# China May Not Be Ready For A Flexible Exchange Rate Even In 2010[1].

*By Takamoto Suzuki, Economist (tsuzuki@ufji.co.jp)*

After a heated debate on the revaluation of the China's Renminbi, triggered by its swelling trade surplus with the U.S., China's shift to a "flexible foreign exchange regime" seems to be agreed upon internationally. Nevertheless, the underlying macroeconomic conditions do not appear to be suitable for such a regime not only today, but also in 2010.

## *Macroeconomic conditions today may not support a shift to a flexible exchange regime.*

1: The level of GDP per capita is still very low: China's GDP per capita will barely reach $1,000 in 2003. In the early 1970s, when western nations and Japan began to float their currencies, their average GDP per capita was between $2,000 and $3,000. In the late 1980s, when the Korean won and the Taiwanese dollar were revaluated sharply, their GDP per capita was also between $2,000 and $3,000.

2: China's growing trade surplus causes trade friction, but it may not last long. Due to strong demand for materials, parts, and capital goods, which reflects rapid economic growth in China, the trade surplus has begun to shrink in 2003. As a result, it is possible that the trade balance will turn into a deficit at the earliest in the first half of 2004.

3: China's international competitiveness is restricted only in miscellaneous goods, and electric and electronics products, most of which are produced by foreign manufacturers. While China's competitiveness has strengthened, its trade surplus has also grown between the late 1990s and early 2000s, partly because of weakness in domestic demand.

In sum, the current macroeconomic conditions indicate that China's exchange rate will not be stabilized if it floats the Renminbi today. In addition, China's domestic financial markets remain fragile and seem unable to support a flexible exchange rate regime: state owned commercial banks have suffered from bad debt problems; foreign exchange and money markets remain small. The daily trading volume of the Shanghai foreign exchange trading center amounts only to $0.39 billion, one twentieth of Japan's daily trading volume of $9 billion. Despite capital controls, China's foreign reserves have surged due to an inflow of speculative money, indicating the difficulty of capital management. Reform of the financial system is one of the promises that the Chinese government made upon entry in the WTO; given such conditions, a shift to a flexible exchange rate regime is one of the last items on its agenda.

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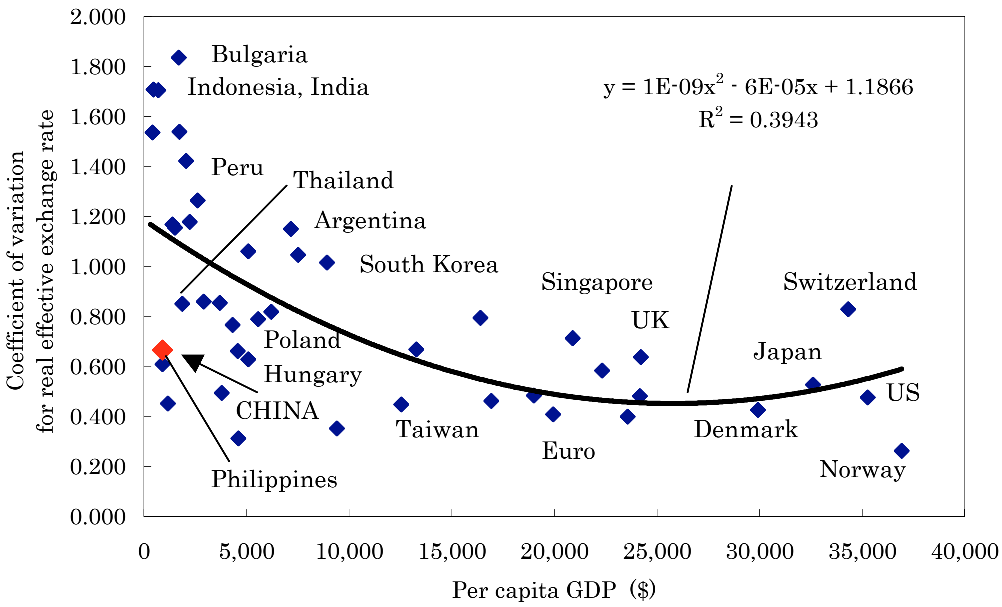
[1] This is an English summary of a report originally published on December 11, 2003. The full report is available only in Japanese, but the author will answer questions regarding the topic by e-mail.

## Macroeconomic conditions in 2010 may not support the case.

In 2010, China's GDP will likely reach the size of Japan's present GDP, but it seems still too early to float the Renminbi from a macroeconomic perspective.

