The Euro and the RMB

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As an emerging power, China's role within domains of international trade, economy and politics has increased dramatically in recent years. Accompanied with the country's increase in international weight, the Chinese currency Renminbi (RMB) has become more and more significant in international financial market. Simultaneously, the dispute over RMB's revaluation has been a recurrent theme recently.

The most recent wave of dispute on RMB's revaluation takes place under the background of global financial crisis which adds to the complexities of the issue. It is much more than contentions on merely exchange rate and currency regime, factors in the sphere of finance, economy, trade and politics should be taken into account. To some extent, this dispute is a return to the previous one between 2003 and 2005. Though the dispute is mainly between United States and China, EU is still a crucial power. This essay would narrow down and place focuses on the roles of Euro and EU in the dispute.

The argument is organized as follow. In the outset, it is a brief introduction on the RMB's regime developments and reforms. Comparing the three general rounds of international dispute over RMB's value provides a historical understanding of the present ongoing dispute. The following part examines Euro's effect upon RMB's exchange rate, talking about the direct and indirect impacts Euro has got. The final session tries to find out EU's stance in the dispute and make an interpretation on the underlying reasons of EU's choice.

The Dispute over RMB's Revaluation

To understand the dispute over RMB's revaluation, knowledge on China's currency regime is a base. Generally speaking, China's foreign exchange regime is closely related to US-dollar. Before 2005, China adopted the dollar-pegged system in which the exchange rate between RMB and dollar was credibly fixed. This system was changed to fully embrace the socialist market economy later. Started from 2005, the currency regime was announced to shift to "a managed floating exchange rate based on market supply and demand with reference to a basket of currencies" (PBOC, 2005). However, US-dollar is still one of the most fundamental benchmark for the RMB exchange rate. Or in the words of Shah et al. (2005), the RMB "has remained pegged to the US dollar".

There is no doubt that the Chinese currency regime is evolving in progress adapting to needs. The following table provides a general idea on how it developed and reformed since the Reform and Opening-up in 1978.

Table 1. A timetable of RMB's regime development and reforms

Time

Development and reforms

remarks

1979

Foreign Exchange Retention Quota System was established to stimulate exports.

1981

During the first devaluation of RMB, the State Council introduced “internal settlement rate” of 2.80 RMB/dollar, started a dual exchange rate system.

1985

The dual exchange rate system was abolished. The RMB/dollar rate was set at 2.80.

1988

The trade of RMB at a rate reflected market demand more closely by enterprises was authorized with the foundation of the semi-official currency swap centres, started a second round of dual exchange rate system.

1 Jan. 1994

The dual exchange rate system was ended. The RMB/dollar was officially devaluated to 8.7 overnight. The RMB appreciated steadily from 8.7 to around 8.28 RMB/dollar between 1994 and 1996.

1996

Complete convert of RMB was allowed in current account while the capital account was excluded.

1997-1999

The RMB/dollar was kept stable resisting the pressure to devalue, fluctuating between 8.2770 and 8.2800 for about three years. RMB/dollar was pegged at around 8.3 during the Asian Financial Crisis between 1997 and 1998 which won praises widely.

2001

China’s formal accession to the WTO with pledges of gradually currency regime adjustment.

2003

International pressure of the RMB appreciation started to mount, with the hope of relieving the global imbalance in trade.

2005

RMB/dollar was revalued to 8.11, and the governing rules of currency system were revised.

2008

The RMB/dollar was pegged to 6.83 to resist the recession resulted from the global financial crisis.

2009

After nearly two-year peg rate of RMB/dollar,

China announced that reforms aiming to increase currency flexibility would be resumed.

19 June 2010

The authority declared that further reforms on the currency regime to reinforce the flexibility of exchange rate would be proceeded. Pressure for RMB appreciation mounted, especially from the United States.

Compiled from Reuters (2010a) and Reuters (2010b)

Drawing from the table above, there are roughly three rounds of international pressures on RMB's revaluation. The devaluation pressures during the Asian Financial Crisis between 1997 and 1999 failed to urge the Chinese government succumb to the temptations. Interestingly, the following two rounds of pressures go to the reverse side insisting that the value of RMB is underestimated and appreciation is needed. The latter kind of ideas is mainly derived from the consideration of adjusting the global trade imbalance. The first Congressional Bill on RMB's value proposed by American Senator Charles Schumer in 2003 intensified the debate on RMB's appreciation (Reuters, 2010a). In response to the intense pressure, the Chinese authority finally announced a small appreciation in 2005. Nevertheless, the revaluation was considered by Chinese central bank, the People's Bank of China (PBOC), to be more than merely a shift in exchange rate, but also a reform in the regime per se. This action had earned positive responses internationally, and the rate of RMB/dollar rose gradually and consistently in the following three years.

