to take policy-coordinating action amongst themselves to address the “overvalued” USD. After that decision and until the Louvre Accord a year and a half later, the US dollar dramatically declined by almost 40 percent. During that period, Japan’s trade surplus increased significantly and foreign reserves were also accumulated very rapidly, which was similar to what had happened in the early 1970s.

3. Capital Flow and Regulations on Capital Account Transactions During These Periods

After World War II and until the mid-1960s, Japan had imposed strict regulation on various overseas transactions under the old Foreign Exchange Control Law enacted in 1945. During this period almost no money flowed between Japan’s private sector and overseas markets. Japan joined the IMF and OECD in 1964 and terminated the regulation on current account transactions and gradually started to liberalize capital account transactions. The deregulation measures, taken on a rather ad hoc basis, were all incorporated into the new Foreign Exchange Law in 1980, which marked the turning point for the principle of Japan’s foreign exchange control from “to prohibit transactions” to “to make transactions free.”

In tandem with the deregulation of capital account transactions such as the domestic investors’ purchase of foreign securities and loosening of the upper limit on the ratio of foreign securities held to total assets, long-term capital flow expanded rapidly, especially after the 1980s. We can observe a couple of features in the development of Japan’s capital flow with foreign markets. First, the long-term capital account has continuously registered deficits (capital outflow financed by current account surplus). Second, if we look at the breakdown of long-term capital flow, while portfolio investment (investment in foreign securities) has been the largest item, foreign direct investment (FDI) has increased dramatically from the late 1980s. Third, while only portfolio investment showed a volatile fluctuation, the balance of

other items, in particular FDI, continued to be deficits (Japan's FDI far exceeds that of other countries in Japan.)

Regarding the relationship between the exchange rate system and regulation on capital account transactions, past lessons in various countries show that liberalizing capital transactions while maintaining an inflexible exchange rate system increases the risk of financial crisis. On the other hand, in the 1997–98 Asian financial crisis, countries with relatively closed capital transactions like the PRC and India were not so much affected by the crisis. In the case of Japan, the early 1970s, when the country moved toward a floating exchange rate system, coincide with the period when the liberalization on capital account transactions was underway.

4. Policy Responses of Japanese Authority

4.1 Early 1970s

Under the economic expansion during the late 1960s, Japan's wholesale prices started to rise and concern about inflation emerged. In order to curb inflation, Japan enforced a tight monetary policy in 1969 and 1970. However, this measure only ended up further widening the trade imbalance. Then, from mid-1970, Japan aimed to stimulate the economy and reduce the trade surplus by adopting expansionary monetary and fiscal policies. However, these policies had no impact on the trade imbalance, which remained from the past phase of economic expansion. Despite the drastic adjustment in the exchange rate through the Nixon Shock and the Smithsonian Agreement in 1971, a loose monetary policy continued in 1972 and Japan faced serious inflation in 1973. High growth of the money supply through the BOP surplus and the first oil crisis in late 1973 aggravated the situation.

After World War II, the Japanese economy had been primarily led by exports and investments made by the exporting industry. Both political and business circles therefore had a strong allergy to the appreciation of yen, which threatened to make the traditional growth pattern totally ineffective. In the late 1960s through the early 1970s, when international transactions

started to be liberalized gradually, Japan faced a dilemma between external equilibrium (i.e., BOP balance) and internal equilibrium (i.e., economic growth with full employment and no inflationary pressure). Due to the aversion to yen appreciation, Japan pursued stimulative economic measures to improve the external imbalance while trying to contain the pressure of appreciation on the yen as much as possible. In other words, what Japan pursued was traditional “adjusted inflation,” namely trying to achieve external equilibrium by raising domestic prices under a pegged exchange system, instead of moving to a floating exchange rate. Perhaps Japan should have floated its exchange rate earlier to achieve external equilibrium. Such a policy measure might have somewhat eased the subsequent inflationary pressure. We could summarize that this was an issue that economic theory later on explained as a trilemma among ensuring free international capital transactions, maintaining the independence of monetary policy, and keeping a pegged exchange regime.

