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Economic Review

Reforms After the 2005 Yuan Revaluation
And Prospects for Near-Term Economic Change

On July 21, 2005, the People's Bank of China (PBC), China's central bank, announced that the exchange rate of the yuan against the U.S. dollar would be raised by nearly two percent, from 8.2765 yuan to 8.11 yuan to the dollar. In addition to the mounting overseas pressure resulting from China's expanding trade surpluses, domestic factors such as the "creeping" inflation caused by the influx of capital were some of the factors behind the decision. As the yuan exchange rate had remained unchanged for nearly ten and a half years since early 1994, there were concerns that the revaluation would cause the yuan to surge and possibly lead to an economic recession— but in fact, the economy has been continuing high growth under a gradually rising yuan.

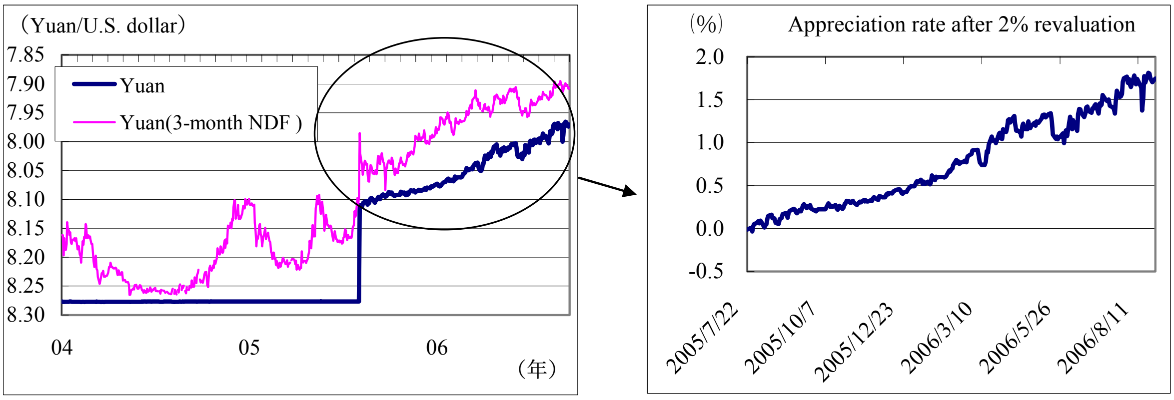
Meanwhile, Chinese authorities have not just focused on monetary operations aimed at moderate appreciation of the yuan; it has stepped up its pace towards developing a foreign exchange and capital control system which would allow exchange rates to be determined through market mechanisms in the medium- to long-term. This report will examine the prospects for yuan exchange rates by looking into the progress of the reform initiatives to develop the yuan exchange and capital control systems.

1. Foreign Exchange and Capital Transfer Regulations After the Revaluation

In addition to the revaluation of the yuan exchange rate, the July 2005 reforms to the foreign exchange management regime included the abandonment of the dollar-peg and introduction of a managed floating exchange rate regime in which the value of the yuan is referenced to a basket of currencies. While the yuan has continued to rise since the revaluation, the rate of appreciation since then has remained under two percent (Table 1). At the Asia-Europe Meeting (ASEM) of finance ministers held in June 2005, Premier Wen Jiabao had presented three principles for China's yuan reforms which were to ensure: 1) "independence" based on China's own needs, 2) "controllability" to avoid large fluctuations in the yuan's exchange rate, 3) "graduality" in proceeding with the reforms progressively.

The central bank appears to be faithfully following these principles, exercising strong control through market operations to prevent the yuan from appreciating drastically. At the same time, the PBC is implementing measures such as the easing of capital transfer regulations, and making progress towards developing a foreign exchange regime based on market demand and supply.

Figure1: Yuan Exchange Rate against the U.S. dollar



Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on CEIC.

In August 2005, foreign exchange forward transactions operations, previously limited to the four state-owned banks and the Bank of Communications, were opened to foreign banks along with the introduction of currency swaps— enhancing risk hedging methods available to the market (Table 1). This was followed by the introduction of over-the-counter transactions to the inter-bank foreign exchange spot market structure in addition to the existing method intermediated by the China Foreign Exchange Trade Center (CFETC), and over-the-counter transactions already represent about ninety percent of total trading. At the same time, the PBC changed its method of determining the benchmark exchange rate from the previous day's close price to the weighted average of quotations collected from fifteen "market makers" in the morning of the same business day.