However, things changed in 2008 when the credit crunch hit the world. The US dollar surprisingly became strong reacting to the global recession (Mckinnon et al., 2009). To retain the control and stability of monetary, China stopped the appreciation of RMB against US-dollar and pegged the exchange rate at around 6.83 (+/-0.3%) in July 2008. This decision dissatisfied some groups and reignited international controversies again. Worse still, the drop of US-dollar again since March 2009 exacerbated RMB's situation and boiled the dispute furthermore. The relatively fixed exchange rate is criticized to have enlarged the trade imbalance as well as aggravated the unemployment towards China's trading partners (Krugman, 2010).

To alleviate the most recent wave of strong pressures on RMB's appreciation, China's central bank released an announcement before the G20 summit in June 2010, stating the resuming of reform in currency regime. Things seem to have come full circle with China's exchange regime back to that in 2005 and a similar lever to address the regime per se rather than the surfacing exchange rate. It is clear that China's response is still and would often be far from the expectation of some. In addition, it is too early to tell the consequences of the policy. Because giving estimation of the equilibrium exchange rate is difficult and problematic, let alone reckoning to what extent the RMB is undervalued (Eichengreen, 2007). Moreover, the causality between RMB's exchange rate and the global trading imbalance is not as clear as some had thought. But these issues are beyond the discussion of this essay, and the following sections will focus on exploring Euro's role and EU's stance in the salient RMB dispute.

Euro's Effects upon the RMB's Exchange Rate

Referring to China's currency regime and the special relations between RMB and US-dollar, it is not surprising that the US is a leading pioneer in the disputes over RMB's revaluation. However, being the second most significant international currency, Euro also plays important role in the recent dispute.

Euro's role, though is not so straightforward, should be taken into account when comprehending the present RMB's dispute and the bilateral monetary and financial cooperation between EU and China. Gu and McNelis (2009) analyze that the dynamics in itself and exchange rate of Euro/dollar are the two major drivers of RMB's Non-Deliverable Forward (NDF) market. The fluctuation in Euro/dollar rate causes a serial of consequences in offshore NDF market and exerts pressures on the financial market in China. Hence, changes of Euro value affect the RMB exchange rate in turn via NDF market (Gu & McNelis, 2009). Back to the case of recent dispute over RMB's revaluation, Euro's continuous depreciation against US-dollar in the late 2008 is a crucial drive of the strong dollar. The increase in value of dollar consequently resulted in a pegged exchange rate of RMB again under considerations of maintaining China's economy and financial stability. However, the fall of dollar again dating from March 2009 complicated matters considerably and brought in disputes.

In general, pressures for RMB's revaluation go to an opposite direction of the dollar's movement. To be more specific, for example, due to the drop of US-dollar against Euro, RMB sees a proportional decline in value under the fixed peg regime. Accordingly, Chinese goods would become more competitive in Euro zone. However, the European economy will not abandon the situation regarding to the huge deficit in trade. Thus pressures requiring RMB for appreciation will increase. The same story happens elsewhere worldwide. Actually, this is the general thread for criticisms of revaluating RMB to satisfy the adjustment of global equilibrium. Consequently, it is safe to say that the appreciation of Euro against dollar is a signal of the return of China's currency regime as well as the augury of present dispute on RMB's revaluation.

Nevertheless, things in practice are not so tacit and much more factors should be considered than the text-book theory. Returning to 2008, the Euro affected the RMB's exchange rate in a more straightforward way for a certain period before the adjustment in July besides the indirect effects through NDF market. Virtually, though announced in 2005, it is not until 2006 when the tight peg between RMB and dollar began to loosen and some other currencies were added to the anchor basket of RMB's exchange rate. Among the non-dollar currencies, Euro was gradually assigned more weight than others. By around May 2008, Euro took a weight as much as that of dollar in the effective anchor basket. (Frankel, 2010)

Euro's effects on RMB's exchange rate were enhanced during the floating period from late 2005 to mid-2008, especially after the introduction of non-dollar currencies into the RMB band from 2006. Generally speaking, RMB fluctuated along with the fluctuation of the basket currencies then. For instance, the appreciation of RMB against dollar in 2007 was rooted from the rise of Euro due to its heavy weight in the basket. However, Frankel (2010) believes that RMB's overall value stayed stable on the understanding of "value" which defined by a benchmark that comprises Euro and US-dollar in fifty-fifty weight between mid-2006 and late 2007. He argues further that RMB's rise against dollar at that time should be attributed to the turn-up of Euro in the basket rather than the popular belief of the basket's fall in value. Therefore, those who accuse China's return to dollar-pegged regime for exacerbating the global trading imbalance and unemployment contradict themselves. The exchange rate of Euro against dollar fell again since 2009. The Greece's sovereign-debt crisis and worries about the spread of the troubles have weakened the Euro further. Providing that China retained the flexible basket regime in which Euro played significant part directly in early 2008, the RMB's value would be much lower than that of today pegging to dollar. Then at least the exporters basing on dollar would be in a worse situation and less competitive in the trading with China. Hence, this kind of criticisms generates a dilemma. Of cause, this argument neither denies the existing undervaluation of RMB nor resists discussions on RMB's revaluation, but just a reminder of prudential consideration. It is out of question that there is misalignment for China's currency regime and further reforms as well as regulations are needed.