4.2 Mid-late 1980s

Following the sharp appreciation of the yen after the Plaza Accord, serious concern re-emerged regarding the adverse impact of the appreciation on economic activities. To address this concern, Japan followed a loose monetary policy from late 1985 to early 1987. From mid-1987 to 1989, although policy makers seemed to be aware that the loose monetary policy might be excessive and did try to tighten the policy, the monetary policy continued to be loose until 1989. Consequently, the “economic bubble” was created in the late 1980s and after its collapse, Japan underwent a recession for quite a long period of time, so long that it is referred to as the “lost decade.” Certainly no single factor can explain the bubble’s creation. However, had monetary policy been tightened earlier, as the monetary authority perhaps originally intended to do, the bubble would have been smaller and its aftermath might have been less extensive.

Then, why did the monetary authority miss the chance to change the policy? After the Plaza Accord, the importance of policy coordination was emphasized among the G-7 countries, and the Japanese authority was also heavily influenced by the commitment to policy coordination when it worked out its economic policy. It seemed that the Japanese authority felt a strong pressure for Japan to increase domestic demand by keeping a loose monetary policy and try to reduce its current surplus. On the other hand, like the previous period when the yen had appreciated, a serious concern existed about the impact of the appreciation on the economy, and it was recognized that one of the primary goals of the monetary policy should be to stabilize the yen exchange rate. Since the consumer price index (CPI) at that time still remained stable, the public did not necessarily share the concerns about the overheating of the economy and inflationary pressure. Additionally, the prevailing argument at that time was that since IT- and R&D-related business investments accounted for the increase in business investments, much worry about the possibility of over capacity of the production lines was unnecessary.

5. Lessons to be Learned

5.1 Similarities and Differences Between the PRC and Japan

Japan's economic situation during these periods somewhat resembles the PRC's recent economic situation. From the PRC's point of view, its most important trade partner, the US, is suffering from the war on terrorism, which consumes significant financial resources. This is similar to the US in the late 1960s with the Vietnam War. The US also suffered from the collapse of a new economy bubble from 2001 until recently. This aggravated the so-called twin trade and fiscal deficits in the US economy and put a downward pressure on the value of the dollar. Domestically, since the PRC joined the WTO in December 2001 and started to gradually liberalize its capital account transactions, the country has registered an increasing trade surplus and

accumulated a large amount of foreign reserves, though some efforts have been made to ease the appreciation pressure on the renminbi.

Three aspects of the situations faced by Japan differ importantly from that faced now by the PRC. First, because the economies of the world are now extensively interlinked through trade, more FDI and international money flow now than when Japan faced the yen appreciations. Second, most major countries have now, in principle, completed liberalization on current and capital account transactions under a floating exchange regime and removed various external barriers. Third, unlike Japan during these periods, the PRC's capital account balance continues to register a large surplus, reflecting the PRC's traditional "one-way" regulation of encouraging capital inflow by attracting foreign-invested enterprises while strictly regulating capital outflow. Furthermore, a significant amount of hot money, most of which is deemed to be the recycling of capital flight in the past based on speculative motivation, and is reflected statistically in the errors and omissions in the PRC balance of payment account, reportedly comes back to the PRC. This further contributes to accumulating significant foreign reserves over a very short period of time. All these factors put a higher pressure of appreciation on the renminbi than that put on the yen in the early 1970s and mid- to late 1980s.

