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While China May Delay Revaluation, Export Limits Could Cure Trade Imbalance

Despite the recent spate of US pressure to revalue the Chinese renmimbi (RMB) in the interests of reducing the US trade deficit, we see higher risk that Beijing further postpones the currency adjustment this year. Although a modest mid-year RMB adjustment of about 3% remains our base-case forecast, this scenario requires a significant decline in speculative pressure during the next month or so, which doesn't seem likely at this juncture.

Instead, we sense that Beijing is looking for ways to change the general perception of a 'super-competitive RMB' in the near term so that the eventual shift to a flexible exchange-rate arrangement will be a successful policy without being subject to persistent revaluation pressure.

Yet perhaps the focus on a revaluation is somewhat misplaced. The way we see it, although we believe that a more flexible exhange-rate policy is ultimately necessary for monetary independence, recent restrictions and tax measures placed on domestic exporters will likely have more impact on China's trade imbalance with the US than would a currency revaluation.

Exports, RMB Policy and the Trade Surplus

Since enactment of the Open Door Policy in 1979, China's economic system has been very much geared toward export promotion, with the establishment of export processing zones and the introduction of tax rebates and other incentives for export enterprises.

In addition, a pegged currency over the past ten years has helped to attract foreign direct investment (FDI) into China which, in turn, has provided a significant boost to manufacturing export capacity. In fact, manufacturing accounted for some 70% of the US$60.6 billion of total utilized FDI last year. As a result, merchandise exports as a share of nominal GDP has surged from below 10% in 1985 to some 36% in 2004. This is significantly higher than merchandise exports' 12% share in Japan and 7% share in the US.

But the economic stimulation created by these export-friendly policies appears less necessary than before. While China does not have an excessive current account surplus, averaging just 2.3% of GDP over the past five years, a surging bilateral trade surplus with the US reached US$162 billion last year according to US trade data—although it has reached just US$55 billion according to Chinese customs statistics (**Displays 1–2**).

In response, government policy has turned in favor of phasing out export incentives and we believe Beijing is planning a program of continuous reduction in VAT rebates during the coming year. Though the average rebate on the VAT to export firms was already cut to 13% (from 16% three years ago), it is still high enough to help export companies to maintain competitive pricing in overseas markets. Moreover, thanks to the government's improved fiscal position, the VAT rebate period is considerably shorter than it was a decade ago, and now is normally within six months. Thus, exporters have been able to factor the rebate into their selling price with more confidence.

A further reduction of export value-added tax (VAT) rebates and the introduction of an export tax for certain sectors are now being considered as a means to curb the trade surplus with the US. Already, a new export license was introduced to textile and apparel exporters in March, and similar export restrictions are expected to be applied to other sectors over time.

In our opinion, higher export taxes and lower rebates will have a more direct impact on Chinese exports, in terms of curbing export volume and boosting export value added, than an RMB appreciation could. Indeed, the high import content of Chinese exports (which averages around 60% to 70%) suggests that the transition effect of a stronger RMB onto final export prices will be fairly limited, as cheaper import costs for raw materials and machinery will neutralize the bulk of the currency effect. In this environment, a modest RMB revaluation of 3% to 5% can hardly make a dent in China's trade surplus with the US.

A Flexible Currency Is Still Necessary

But this is not to say that we do not hope for a floating RMB. Despite the merits of adjusting fiscal incentives to control exports, the inevitable increase of administrative controls through selective removal of government subsidies from certain sectors is against the principle of moving toward fuller use of market-based instruments to rectify economic imbalances.

In our view, while economic fundamentals may not justify a massive RMB revaluation, China needs a flexible exchange rate regime to achieve a higher degree of monetary policy independence. This is particularly important now. Indeed, as China's capital account becomes *de facto* open, a flexible exchange rate is crucial for bringing external flows into balance to alleviate the adjustment pressure on domestic interest rates.

