TD Economics

Topic Paper

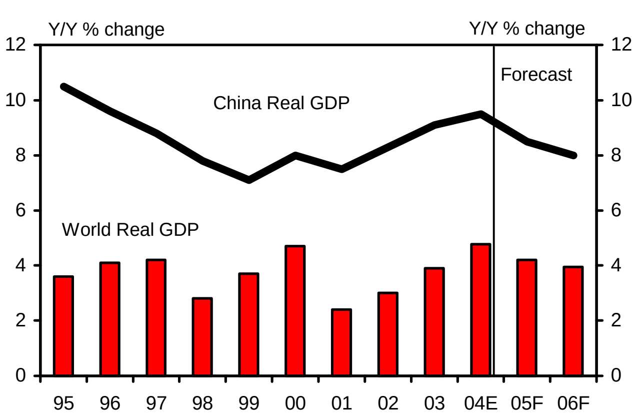
April 18, 2005

PRESSURE ON CHINA COULD DELAY APPRECIATION OF CHINESE CURRENCY

- **G-7 call for more flexibility in exchange rates aimed at China**
- **A stronger Chinese renminbi is in China's interests**
- **Political pressure could backfire and delay adjustment**
- **Still expect a 10 per cent appreciation in China's currency, but timing is impossible to call**

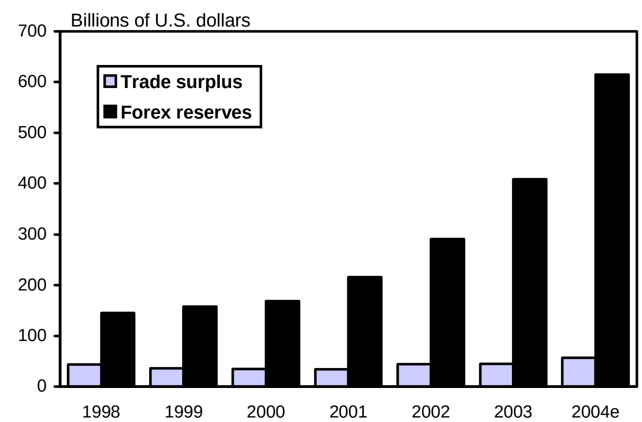
This weekend's G-7 finance ministers' meeting saw increased pressure put on China to allow its currency to appreciate. Although there was no explicit reference to China in the G-7 communiqué, there was no doubt as to who the call for "more flexibility in exchange rates" was aimed at. While the U.S. was arguably the loudest proponent, with Treasury Secretary Snow stating that "They are ready to move to flexibility…Now is the time", it was not alone in the demand for change, with officials from Europe also making strong comments supporting the cause. Japan was far more tentative about the proposition. The real question is whether China will acquiesce.

CHINA ECONOMIC OUTLOOK



Forecast by TD Economics as at March 2005
Source: IMF, TD Economics

CHINA: TRADE SURPLUS AND FOREX RESERVES



Source: IIF

In China's interests to have a stronger currency

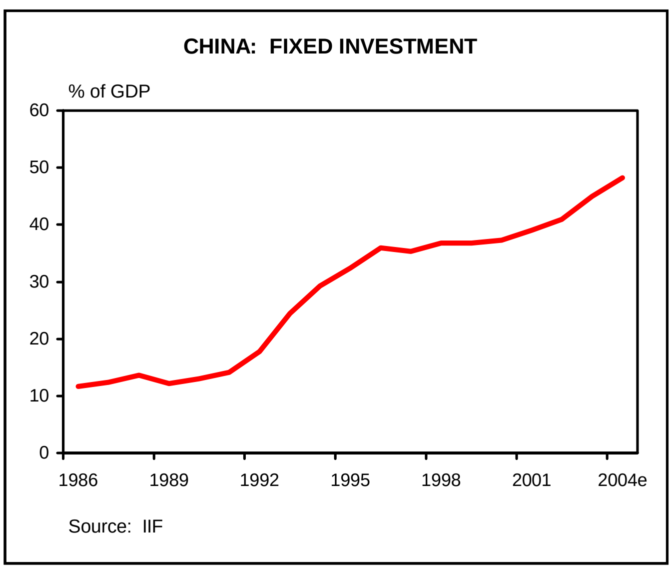
In our opinion, it is in China's self interest to allow its currency to appreciate, either by widening the band around the current peg to the U.S. dollar or by adopting a new peg to a weighted basket of currencies including the euro. The central government authorities have clearly indicated that they want the Chinese economic boom to slow from the torrid 9.5 per cent pace posted in 2004. In particular, they are concerned about an investment bubble forming, which could lead to deflationary pressures if the bubble were eventually to burst. Maintaining the currency peg at its present level is aggravating these pressures. The resulting build-up in foreign exchange reserves has led to rapid money supply growth, which China's weakly supervised banks have churned into new loans, further stoking investment growth in sectors of the economy that were already overheating.