On the other hand, the PRC currently faces two serious factors that did not exist in Japan in the past. These may explain why the PRC government is very careful about or strongly resists renminbi appreciation. One factor is the serious unemployment problem in rural areas and the mounting pressure to create employment opportunities in urban areas. In the eyes of the PRC government, only rapid economic development can solve these problems. Naturally, the PRC is thus very sensitive to anything that might affect employment opportunities in rural as well as urban areas.¹ The other factor the PRC now faces relates to solving non-performing loans (NPL) in state-owned banks (SOB). In recent years, it seems that the PRC government and four asset management companies (AMC) have been trying to involve foreign investors in the liquidation and disposal of NPLs. However, a sharp appreciation of the renminbi would definitely discourage them from

participating in the NPL disposal. Clearly, this is what the PRC does not wish to see happen.²

Table 1. Balance of Payment and Foreign Reserves of PRC

(Unit: one billion USD)

	2000	2001	2002	2003	2004*
Current balance	20.51	17.41	35.42	11.12	20.00
Trade	28.87	28.08	37.88	7.26	32.00
Capital balance	1.92	34.78	32.29	44.43	112.00
FDI	40.72	46.88	52.74	53.51	61.00
Errors & omissions	▲11.9	▲4.9	7.8	18.4	20.0
Foreign reserves	165.57	212.17	286.41	403.25	609.90

(Source) China Foreign Exchange Bureau, China Ministry of Commerce

* Provisional

Table 2. Background Comparison Between PRC and Japan

<u>For PRC</u>	<u>For Japan</u>
(Similarity)	
* US war on terror, Iraq	* US war in Vietnam
* PRC trade surplus with the US	* Japan trade surplus with the US
* US inflation pressure	* US inflation pressure
* US fiscal deficit	* US fiscal deficit
* PRC high foreign reserves	* Japan high foreign reserves
(Difference)	
* PRC FDI surplus	* Japan FDI deficit
* Major countries capital account liberalization already in place	* Major countries capital account liberalization not completed
* Some lessons can be learned	* No lessons learned
* PRC remains a developing country	* Japan was already an industrialized country

5.2 Impact on Macro Economy

Japan faced serious inflation both after the early 1970s and in the mid-late 1980s. One of the important underlying factors is loose monetary policy. Due to the strong allergy or serious concern about possible adverse impacts of the sharp appreciation of the yen on economic activities, in particular on the export-oriented manufacturing industries, perhaps the loose monetary policy was excessive. Also, policy change was not implemented in a timely fashion in either period. However, it seems the actual macro economic situation was not as seriously affected as anticipated and it started to recover earlier than predicted. In other words, the impact of the currency appreciation on the economy tended to be overemphasized. Thanks to the appreciation of the yen, prices of raw materials declined and terms of trade (export/import price indices) were improved significantly, even benefiting Japanese industries. The international competitiveness of Japanese commodities was also unexpectedly high in terms of quality management. Furthermore, many Japanese companies flexibly started to adjust to the new environment by such means as shifting their production lines to locations overseas. These unexpected benefits indicate the importance and difficulty of assessing the behavioral change and international competitiveness of enterprises and predicting the overall impact of currency fluctuation on the macro economy.

In the PRC context, theory and empirical evidence have shown that the renminbi was indeed undervalued on average by about 17 percent in past years. Thus, the 2.1 percent revaluation of the currency announced in July 2005 is not sufficient to weaken the competitive power of the PRC economy and reduce the trade surplus against the US. In the short run, the J-curve effect may cause the balance of trade to continue expanding. The revaluation has a limited impact on overall inflation. Considering the chain effects and accumulated effects of renminbi revaluation, the PRC economy could endure more extensive revaluations from the macro economic point of view. However, the PRC's main problems are not in the aggregate level, which is maintaining 9 percent growth, but in the structural or sectoral levels. Different industries have different endurance to the shocks of revaluation.

The PRC government is worrying most about the agricultural and automobile sectors, which may be easily affected by renminbi revaluation, and the unemployment problem induced by revaluation.

Currently one of the major sources for absorbing excess labor and mitigating the unemployment problem is FDI in the PRC. Assuming the current renminbi exchange rate and looking for cheap labor, many foreign companies have set up production lines and recruited a number of rural workers in China, in particular in special economic zones. If the renminbi is sharply appreciated, the PRC's noncompetitive agriculture sector and SOEs will be affected and more excess labor will be created; FDI may somewhat decline due to the higher operating costs in the Mainland. These changes might make the unemployment problem even worse.