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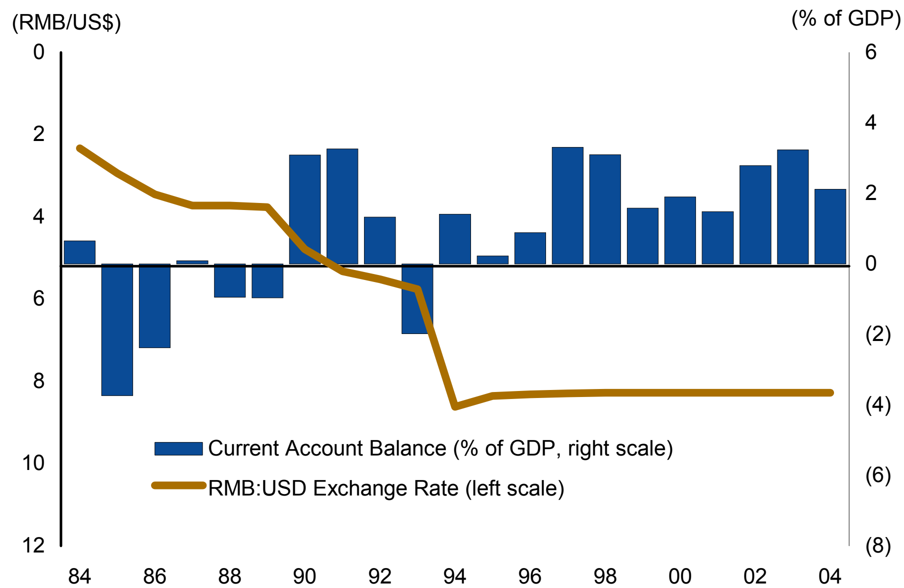
Display 1: Current Account Surplus Is Not Substantial

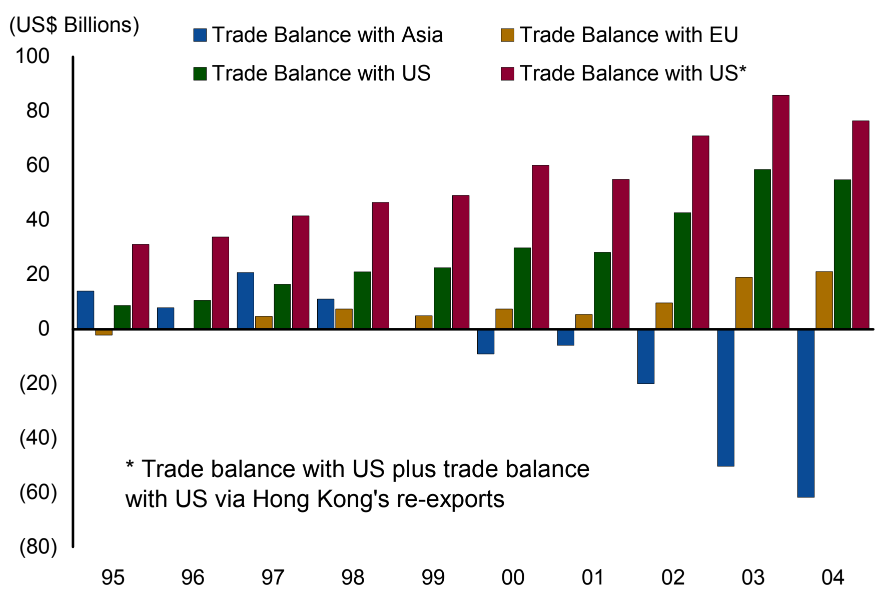
Current Account Balance as a Percent of GDP and the RMB/US$ Exchange Rate



Source: CEIC Data Inc. and Alliance Capital Fixed Income estimates, May 9, 2005

Display 2: The Main Problem—a Surging Bilateral Trade Surplus With the US

China's Bilateral Trade Balances



Source: China's Customs Bureau, CEIC Data Inc. and Alliance Capital Fixed Income estimates, May 9, 2005