

# The Future of the Chinese Foreign Exchange System and Its Influence on the International Strategies of Japanese Companies

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## Introduction

Since the end of 1997, China has adopted the US dollar peg system. However, on July 21, 2005, the Chinese government announced that it would move from the dollar peg exchange system to a managed floating exchange rate system with reference to a currency to a basket based on market supply and demand. At the same time, the government increased the value of the Chinese yuan against the dollar by 2.05%.

After the reform of China's foreign exchange system in July 2005, the daily closing value of the yuan against the US dollar began to fluctuate from the central rate. However, the fluctuation of the closing value on each trading day from the central rate has yet to reach the approved limit of  $\pm 0.3\%$ , and in fact has never fluctuated more  $\pm 0.1\%$ . As a result, the yuan against the US dollar has not appreciated to a standard expected by the market.

## Analysis of the Foreign Exchange System Reform and the Inconsistency with Announcements by the People's Bank of China

The Governor of the People's Bank of China indicated in his speech that: (1) it is natural that the US dollar, euro, yen, and South Korean won become major currencies of the basket; and (2) the weight of the dollar in the basket is well below 50% (as of January 2006). However, the weight of each currency in the approved currency basket has not been made public, and the government has been adjusting the weighting at its discretion, according to internal and external economic conditions. Based on the hypothesis that the yuan is pegged to the currency basket for the time being, and using the Frankel and Wei method as a reference, if the weighting of the principal currencies

in the yuan determination basket is measured, the weight of the dollar exceeds 90% (between July 21, 2005 and March 31, 2006).

The reason for the discrepancy between this analysis result and the points made by the Governor in his speech may be that either the Chinese currency authorities only place a small degree of importance on the currency basket, or the basket comprises many currencies that are closely linked to the dollar, in addition to the principal four currencies. In other words: (1) some of the currencies that are not included in the basket are possibly being used as reference indicators than the basket when the yuan exchange rate is determined so that only the yuan does not rise against the US dollar; or (2) among the currencies<sup>1</sup> that have been declared important for determining the yuan exchange rate, the basket may include several currencies that move very closely with the dollar. These are some possible explanations for the difference between the demonstrated analysis results and what the Governor stated.

## Improvement of the Environment for the Increased Flexibility of the Exchange System

Any time the Chinese foreign exchange system is mentioned by the international community, China responds that it will not bow to outside pressure. For this reason, even if demands continue for China to loosen its foreign exchange system, it is hard to imagine that China will approve such reforms. China's inability to approve any rapid reform stems from: (1) fear of negative impact on the trade that is supporting China's economic growth along with investment; and (2) concern over a sudden appreciation of the yuan (overshoot) and the shock it would impart on the real Chinese econ-

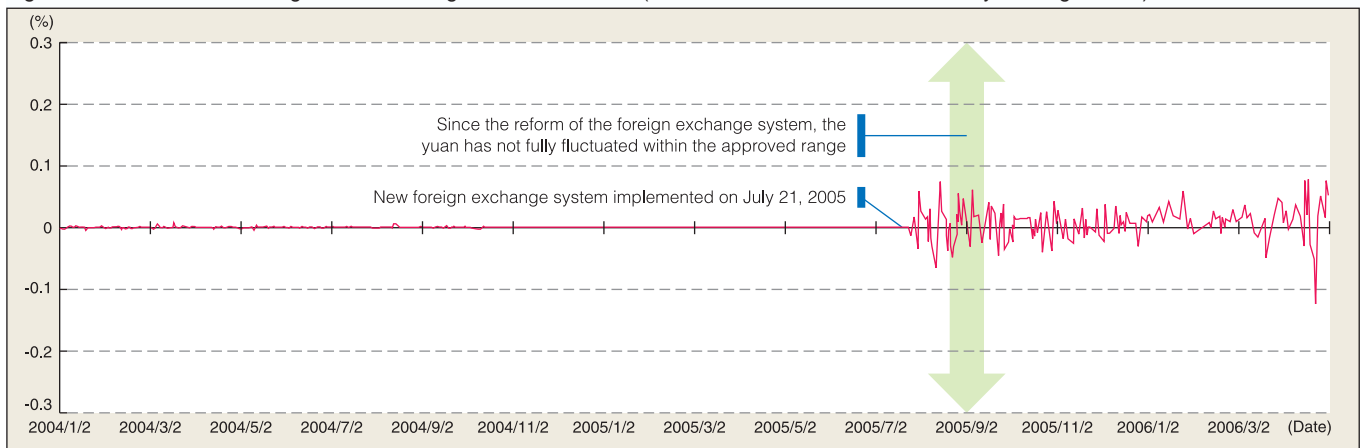
omy.

