

## What is behind China's new language on the renminbi?

- *Shifts in official language on the exchange rate do not reliably signal policy moves*
- *Foreign pressure on China to let the renminbi appreciate is manageable*
- *We still think the dollar peg will remain in place until Q2 2010*

A subtle change this week in the language China uses to describe its currency policy has been widely seen as a significant shift in policy stance. Is this justified?

The change came in the People's Bank (PBC) Q3 Monetary Policy Report, published late on Wednesday in Beijing. In a discussion of the future direction of currency policy, the PBC dropped a phrase about maintaining currency stability and added one about responding to movements in major currencies and to capital flows.

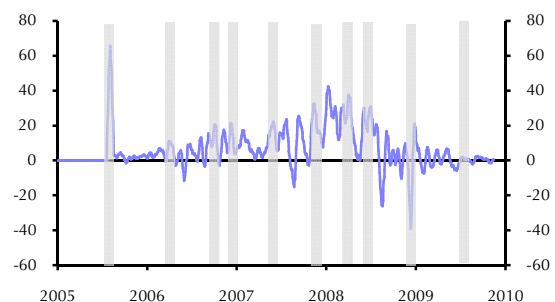
**It is tempting to view the change in language as a gesture intended to reduce political pressure ahead of President Obama's first visit to China,** which starts on Sunday. Certainly, China has used changes in exchange rate policy to manage the bilateral relationship at sensitive times in the past.

As Chart 1 shows, for the three years after revaluation in mid-2005, renminbi appreciation picked up in the run-up to high profile meetings with the US (those meetings are marked with grey bars on the Chart). The most significant formal reform to the exchange rate regime since revaluation, the widening of the renminbi's trading band against the dollar, was announced on the eve of the second round of the US-China Strategic Economic Dialogue in May 2007, and helped to defuse growing tension.

**But the dynamics of the relationship have changed.** The second grey bar from the right shows that there was an uncharacteristic fall in the renminbi immediately before last December's Dialogue. This was the result of the largest one-

day drop since revaluation. That move seemed to be a shot across the bows of the US, warning against pushing too hard for further strengthening of the renminbi at a time when many Chinese exporters were arguing for *depreciation*.

**CHART 1: RENMINBI APPRECIATION AGAINST DOLLAR**  
(%, 2-WK AVERAGE, ANNUALISED; GREY BARS MARK PLANNED VISITS AT HEAD OF STATE OR TREASURY SECRETARY LEVEL)



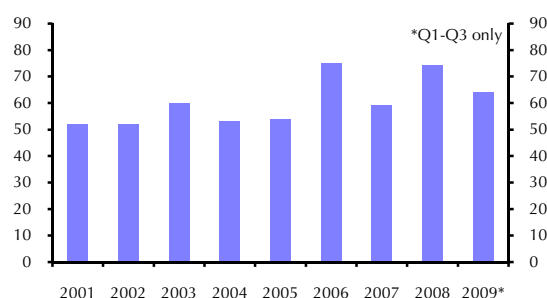
Sources – Bloomberg, Capital Economics

As China's economy, including its export sector, now looks much more secure, pressure on China to loosen the dollar peg is rising again. However, currency concerns go both ways. Chinese officials may be less inclined to respond to US concerns over the weakness of the renminbi relative to the dollar while they are also worried about the weakness of the dollar relative to other major currencies, and the implications this has for the value of their dollar assets.

Admittedly, pressures on China are mounting from other directions. Many in Europe and Asia are also calling for the renminbi to rise. **WTO members are on course to launch a record number of investigations against Chinese imports this year.**

However, the recent increase in protectionist measures has – so far at least – been relatively modest and is unlikely yet to be a significant cause for concern. (See Chart 2.)

**CHART 2: WTO MEMBERS’ NEWLY-INITIATED INVESTIGATIONS AGAINST CHINESE IMPORTS**



Source – Bown, Chad P. (2009) “The Pattern of Antidumping and Other Types of Contingent Protection,” World Bank, PREM Notes No. 144.

### How significant was the change in language?

The new wording appeared on page 45 of the monetary policy report. The PBC said that it would “improve the renminbi exchange rate mechanism, be proactive, maintain control, move gradually and account for international capital flows and trend movements in major currencies.”

Compare this with the equivalent sentence in the Q2 report. There, the PBC said it would “closely monitor movements in major currencies, and continue to improve the renminbi exchange rate mechanism, acting proactively, maintaining control and moving step-by-step; strengthen exchange rate flexibility; and keep the renminbi basically stable at a reasonable, balanced level.”

How much should we read into these difference? Most commentary has focused on the added reference to capital flows and dropping of mention of currency stability as potentially signalling a return to renminbi appreciation. But the omission of the objective of “strengthening exchange rate flexibility” could suggest the opposite.

More generally, a glance back at the phrasing used in the quarterly reports over the past three years shows considerable variation. **Most importantly, changes in phrasing are not reliable signals of changes in policy.** (See Table 1.) For example, the PBC stopped talking about allowing market supply and demand a greater role in determining the exchange rate in the report for Q2 2008, just as the renminbi was re-pegged to the dollar. But, three months later, it dropped mention of currency stability, when the peg became tighter still.

The upshot is that the phrasing used by the PBC cannot be taken as a reliable guide to the policy stance. We do expect the renminbi to start appreciating against the dollar as attention shifts from crisis-response to long-run rebalancing and as pressure from overseas mounts. (See our *Global Markets Update*, “Return to gradual renminbi appreciation”, 21<sup>st</sup> October). **However, we still think that shift is not likely before the second quarter of next year.**

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**TABLE 1: PHRASES ABOUT EXCHANGE RATE IN “UPCOMING POLICY DIRECTION” SECTION OF PBC MONETARY POLICY REPORTS**

THE PBC WILL...	2007				2008				2009		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
... maintain currency stability	✓	✓	✓	✓	✗	✓	✗	✓	✓	✓	✗
... increase currency flexibility	✗	✓	✓	✓	✓	✗	✗	✓	✓	✓	✗
... improve managed float system	✗	✗	✓	✗	✗	✗	✗	✗	✗	✗	✗
... give greater role to market supply and demand	✗	✓	✓	✓	✓	✗	✗	✗	✗	✗	✗
... allow exchange rate a role in rebalancing	✗	✗	✗	✓	✗	✗	✗	✗	✗	✗	✗
... account for capital flows	✗	✗	✗	✗	✗	✗	✗	✗	✗	✗	✓
... consider movements in major currencies	✗	✗	✗	✗	✗	✗	✗	✓	✗	✓	✓
RMB appreciation over next 3 months (% vs. \$) <sup>(1)</sup>	1.7	1.8	3.2	2.8	2.1	0.7	0.1	0.2	-0.1	-0.1	-

Sources – People’s Bank of China, Capital Economics. Note: (1) Appreciation is measured over 3 months from date of publication of report