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China: To Float or Not To Float? International Finance Executive Summary On July 21, 2005, China revalued its decade-long quasi-fixed exchange rate of approximately 8.28 yuan per U. S. dollar by 2.1% to 8.11. Simultaneously, the People's Bank of China announced that the daily trading band of 0.3% against the dollar would be maintained. Many analysts and economists believed that the real trade-weighted value of the renminbi was undervalued by up to 30% to 35%.

Companies that produce in China for the overseas market, retailers, and importers clearly benefit from an undervalued Chinese currency, as well as from the abuse of workers' rights. On the other hand, companies actually producing in the foreign countries ??? whether for the domestic market or for export ??? face debilitating and unsustainable disadvantages from both currency manipulation and violation of workers' right in China. By 2004, the combined value of China's exports and imports rose to 67% of its GDP, making China's growth relied heavily on its international trading.

The excess foreign exchange reserves resulting from the fixed yuan exchange rate was used as collateral to attract FDI inflows and support China's development strategy ??? FDI brings useful technical and management skills as well as jobs to China. A sharp depreciation of renminbi will certainly reduce exports, increase unemployment, and force multinational companies with factories in China to shift production to other low-cost countries. However, the fixed exchange rate was expensive to sustain, and it also limited China's flexibility in responding to a potentially overheating economy.

Summary of Q3 Chinese commercial banks face foreign exchange risk in three categories: banks' capital exchange risk, asset liability net position risk, and the foreign exchange settlement risk. Yet Chinese banks' company governance and international operation expertise are still far behind international competitors. A sudden change of foreign exchange policy such as floating exchange rate could bring huge risk to Chinese banking system. Foreign investors (or speculators) flood large amount of "hot money" into China, causing high inflation especially in property and commodity market.

In order to control inflation, central bank has to issue bonds to commercial banks. As a result, the central bank's independence is seriously challenged. Therefore, the exchange rate reform should be arranged after banking sector reform and capital control liberalization. Q1. Implications of China's exchange rate policy on doing business with and against China After embarking reform in various sectors, especially trade and foreign investment reform, China has increased the total value of both imports and exports.

Between 1977 and 2004, China's share of world trade increased from 0.6% to 6.0%, and strong trade growth continued afterward. The composition of exports also changed dramatically over time. The dominant export product varies from agricultural and petroleum from the earliest year of reform, textiles in 1990s, electronics in 2000s, to automobile and aerospace products by the mid-2000s. It is clear that now China not only has spectacular trade growth, but also moves its exports up to the value-added chain.

China's partners who buy and sell products with China or its competitors who compete Chinese goods in the international markets have expressed their dissatisfaction with the current situation, as many of them suffers trade deficit with China or attack on domestic industries due to flood of inflows of Chinese goods, particularly US. They argued, undervalued Chinese currency and a fixed exchange rate against dollar allowed Chinese goods an unfair advantage.

Suppose that Chinese currency was undervalued and the cost of producing was the same globally, the fixed exchange rate system would always make Chinese product cheaper when selling in international markets. Besides, fixed exchange rate was a barrier to prevent increasing value in renminbi. Therefore, many countries became uncomfortable with Chinese growing exports and targeted China's exchange rate system, such as USA, EU nations and Brazil. US claimed imports from China caused great trade deficit and hurt American employment.

Brazil said they also suffered trade deficit since China only imported basic products from Brazil while sold value-added products. Q2. Linkage between China's exchange rate policy and its development strategy After the Asian crisis, growing capital flows into China and put pressure on the exchange rate. In order to keep the value of the yuan from rising against U. S. dollar in the face of these inflows, China's central bank intervened by exchanging incoming dollars for renminbi at the fixed yuan exchange rate and using the dollars to buy dollar assets such as U. S. Treasuries.

As FDI keeps flowing into China, the resulting excess reserves appeared to create an imbalance on China's external balance sheet. In some economists' view, the imbalance was necessary to support China's development strategy, with reserves and current account surpluses serving as collateral for FDI inflows. China's priority is stability. Currency flexibility should not be allowed to conflict with this goal. Given that China is in transition, as an industrializing, and urbanizing economy with 300 million surplus workers, it faces immense challenges beyond the experience of many in the west.