Reform on the restrictions to transfer of capital is also under way at a high pace. Since the start of China's reform and open-door policies, outflow of capital was heavily controlled to curb demand for foreign currency, while capital inflow such as foreign direct investment was actively sought in order to cover its shortage of capital. However, now that the excessive inflow of capital has become a constant, the authorities are seeking ways to ease restrictions that can prevent illegal hot money from flowing in or promote the outflow of funds through legitimate routes.

The enhanced controls on capital inflow are becoming a concern for foreign banks and corporations, as in addition to delays in overseas remittances and payments for imports, the restrictions are starting to impact overseas financing by foreign banks and borrowing by foreign corporations through their parent companies' guarantees.

For the outward flow of funds, the opening of overseas securities investment to qualified domestic institutional investors (QDII) in April 2006— following the progressive raise to limits on foreign currency holdings for enterprises and foreign exchange purchase quotas for individuals ---was a groundbreaking event. The authorities had announced it would examine the introduction of QDII in October 2001, but due to factors such as the risk of a further slump in the domestic stock markets, it took four and a half years to be realized.

In closer detail, this deregulation enabled: 1) qualified banks to collect funds from domestic institutions and individuals and invest in overseas fixed income products upon converting the funds into foreign currency; 2) qualified securities brokers (QDII) to collect individually-owned foreign exchange from domestic institutions and individuals and use the funds for overseas portfolio investment including the purchase of stock; 3) qualified insurance institutions to purchase foreign exchange for the purpose of investing in overseas fixed-income products and money market instruments. Eight banks and one fund management company have been approved as QDII and were allowed to invest up to a combined total of 8,800 million dollars. This exceeds the current investment quota of 7,495 million that is approved for qualified foreign institutional investors (QFII) to invest in domestic securities, based on the framework introduced in December 2002.

With limited variety in fixed-income products available as only banks actually offer any products based on this new framework, in addition to prospects for a stronger yuan, there has not been much of a momentum among domestic investors. However, there should be a sizable potential demand for investment in overseas blue chip firms. Once overseas securities investment become available through fund management companies, there is expectation for these investment activities to contribute in improving international trade imbalances.

2. Exports: Signs of changes within continued high growth

(1) Little Progress in Transfer of Costs

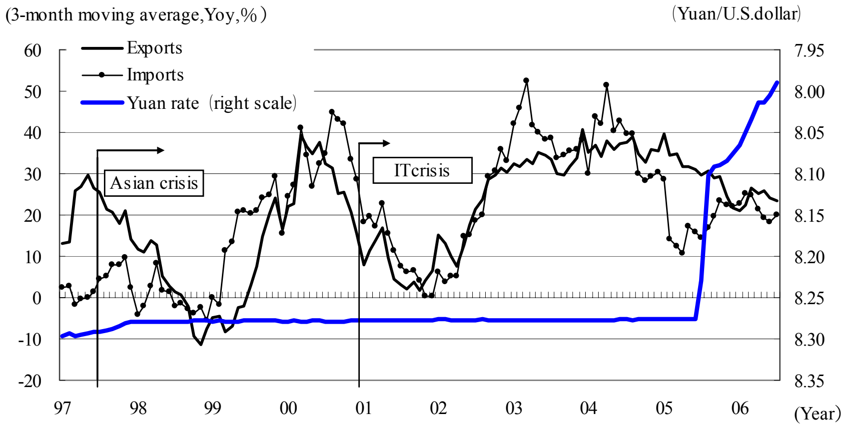
As discussed above, China’s authorities have maintained a gradual upward trend of the yuan as it expands its reforms to cover other areas related to the foreign exchange management regime. Meanwhile, China’s exports ―which had continued to grow at a rate beyond thirty percent for the past three years after its downturn under the Asian currency crisis and burst of the IT bubble― has started to slow down (Figure 2). Export growth is still considerably high however, and one of the main factors behind this is that the price competitive power of China’s export products has hardly declined. While the yuan’s exchange rate to the US dollar has continuously risen since July 2005, the US price index for imports from China continues to fall even after the Yuan Revaluation and the latest decline rate is in line with imports from ASEAN (Figure 3). By contrast, the US price index for imports from Mexico continues to rise in spite of the sharp fall in the Mexican peso’s exchange rate to the dollar.