1: As shown in the chart below, fluctuation in exchange rates will become small and then turn larger again along with the level of GDP per capita. Exchange rates tend to stabilize when per capita GDP reaches between $10,000 and $15,000. According to World Bank estimates, China's per capita GDP at the purchasing power base will reach about $8,000 in 2010 and $12,000 in 2020. In order to avoid large fluctuation in exchange rates, it would be better to wait until the mid-2010s to float the Renminbi.

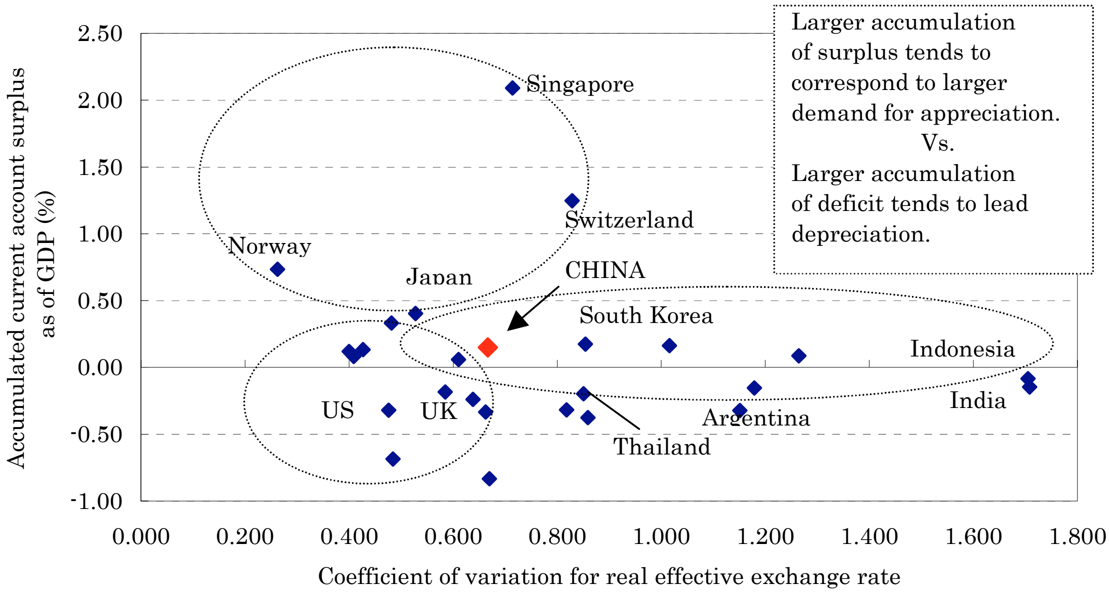
**Exchange rate fluctuations and per capita GDP**




Source: JP Morgan, The World Bank

2: Assume that the accumulated current account surplus reflects the international competitiveness of a country. As shown in the chart on page 3, a larger surplus corresponds to a smaller fluctuation in exchange rates. The U.S. and the U.K. are the exceptions: despite current account deficits, their currencies do not fluctuate much since there is strong confidence in them. It is likely that China's current account surplus will diminish due to an aging population, and major events, such as the Beijing Olympic Games and the Shanghai World Exposition. As China grows economically, demand for a shift to a free float system may heighten, but a changing regime does not necessary mean the revaluation of the Renminbi, since China's current account surplus will likely shrink. Indeed, as China's service markets will be liberalized, as a result of China's entry to the WTO, a continuous foreign direct investment (FDI) inflow, mainly led by the service sector, may offset the effect of a diminishing current account surplus and push up the value of the Renminbi.

**Exchange rate fluctuations and accumulated current account surplus**




Source: JP Morgan, IMF

3: By 2010, China's financial markets will have grown to a significant extent, but their relative size to GDP will remain small, as the GDP will also grow. It may also take some time for China to develop domestic bond and stock markets with considerable depth.

4: Under a floating exchange rate regime, monetary policy should be effective in order to assure continuous economic development. Banks' bad debt problems may have been alleviated by 2010, but it is questionable whether China will have effective monetary policy tools by then, partly because its financial markets will remain small.

In sum, even in 2010, it appears too early to introduce a free floating system. Based on the analysis above, it would be appropriate to expand the range of exchange rate fluctuations gradually, but maintain some capital controls. In this case, Renminbi rates may appreciate, due to continuous FDI flows. In addition, it is important that China's domestic demand should be large enough to offset the negative impact on external demand; the Chinese economy must continue to grow, led by domestic demand. If China stumbles, the global economy will be destabilized.



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