Overall, prices have remained stable in the PRC. However, inflationary pressure, especially in terms of real estate prices, has been increasing in recent years. However, this pressure comes not only from the undervaluation of the renminbi, but from some other factors. Economically, to stabilize the renminbi exchange rate under the surplus in the current account, the PRC has to absorb USD by issuing renminbi notes, which increases the money supply.³ Politically, the new PRC Administration differs from the old one in that it tends to (or cannot but) accommodate all requests for development assistance from regional governments under the policy agenda of addressing regional disparities. This additional funding to regional governments is also putting inflationary pressure on the economy as a whole.⁴

5.3 Independent Monetary Policy and Regulations on Capital Flow

The events of both the early 1970s and mid-late 1980s raised the traditional question of a trilemma among the three economic goals: ensuring free international capital transactions, maintaining independence of the monetary policy, and keeping a pegged exchange rate regime. In the early 1970s, Japan tried to maintain a pegged exchange rate regime while allowing adjusted inflation to achieve external balance (in other words, a somewhat loose independent monetary policy). In the mid-late 1980s, under the framework of

international policy coordination put forward in the Plaza and Louvre Accords, readjusting or keeping exchange rates stable became a major goal of monetary policy. Differing views may exist about the goals of monetary policy, but in this case, when monetary policy lost its freedom, domestic equilibrium was sacrificed. We should keep in mind that all goals cannot be achieved simultaneously; we must think about relevant policy assignment.

In the PRC context, we need to take note that the trilemma argument that generally applies to small-sized economies is not necessarily able to explain the situation in the PRC. The trilemma argument states that a small country cannot carry out an independent monetary policy and a fixed exchange rate policy while keeping free capital flow. At the early stage of economic reform, PRC was economically a small country. Monetary policy was regarded as an indication of sovereignty and had to be maintained. If we apply the trilemma argument to the PRC under the early stage of economic reform, under the situation when its capital account transactions were not fully liberalized yet, to maintain and pursue a fixed exchange rate system and independent monetary policy could be justified especially if PRC achieved a trade surplus.

Recently, the PRC can no longer be regarded as a small country; if it was economically small, the US would not have needed to put pressure on the renminbi exchange rate. As a large economy, the PRC is capable of carrying out an independent monetary policy under a fixed exchange rate regime with regulated capital transactions. Thus, for the PRC internally, a fixed rate regime may not be a very serious problem, although it may result in external imbalance and incur foreign pressure. Such imbalances are certainly not caused only by the exchange rate, but also by other factors, for example, the US war on terror and the collapse of the US bubble economy.

In fact, many measures could be taken to deal with one problem. The current problem between the PRC and the US can be resolved through either external or domestic adjustment. Adjusting the renminbi exchange rate is only one of the options available. For example, the current imbalance could be resolved by cutting US public or military expenditures, which amount to more than 50 percent of the whole world's spending in these categories.

Alternatively, it could be resolved by easing export restrictions on the PRC. Looking at Japan's experience, inflationary pressure could be mitigated by taking a more timely monetary policy and leaving the external balance basically to the adjustment of the exchange rate. This is something that the PRC may learn from Japan's experience.

Regarding regulations on capital transactions, the PRC is still in the process of change. In the course of liberalization, it is moving to lift regulations on capital outflow with the "Go Overseas" (Zou chuqu) policy.⁵ This policy is expected to mitigate appreciation pressure to some extent. However, at the same time, there would be an increasing risk if the PRC further deregulated capital outflow while keeping a rigid exchange rate regime. This is an issue of policy sequence. In the case of Japan, intentionally or unintentionally, the move toward a floating exchange regime took place in tandem with the deregulation of capital account transactions.