A sharp depreciation of renminbi will certainly reduce exports, increase unemployment, and force multinational companies with factories in China to shift production to other low-cost regions such as India or Southeast Asia. It is extremely unlikely that China could tolerate substantial currency volatility. Impact of growth in China as well as the rest of the world by the changes in exchange rate policy As most observers took it for granted that the yuan was undervalued, one specific study estimated yuan undervaluation against the U. S. dollar of at least 35% based on the price level of goods and services in China compared with those of its trade partners. As a result, there will probably be a sharp appreciation of renminbi if Chinese government switches over from the fixed exchange rate policy to flexible exchange rate policy. A common figure cited for a 20 to 25 percent move of renminbi would be devastating to China, which would cause deflation, cut economic growth, cut off foreign direct investment and would destabilize Asia. On the other hand, other low-cost countries in Asia may benefit from the shift of FDI and production of multinational companies.

However, most high-wage countries like U. S. may still face a rising trade deficit because their imports from other low-wage countries would replace products made in China. Sustainability of the current exchange rate policy

Many economists ??? focusing on the strain the tightly managed exchange rate imposed on China's economy ??? agreed that China needed to institute more flexibility. They noted that not only was the exchange rate expensive to sustain, but it contributed ??? as well as limited China's flexibility in responding ??? to a potentially overheating economy.

As a common way to correct the overheating economy in China, increasing interest rates would also attract further capital inflows and put additional inflationary pressure on the economy and appreciating pressure on the currency. Furthermore, the central bank's ability to continue to sterilize monetary base growth associated with capital inflows was becoming limited.

Q3. What would be the impact for China and the U. S. of a drastic reduction in the U. S. trade balance deficit? Q4. Exchange rate policy, banking reform ; capital control

Exchange rate reform will cause a lot of new issues to commercial banks and capital control. So the exchange rate reform should be arranged after banking sector reform and capital control liberalization. The objective of China's banking sector reform is to build international standard banks, separate commercial banks from quasi government organization, there are seven parameters to measure it: Net rate of return on total assets, the net rate of return on equity, cost to income ratio, non-performing asset ratio,

capital adequacy, large risk exposures and concentration of non-performing loan coverage ratio.

In order to achieve four largest banks' seven parameters to be world top 50 standard, Chinese government stripped off large non-performing loans, injected capital with foreign currency reserve and let the banks went public to raise capital from international investors.

The reform changed the four largest banks' performance phenomenally, and those banks' capital value went to top 1 in world for certain period of time. Yet Chinese banks' company governance and international operation expertise are still far behind international competitors. A sudden change of foreign exchange policy such as total float exchange rate could bring huge risk to Chinese banking system.

Chinese commercial banks face foreign exchange risk in three categories: the first one is banks' capital exchange risk, commercial banks' foreign currency reserve come from foreign stock market, foreign strategic investors and capital injection from government, if RMB appreciate too quickly, banks' foreign capital may shrink too much, which could negatively affect their capital adequacy ratio and return on equity ratio; the second risk comes from Asset Liability net position risk; the third risk comes from foreign exchange settlement risk, derived from daily transaction exposure, time, quantity mismatch etc.

The change of trade volume and direction due to the exchange rate policy changing will also greatly affect banks' performance and system risks. The

methods of profit generating is narrow, China's banks mainly depend on interest difference between borrowing and lending. Based on current situation, it is very unlikely Chinese government would make sudden change to exchange rate policy before banking sector could be competent enough in all major aspects of banking business. Under Mondel's impossible triangle, a central bank cannot achieve fixed exchange rate, capital mobility and independent monetary policy at the same time.

Under currency pegged exchange rate system, Chinese economy is integrated much tighter with international economy, the request for liberalizing capital control is ever higher, at the same time, control spores are larger and larger; though Chinese central bank put close eyes to capital movement, the error and omission in balance payment keep increasing, foreign investors (or speculators) flood large amount of "hot money" into China, causing high inflation especially in property and commodity market, on the domestic side, large amount of money still can find secret channel to be moved to foreign market.

In order to offset foreign capital inflow and retain fixed exchange rate, central bank has to purchase foreign currency, mainly USD, and issue equal amount of RMB, which is one of the main causes of current inflation. Consequently, in order to control inflation and slow down money supply, central bank has to issue bonds to commercial banks and decrease the liquidity. Central bank's independence is seriously challenged in this system, the inflation of China is greatly influenced by the money supply from US fed!

After the liberalization of capital control, foreign exchange and interest market should be liberalized as well, exchange rate and interest rate will be determined primarily based on market supply and demand. Central bank will have more tools in open market operation, and align the RMB appreciation with domestic inflation and major trading partners' currency appreciation or deprecation.