First, let us look at the impact on trade. The only four currencies that are traded with the yuan on China's foreign currency exchange market are the US dollar, yen, euro and Hong Kong dollar (HK dollar, is pegged to the US dollar under the currency board system). The share of China's total trade held by Japan and the EU is only 28%. Therefore, the major share of the growing trade with China is being carried out using the US dollar or the HK dollar which is closely tied to the US dollar. China has insufficient measures for foreign exchange risk hedging. Futures and swap transactions relating to the yuan only began in August 2005, and they make up just 1% of China's entire foreign currency transactions. Transactions relating to yuan interest rates, which are essential for the formation of yuan futures rates, only began on a trial basis this year. If the various risk hedge markets relating to these kinds of foreign exchange transactions are not sufficient, there is a fear that a more flexible foreign exchange system will have a negative effect on trade.<sup>2</sup>

Second, the outflow of capital is restricted in China, and funds tend to stay inside the country due to the increase in direct investment into China and China's current account surplus. Therefore, greater foreign exchange system flexibility could directly contribute to a sudden appreciation of the yuan. A rapid and substantial appreciation of the yuan could have a huge impact on the Chinese economy. If the yuan appreciated 20% from its current position, China's real GDP growth rate could become close to a negative 4%, according to an economist of the Asian Development Bank. As is seen in the official announcement approving the liberalization of investment in foreign securities by Chinese financial institutions, today the outflow

Notes : 1) In his speech, the Governor of the People's Bank of China stated that the currencies of Singapore, the UK, Malaysia, Russia, Australia, Thailand and Canada were also important for the determination of the yuan exchange rate, in addition to the four currencies given previously.

Figure Fluctuation Band /Range of the Yuan against the US Dollar (Transition from Central Rate to Daily Closing Values)



Source : SAFE Administration of Foreign Exchange

of capital from the Chinese government continues to be liberalized and pressure on yuan appreciation is being eased. However, the liberalization of rapid capital outflow could cause a recurrence of the 1997 Asian currency crisis, depending on the economic fundamentals, therefore, the Chinese government cannot push forward the liberalization of capital flow rapidly.

On the other hand, as is clear from the “open-economy trilemma” of the international financial system, the effectiveness of China’s internal monetary policy is being damaged by maintaining the stability of the yuan against the US dollar. The provision of money to the market, caused by the limits of sterilization while there is strong upward pressure on the value of the yuan, is an invitation for an overheating of the economy.

Given these conditions, the direction of the Chinese foreign exchange system will become apparent on its own. That is to say, while China continues to maintain the framework of the current foreign exchange system, it will likely approve a certain level of increase in the value of the yuan, based on market supply and demand. Moreover, the Chinese government will probably continue easing the pressure on yuan appreciation by reducing capital outflow restrictions and the impact on trade by developing a risk hedging mar-

ket for foreign exchange. Finally, the Chinese foreign exchange system is becoming far more flexible.

### Retooling the International Strategy of Japanese Companies, Based on the Future Direction of the Chinese Foreign Exchange System

If the loosening of the Chinese foreign exchange system continues, the yuan will most likely appreciate against the US dollar depending on the degree of deregulation. According to an analysis of relative purchasing power parity on a 1993 basis using Chinese and US producer prices, the yuan was predicted to reach the level of 7.28 yuan to the US dollar in 2004.

By analyzing the impact of this kind of yuan appreciation on Japan’s macro economy using the general equilibrium model, even if the yuan appreciates 20%, it is clear that compared to the reduction in Chinese exports and domestic production, the scope of increase in Japanese exports and domestic production would be small, and the ripple effect would be extremely limited.

Nevertheless, an appreciation in the yuan could have a big impact on Japanese companies operating in China. Many Japanese companies in China have set up export bases to take advantage of the competitive operating

costs that include China’s abundant, low-wage workforce. According to the fiscal 2003 Survey of Overseas Business Activities, Japanese companies obtain about 50% of their sales through exports. If the yuan were to appreciate, the cost of exports would increase. According to a Japan External Trade Organization (JETRO) questionnaire survey, Japanese companies are looking at operating-cost reduction and switching from exports to sales in the Chinese domestic market as measures to address any rise in the yuan. However, such measures have limitations when considering the trend towards rising operating costs in China and the intensification of competition in the Chinese market (the White Paper 2006).

Since a loosening of the Chinese foreign exchange system and a resulting rise in the yuan is expected in the medium and long-term, we are approaching the point where Japanese companies will need to switch their international strategy from one of concentrating manufacturing facilities in China to one of diversifying their bases for production and procurement. **JS**

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2) The White Paper 2006 verifies that even in Japan, where there is relative growth in the risk hedging market: (1) exchange rate fluctuations have an impact on corporate profitability; and (2) the expansion of exchange rate volatility may have a negative impact on exports.