5.4 External Imbalance and Exchange Rate Adjustment

Japan's experience also indicates that external balance cannot be achieved only through exchange rate adjustment. It is generally expected that currency appreciation raises export prices in terms of USD, which cuts down price competitiveness and decreases export volume. However, looking at Japan's experience in the mid-1980s, export prices in USD terms were raised by only 50 percent in terms of the percentage change of yen appreciation and the overall export volume was not much affected. The remaining 50 percent was absorbed by the streamlining efforts by the enterprises and the decline of the prices of imported raw materials (Japan's White Paper on International Trade and Industry). After all, looking at the I-S balance, the current imbalance reflects a domestic I-S imbalance among the countries concerned. Since under a free international capital flow regime, the exchange rate itself is deeply affected by capital flow and interest rates among countries, the adjustment role of exchange rates to current balance tends to be diminished (Japan's Economic White Paper). We should therefore note that to solve

external imbalance problems, it is essential to focus on the structural I-S imbalance of each country.

In the PRC context, the current surplus is basically matched by huge over-saving in the household sector. Promoting household consumption is an important policy agenda not only for addressing external imbalance but also for making economic growth sustainable.⁶ Regarding the direct impact of the appreciation of renminbi on the PRC's exports, it should be noted that exports by foreign-invested companies account for more than half of the country's total exports, so they may not be seriously affected. Companies that import raw materials and intermediate goods from other countries could offset the impact of the increase in export prices by a decline in import prices. Companies that operate in coastal areas where labor costs are already high could mobilize more labor from inland areas. In the case of Japanese companies, which dispatch many Japanese expatriates, they could replace those staff members with cheaper local staff.

5.5 Impact on Different Interest Groups

Japan's experience also gives us a lesson to keep in mind: different interest groups are affected differently by currency fluctuation and some groups have a bigger voice than others. For Japan, doubtless the manufacturing industry sectors such as steel and machineries suffered from the appreciation of the yen, and since these sectors traditionally had bigger political voices, they had more ability to influence policymaking. Meanwhile, non-manufacturing industries and consumers who must have benefited were not so politically influential compared to the manufacturing industry, and their views were not necessarily reflected in the policy decision-making dealing with the currency appreciation. This indicates the importance and difficulty of ensuring fairness and balancing the interests of various groups.

Who in the PRC benefits and who loses due to the appreciation of the renminbi? State-owned enterprises (SOEs) and state-owned banks (SOBs), having no international competitiveness, and other export industries including agriculture will definitely suffer. Foreign-invested companies in

general will also suffer. This may affect FDI as a whole, but the effect should not be expected to be too much because many foreign-invested companies are no longer looking only for cheap labor in the PRC, but are looking at the huge potential of the domestic market. Perhaps the consumers stand to benefit from renminbi appreciation.

As for the political influence of each group, the SOEs and SOBs may still have big voices. However, as the market economy matures and people become richer, private enterprises and individual households are gaining influence.

5.6 Long-term Impact of Currency Appreciation

Japan's example shows that we need to pay attention not only to the immediate impact of currency appreciation, but also its long-term effect on the economy, in particular on the nation's industrial structure. The sharp appreciation of the yen triggered upgrading or conversion of the industrial structure in both the 1970s and 1980s and made Japan a more advanced or high-value added economy. In the 1970s, traditional leading industries such as textile, steel, non-ferrous metal, and chemical were replaced by assembly-type industries like automobile, electric appliance, and machinery. In the 1980s, many Japanese companies started to shift their production lines overseas while trying to focus domestic production on more high-value added commodities.

In the PRC context, the appreciation of the renminbi or moving to a more flexible exchange rate regime should provide a good opportunity to move toward a more market-oriented economy. As estimated, the renminbi is severely undervalued under a fixed exchange rate regime, which distorts resource allocations across countries. Appreciation of the renminbi will help to correct the distortion. However, different estimates show differing views on how much the currency should be adjusted. We estimate that the currency is undervalued by 17 percent in terms of the nominal exchange rate (see our ADBI research paper series on renminbi revaluation). The variation of estimates, however, indicates how difficult it is for a planned economy to

reach consensus on the appropriate equilibrium level. The best answer is to pursue marketization, adopting a more flexible exchange rate regime and letting the market determine the equilibrium level.