Table 1：Recent Reforms in Capital Controls and the Foreign Exchange System

	Capital Controls	Foreign Exchange System
2004 March	• The limit of foreign currency holdings was raised to 30%or 50%from 20% of foreign exchange income for each enterprise.	
May	• The quotas were imposed on the total of funds that foreign banks procure outside of China.	
2005 April	• Foreign companies were obliged to register domestic loans under external guarantees (often from their parent companies) as external debts. Their accumulative registered external debt amount shall not exceed the minus between the aggregate investment and the registered capital.	
May	• Local administration branches were authorized to approve outward investment projects at as much as US$10 million (previously, US$3 million). The foreign exchange quota for outward investments was increased to US$5 billion a year (previously, US$3.3 billion) .	• The market maker system was introduced in transactions between foreign currencies.
June	• Insurance companies were allowed to investment their own foreign currency in overseas share markets.	
July		• **The exchange rate system was changed from the dollar peg to a managed float adjusted by referring to a basket of currencies.**
August	• The limit of foreign currency holdings was raised to 50% or 80% from 30% or 50% of foreign exchange income for each enterprise. • Foreign exchange purchase limits per individual was raised to US$5,000 or US$8,000 from US$3,000 or US$5,000.	• Foreign exchange forward transactions were opened to foreign banks. Currency swaps were introduced.
September		• The yuan's trading band against non-US dollar currencies were widened to 3% from 1.5%.
October	• The management of external debts was changed（Domestic loans under external guarantees shall be registered on the basis of the performed amount instead of the contracted amount）. • The International Finance Corporation (World Bank Group) and the Asian Development Bank issued the first yuan-denominated bonds as non-residents (panda bonds) .	
2006 January		• Over-the-counter trading of the yuan, along with a market maker system were introduced. Under the new system, the central parity rate is set based on daily hearing from market makers.
April	• Deregulation of foreign exchange management system: （①Qualified domestic institutional investors（QDII) were allowed to collect funds of customers to invest overseas. ②The limit of foreign currency holdings was raised to total of 80%of foreign exchange income and 50% of foreign exchange expense. ③Foreign exchange purchase limits by individuals were raised to US$20,000 a year, etc）	• Interbank trading of foreign currency swaps was introduced.
June	• The foreign exchange quota for outward investments was abolished.（previously US$5 billion a year）	• Primary dealer system was introduced.

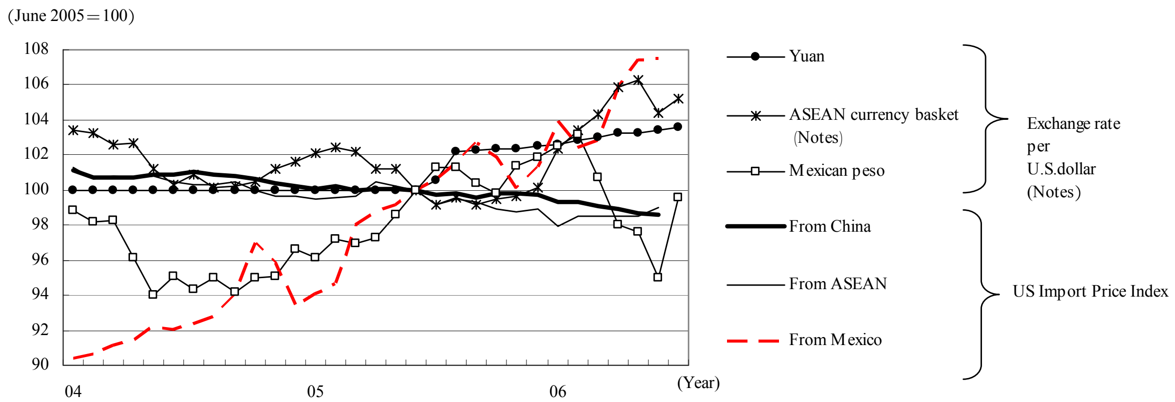
Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on media reports, etc.

Figure 2：China's Foreign Trade and Exchange Rate



Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on CEIC.

