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Economics Group

Special Commentary

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China Reintroduces Currency Flexibility

Chinese Currency Move: Much Ado About Nothing?

In July 2005, Chinese officials decided to allow some flexibility in the exchange value of the renminbi, and it subsequently strengthened 21 percent against the U.S. dollar over the next three years (Figure 1). However, as uncertainty about global economic prospects spiked in the summer of 2008, the appreciation of the yuan versus the dollar came to a grinding halt and the exchange rate remained essentially fixed over the next two years.[1] Over this past weekend, Chinese officials reverted to their 2005-2008 policy when they announced their intention to "proceed further with reform of the renminbi exchange rate regime and to enhance the renminbi exchange rate flexibility." Overnight, the yuan strengthened 0.4 percent vis-à-vis the greenback, its biggest daily move since the one-step revaluation of 2 percent in July 2005.

Unlike the euro/dollar exchange rate, which is set entirely by market forces, the exchange value of the renminbi, even under the current policy, is heavily managed by the central bank. During the 2005-2008 period, the policy of the People's Bank of China (PBoC) was to manage the exchange value of the renminbi versus a basket of currencies and to constrain daily fluctuations in the yuan/dollar exchange rate to 0.5 percent. In reality, the exchange rate moved much less on a daily basis. This policy has now been re-introduced, which should allow some modest appreciation of the yuan in the months ahead.

Figure 1

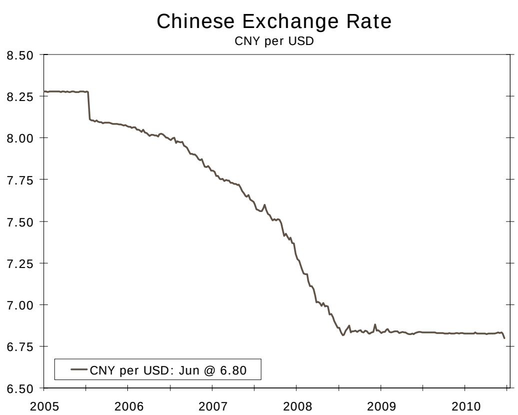
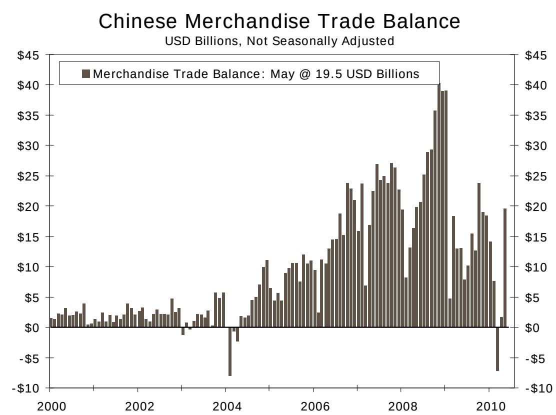


Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

Why Did China Take This Step Now?

In its press release, the PBoC said that it was taking this step now because the "recovery and upturn of the Chinese economy has become more solid with the enhanced economic stability. It is

[1] **The terms "renminbi" and "yuan" can be used interchangeably.**

desirable to proceed further with reform of the renminbi exchange rate regime and increase the renminbi exchange rate flexibility." Indeed, the policy move dovetails with the current economic needs of China because the major risk to the economy has shifted from insufficient economic growth to inflation that could potentially be higher than desired. Currency appreciation helps to constrain inflationary pressures directly via lower import prices and indirectly by slowing export growth somewhat.

There are political reasons for the decision as well. First, the move should reduce some criticism of China's exchange rate policy at this weekend's G-20 summit meeting in Toronto. President Hu can come to the meeting claiming that China is upholding its international responsibilities to help re-balance the global economy. In addition, protectionist sentiment is starting to rise again in the U.S. Congress ahead of November's mid-term elections, and the move may help to defang some of the arguments that China unfairly manipulates its currency.

How Much Will the Renminbi Strengthen?

Wells Fargo's currency strategy team does not look for <u>significant</u> appreciation of the renminbi against the dollar. The team forecasts an exchange rate of 6.70 yuan/dollar in six months and 6.30 yuan/dollar in eighteen months. If this forecast is realized, then the renminbi would be about 2 percent stronger vis-à-vis the greenback in six months and 8 percent higher in eighteen months than it was at the end of last week. To put these forecasted moves in perspective, recall that Chinese authorities allowed the currency to appreciate only 0.5 percent against the dollar between July 2005 and the end of that year. By the end of 2006 (about 18 months after the initial revaluation), the yuan had appreciated 6 percent in total against the dollar.

The most important priority for Chinese policymakers is social stability, and economic policies are rarely changed in a dramatic fashion. Rather, Chinese officials prefer to move in a very deliberate fashion to minimize the probability of negative shocks to the economy. As the experience of 2005-2008 demonstrates, we doubt that policymakers will now allow runaway appreciation of the yuan. Indeed, the PBoC said in its press release that "the basis for large-scale appreciation of the renminbi exchange rate does not exist."

Implications for Other Markets

We are not inclined to make changes to our Chinese macroeconomic forecast because we had already factored in a return to currency appreciation. We forecast that the Chinese GDP will grow in excess of 10 percent in 2010 before slowing to about 9 percent next year. In our view, the modest amount of yuan appreciation that we forecast over the next eighteen months will not have a significant negative effect on the Chinese economy. Due to its very high saving rate, which probably won't be affected much by the modest change in policy, we also believe that China will continue to rack up current account surpluses over the next few years (Figure 2). This currency move should also have very little impact on the U.S. current account, which we forecast will remain in deficit for the foreseeable future. In other words, a major re-balancing of the global economy, where the U.S. current account deficit and the Chinese current account surplus both move toward balance, does not seem likely due solely to this currency move.

Some investors fear that yields on U.S. Treasury securities will snap higher if Beijing allows its currency to strengthen, and the Treasury yield curve is 5 bps-8 bps higher this morning than it was on June 18. However, we do not look for a significant rise in Treasury yields due to this move alone. As noted above, China will likely incur trade surpluses for the foreseeable future. Therefore, the PBoC will need to buy dollars on the foreign exchange market in order to constrain the appreciation of the renminbi, and the PBoC will need to find interest-earning assets in which to park its foreign exchange reserves. In our view, the PBoC will continue to purchase U.S. Treasury securities for the foreseeable future.

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