However, the exchange rate is much more volatile than goods prices, and its sometimes explosive behavior may bring some economic and political chaos. For example, some thought that the ten years of loss in Japan related to the sharp appreciation of the yen. The radical price reform in 1988 in the PRC directly resulted in high inflation economically and the political storm in 1989 forced the general secretary of the Central Communist Party to step down. In view of the negative experiences of Japan and the PRC and the successful experiences of gradual reform in PRC, we think that the PRC should stay firmly on the road toward a more flexible exchange rate regime with a gradualist principle and let the foreign exchange market explore its equilibrium level in two or three years so as not to cause too many shocks to the economy and to give market participants more time to adjust their behavior and gradually adapt to the new exchange rate. From this viewpoint, the principles of controllability, gradualism, and balance, which were announced by the PBOC, could be deemed to be relevant ones.

Select References

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¹ According to the official data, the unemployment rate in urban areas was 4.2 percent (about 8 million) at the end of 2004. However, it is widely estimated that there are about 10 million laid-off employees (xiangang) in the SOE sector and 150 million members of the excessive labor force in the rural areas, of which 8–10 million come to the urban areas to look for job opportunities every year. In addition, roughly 8–14 million new workers flow into the market every year.

² At the early stage after the AMC's were set up in 1999, the PRC authorities already expressed interest in or acknowledged the necessity of inviting foreign investors to solve this problem. For instance, at the international forum on NPL, which was held in Beijing in 2001, the Governor of the PBOC, while admitting to the poor management environment of the AMC's and referring to the limited financial measures available to cope with NPL's, expressed the need for the mobilization of foreign funds to solve this problem. The State Development and Reform Commission (SDRC) issued the "Circular on Administration of Foreign Debts Relating to External Transfer of NPL by AMC's" in 2004. This circular aims to streamline the procedure and entice foreign investors to invest in NPL. It is reported that Huarong AMC attempted to sell a package worth 150 billion RMB for a record largest sale targeting foreign investors in late 2004 (SCMP Oct. 20, 2004). It is also reported that Silver Grant International Industries Ltd., a Hong Kong, China listed company controlled by China Xinda AMC, which has dealt with the disposal of NPL, unveiled a plan to sell more than 200 million USD worth of new shares and convertible instruments to Citigroup Global Investment Management and that Silver and Citigroup signed an MOU to establish a joint venture that will invest in NPL in the PRC (China Economic News Jan. 10, 2005). External sources are also expected to be used to strengthen banks' capital adequacy ratio (e.g., the injection of 4.5 billion USD of foreign reserves as an additional capital fund to two of the four SOBs).

³ M2 in the PRC increased by 12.3%, 17.6%, 16.9%, 19.6%, and 14.6% in each year, respectively, from 2000 to 2004 (PBOC statistics) compared to the average economic growth of 8–9%. Although the growth rate of M2 declined in 2004, the velocity of money rose sharply, due primarily to the expansion of credit demand.

⁴ The National People's Congress in 2005 launched another regional development initiative called the Central Area Development Plan (Zhongbu boxing), in addition to the Go West Policy (Xibu daikaifa) and the development plan for northeast area.

⁵ The Zou chuqu policy encourages not only SOEs but also all kinds of ownerships to invest abroad. Under this policy, the State Administration of Foreign Exchange (SAFE) streamlined the approval procedures for companies who invest abroad, only requiring the approval of local foreign trade authorities. The policy also includes various measures, such as permitting PRC enterprises involved in international transactions to retain more foreign currency holdings and allowing Chinese citizens emigrating overseas to transfer assets to their new locations.

⁶ In the PRC, a high proportion of investment to GDP is eminent. It has not been lower than 35% since 1983 and recently stood at more than 40%. While the saving rate of households declined in 2003, consumption has not necessarily increased. Instead, households took greater advantage of investment channels (state bonds and funds) due to the negative interest rates on bank deposits.