Figure 3：Exchange Rates against U.S. Dollar and US Import Price Index



Note:1.ASEAN currency basket is obtained by weighting the currencies of Malaysia, Thailand, Indonesia and Philippines with the US import value from each country.

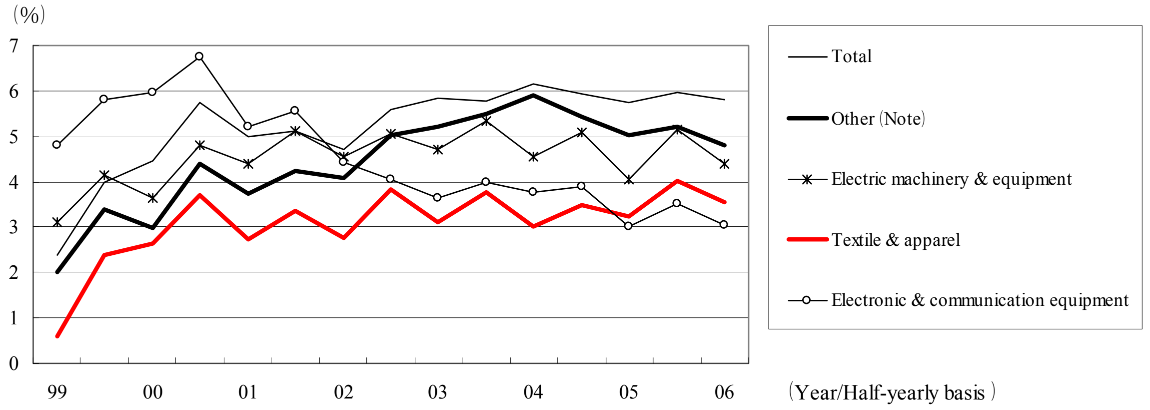
2.Higher index of exchange rate of Yuan、ASEAN currency basket、Mexican peso means to appreciate against U.S. dollar.

Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on CEIC, etc.

While companies would be able to maintain export growth by reducing the dollar-based export price to the US even under a rising yuan against the dollar, this would most likely lead to a further decline in the already low profit margins. According to a survey conducted by the PBC on 302 Chinese companies, only 8.7 percent have been able to transfer the increase of the yuan in its pricing. In another survey jointly conducted by the National Bureau of Statistics of China and the National Development and Reform Commission on large- and medium-sized enterprises, about half of respondents admit their exports have been affected by the rising yuan. Furthermore, a PBC Shanghai Head Office (equivalent to a second head office) survey on seventy manufacturing companies revealed that in spite of the increase in value of exports by 17.5 percent, the companies experienced average profit decline of 46.3 percent.

Looking at the return on sales of major export industries, the negative effects of the yuan revaluation are not clearly evident in recent figures (Figure 4). However, the return on sales of electronic & communication equipment industry had started declining before the revaluation and that of electric machinery & equipment, and textile & apparel industries are below the average of "other industries" in the graph. Based on these trends, resistance to the yuan's rise is expected to be somewhat limited.

Figure 4：Return on Sales of China's Major Industries



Note: "Textile & apparel", "Electric machinery & equipment" ,"Electronic & communication equipment" and "Petroleum & natural gas extraction" which is extremly profitable because of current oil price hike are excluded.
Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on CEIC.

(2) Rising Yuan and Wages Reducing China's Appeal as Production Base

China's rapid growth in its export power is largely based on the fact that many foreign companies chose China as their production centers, and the share of foreign companies in total exports reached 58.4 percent in the first half of 2006—- but the rising yuan is contributing to the decline in cost competitiveness which was one of its main appeals.

In the southern regions such as Shenzhen, there has been a rapid rise in labor costs which had been under control for a long period. Some of the factors behind this trend are the reduced inflow of rural migrants due to the creation of jobs in the inlands and the rural income expansion policies by the Hu Jintao government, in addition to the regional governments' raising the minimum wage. While the wage levels of neighboring countries have generally declined after the Asian Crisis, China has marked a clear rise in labor costs and is thus substantially losing its cost-advantage (Table 2).

Many foreign companies are still entering China in pursuit of its giant market, but some suggest that there are moves to reconsider strategy in light of the decline in the country's appeal as a production center. In effect, foreign direct investment to China has declined in 2005, and 2006 January-July has also shown a modest downward trend from the previous year. It is quite possible that these developments eventually affect the growth in exports.