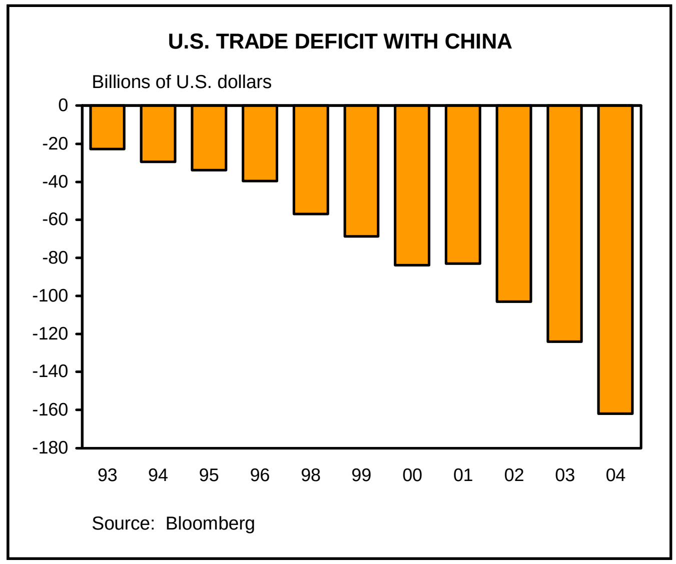
Thus, an appreciation in the Chinese renminbi could be beneficial, by simultaneously dampening real GDP growth and imports of investment inputs, while reducing liquidity in the financial system.

In addition to meeting these domestic economic objectives, China could also reduce the looming threat of international trade disputes by changing its foreign exchange policy. The U.S. trade deficit with China has ballooned in recent years and is poised to continue widening, raising the spectre of a protectionist backlash. For example, the U.S. Senate is already considering legislation that would impose duties as high as 27.5 per cent on Chinese imports. And, while the White House has appeared more tolerant than Congress over China trade issues in the past, the pressure from the Bush Administration appears to be intensifying. Meanwhile, the European Union is also considering legislation to restrict Chinese textile imports.

Markets look for 3-5% appreciation, but could be more

Given this backdrop, markets have been speculating about an eventual appreciation in the Chinese currency, with the consensus call being a modest 3 to 5 per cent increase in the peg, accompanied by a shift to a mixed basket of currencies with undisclosed weights. TD Economics, along with a few other forecasters, have been anticipating a more aggressive 10 per cent appreciation in the Chinese currency at some point in 2005 or 2006, under the assumption that the Chinese government would want to signal to markets that this is a 'once and for all' change in the level of the peg, thereby eliminating any speculation that the appreciation is only the first step of many. However, Chinese officials have clearly stated that they will not respond to financial market pressure to revalue the peg. And, prior to the G-7 finance ministers' meeting this weekend, futures markets had scaled back their anticipation of a strengthening in the renminbi.





International pressure could backfire

With the financial market conditions for an adjustment in the peg increasingly in place, the renewed pressure on China from the international political community may prove untimely, as it could actually delay the foreign exchange adjustment. China has repeatedly stressed that it will not change the peg in response to political pressure. It is a Chinese policy decision that will occur when the central government authorities decide that the time is right, and not a moment sooner. Moreover, there is no question that China is prepared to incur economic and financial costs to achieve political objectives. So, the more the international community pushes China, the more likely China will push back, delaying the eventual change in the foreign exchange rate. As a result, while we continue to expect China to permit a 10 per cent appreciation in its currency, the odds of such a move before the autumn of 2005 have fallen and some point in 2006 may be an even better bet. This is unfortunate, as it raises the risk of international trade disputes between China and many of its trading partners in the near term.

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