Table 2：Labor Costs in Asian Cities

(U.S. dollar)

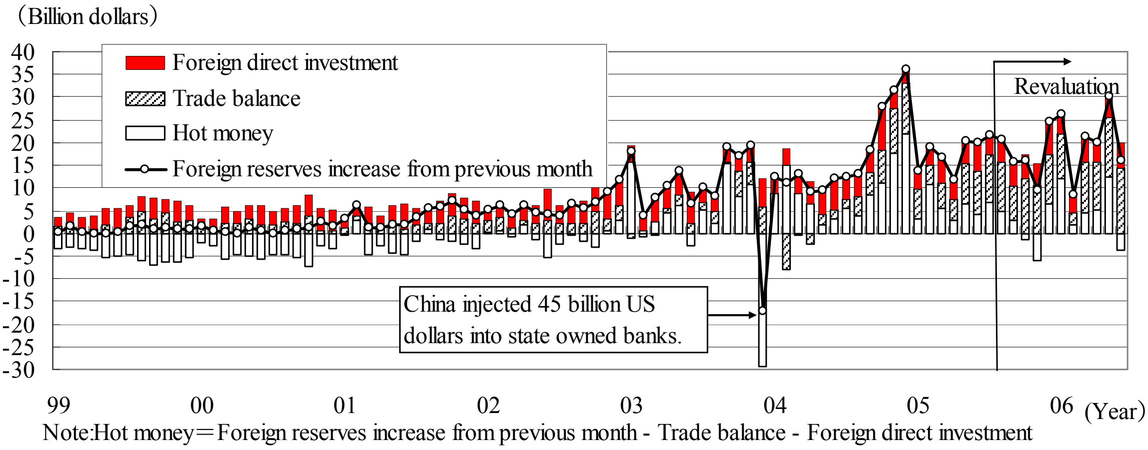
	Workers		Engineers		Middle management	
	June 1997	November 2005	June 1997	November 2005	June 1997	November 2005
Shanghai(China)	**132**	**237**	**235**	**464**	**274**	**1,147**
Shenzhen(China)	**119**	**174**	**221**	**403**	**269**	**744**
Hochiminh City (Vietnam)	123	148	257	311	450	813
Jakarta(Indonesia)	126	131	381	270	1,291	618
Manila(Philippines)	263	182	325	279	828	649
Bangkok（Thailand)	266	146	672	316	1,434	584
Kuala Lumpur（Malaysia)	329	205	1,069	790	1,844	1,643
Singapore(Singapore)	1,028	530	2,139	1,668	3,450	2,993
Seoul(South Korea)	1,877	1,479	2,177	1,976	3,456	2,414
Taipei(Taiwan)	1,148	1,194	1,651	1,767	2,655	2,740
Yokohama(Japan)	2,992	2,984	4,165	4,173	5,701	4,624

Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on *Survey of Investment-Related Cost Comparison in Major Cities and Regions in Asia* , JETRO

3. Continued Influx of Capital, While Burden of Market Operations Should Decline

The yuan's revaluation was expected to have some effect in curbing capital inflow to the country. In order to prevent the Yuan from rising against the trade surplus, foreign direct investment, and the influx of hot money that increased from around 2003, the PBC has accumulated a huge amount of foreign currency reserves through market interventions in which tens of billions of US dollars were purchased in exchange for the yuan each month (Figure 5), while it was also forced to perform open market operations to absorb the liquidity it provided to the domestic market. The PBC had strong concern for continuing this situation, and is believed to have urged itself to limit market expectations for a higher yuan through last year's revaluation.

Figure 5：Balance of Payments and Foreign Reserves



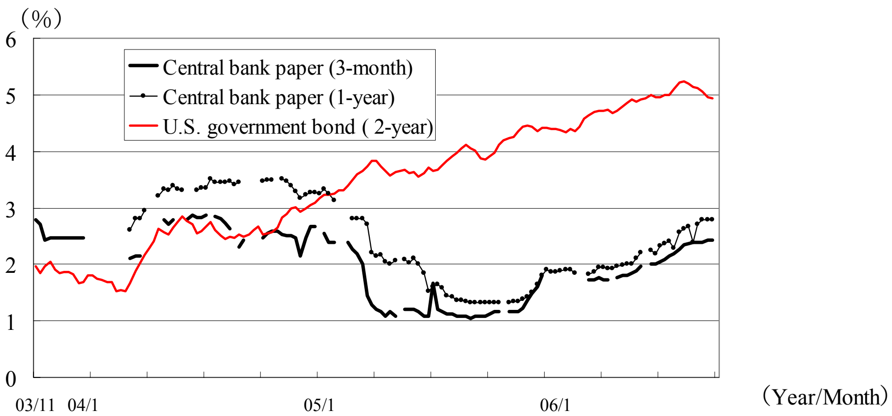
Note:Hot money＝Foreign reserves increase from previous month - Trade balance - Foreign direct investment
Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on CEIC.

The average monthly net inflow of "hot money" has come down to 3.6 billion US dollars in the eleven months following the yuan revaluation from the 8.5 billion monthly average in the preceding twelve months, and some months have ended with a net outflow. The yuan's appreciation being kept at a very gradual pace, remaining at a rise of two percent weak after one year seems to have had some effect in discouraging speculators. On the other hand, expectations for a higher yuan have not completely been eliminated, and China's authorities view that its huge trade surpluses include large amounts of speculative funds (Note). In fact, the pace of slowdown of China's foreign currency reserves have remained limited mainly due to the expansion of trade surpluses, and the PBC still continues to intervene in the foreign currency markets and absorb domestic liquidity.

Note: Overstatement of export costs, understatement of import costs, methods to advance or delay the payments or receipts of import/export costs according to the expected direction of foreign exchange rates called "leads and lags" have been pointed out.

Still, the burdens associated with these operations are decreasing. This is because the interest rate gap between the two countries has been reversed— interest on US government bonds mainly used to manage foreign currency reserves were previously lower than the interest on China's central bank papers used to absorb domestic money resulting in a negative spread, but successive US rate hikes have led to a positive spread from 2005 onwards (Figure 6). Earlier this year in March, Li Yang, a former Monetary Policy Committee member and current Chinese Academy of Social Sciences economist, was reported to have acknowledged that large amounts of holding gains were being earned from the foreign currency reserves.

Figure 6：The Interest Rates in China and USA



Source: Compiled by the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ based on CEIC.

4. Near-term Prospects

As we have seen, the Chinese authorities have controlled the appreciation of the Yuan at a modest rate since the two-percent revaluation performed last July— while the negative effects to the real economy has so far been limited, issues such as the difficulty of passing on the higher prices to exports goods and the declining appeal of China as a low-cost manufacturing center have been confirmed. On the other hand, though intervention to counter the influx of capital still continues, the burden of market operations has been somewhat reduced with US interest rates now exceeding China's (Figure 6). In light of these developments, it seems reasonable to expect that the authorities will continue to promote the yuan's gradual appreciation based on the three principles of "independence, controllability, and graduality." Still, possibilities remain for the pace of appreciation to increase or the daily trading band to be expanded from the current 0.3 percent.

It is also true that strong pressure for greater change remains. In particular, over twenty bills have been submitted to the US congress as countermeasures to China, including the hard-line bill drafted by Democratic Senator Charles E. Schumer and Republican Senator Lindsey Graham which demanded a 27.5 percent tariff on Chinese imports alleging the yuan's undervaluation. The US Treasury has continued to suggest possibilities that China will be specifically named as a "currency manipulator" in its Semiannual Report on International Economic and Exchange Rate Policies. Much expectation is directed to the newly appointed Treasury Secretary Henry Paulson, with extensive ties in China's political and financial circles as a former chief executive of the Goldman Sachs Group, in resolving the yuan exchange rate issue. Considering the fact that the US-China Summit was a large factor in the political judgment towards the July 2005 revaluation, the US will continue to be a major influence in future developments. We must closely observe how US pressure against China will grow as the mid-term elections draws near in November.

Finally, while deregulation of capital controls is expected to continue in order to ease the pressure for a higher yuan, we should also fully recognize that in an event where China's weaknesses such as its still-highly-fragile banking system are brought to focus, these liberalization policies also contain the risk that a sudden and severe flight of capital can arise leading to an "Asian Crisis-type" of currency devaluation.

(Yoko Hagiwara, August 30, 2006)

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