Though Euro lost its weight in affecting RMB exchange rate directly after the adjustment in 2008, it is predictable that there will be a comeback for it to the RMB band. Actually, the proclamation made in June 2010 by the People's Bank of China (PBOC), has start the course of return. After talking over Euro's role in the RMB's exchange rate regime, next section will try to find out the EU's stance in the heated dispute in progress at present.

EU's Stance in the Dispute over RMB's Revaluation

Though the fire on RMB's undervaluation is mainly led by US, the world is bigger than US and China. Therefore, other countries and entities have powers in the dispute and should have their say. See from the chart below, being China's biggest export destination, China is likewise the EU's second largest trading partner following the US (European Commission, n.d.). There are close relations in trade among the three bodies, so the results of the dispute are significantly related to EU's domestic interests. But what position should EU take in the dispute? Should EU adhere to American's proposition if the US authority finally labeled China the "currency manipulator"?

Leading Client and Supplier Countries of the EU27 in Merchandise Trade (value %)
2008, excluding intra-EU trade

The Major EU Import Partners				The Major EU Export Partners				The Major EU Trader Partners			
Rank.	EU Imports from	Mio euro	% world	Rank.	EU Exports to	Mio euro	% world	Rank.	Imports+Exports	Mio euro	% world
	Source: Eurostat (Statistical regime 4)										
	World	1,558,444	100.0		World	#########	100.0		World	2,867,590	100.0
1	China	247,655	15.9	1	USA	249,600	19.1	1	USA	436,159	15.2
2	USA	186,559	12.0	2	Russia	105,132	8.0	2	China	326,128	11.4
3	Russia	174,937	11.2	3	Switzerland	97,991	7.5	3	Russia	280,069	9.8
4	Norway	95,559	6.1	4	China	78,474	6.0	4	Switzerland	178,082	6.2
5	Switzerland	80,091	5.1	5	Turkey	54,256	4.1	5	Norway	139,270	4.9

Source: European Commission, http://trade.ec.europa.eu/doclib/html/122530.htm

In spite of the common concerns on trade deficit[1], EU should be modest in dealing with the issue of exchange rate. Unlike the US, EU is a supranational organization. Its stance in the dispute over RMB's revaluation is divided and undermined by member states with their own domestic interests and needs to bear. Messerlin (2010) makes analysis on EU's response to the issue from both economic and political factors, and draws a conclusion that EU is apt to maintain a low profile. According to his explanations, the focal point for EU's weak say originates in the difficulties to speak in one voice. The inconsistence of EU results a lack of prestige to convince China. On the contrary, EU has to be cautious of the possible trouble in return towards Euro's exchange rate regime.

First of all, Euro is not the official currency within the entire EU sovereign. For EU members outside the Eurozone, the Euro/RMB rate is less priority to the rate of their own currency against RMB. The various demands of these countries put them in different position of the dispute. What's more, even within the Eurozone, there is still dissent on Euro. As a young currency, Euro still has uncertainties of its own after a decade's development. Provident leaders would avoid complicating matters in a bad time like that at present.

With respect to trading imbalance, EU does not have so strong appeals towards China as that in the US. Messerlin outlines that the global deficit in trade of EU today is different from that in the mid-1990s only in terms of the difference of traders: China takes over several countries in Asia to be the sole actor. European politicians and economists are less sensitive to EU's deficit and China's surplus than their counterparts in the US, because the intra-EU trading imbalance is so usual that nearly all the member states have surplus with some and deficit with others. More often than not, the intra-EU imbalance in trade is larger than that with China. In addition, the huge overall deficit is lessened if distributed among member states. Emerging in the global economy and politics, China's trade and other cooperation with both the integrated EU as a whole and individual member states are boosting. EU has to be more careful with the bilateral relations, and irritating China by less deliberated decision is the last thing EU need.

Finally, criticisms and complaints upon China may become bullets fired back to EU referring to the problem of Germany who is to other EU countries what China is to the US. To some extent, Euro is a highly pegged exchange rate system around Eurozone. Although Germany's surplus of current account (135 billion dollar) is smaller than half of China's (297 billion dollar) in 2009, it is reckoned that the former would have a minor fall in surplus than the latter this year (The Economist, 2010). That implies the weight of Germany imbalance of the global level increases while China sees a fall in it. Given the prediction valid, EU would not like to draw attentions in the current flagging circumstance. Once the German dispute was ignited, divisions within EU would be degenerated.

However, though unlikely to officially regard China as "currency manipulator", it is possible for EU to make appeals for RMB's revaluation. In a summit in last November, President of European Commission Jose Manuel Barroso made an appeal for RMB to appreciate against Euro, but the call was rejected by Chinese Premier Wen Jiabao firmly. The EU has been relatively silent after the assertive rejection. Compared with movements in US, EU is definitely calmer.

Conclusion

China's currency regime is an in progress evolvement accommodating to mainly economic needs. The authority has strong power in intervening exchange rate to satisfy the domestic interests. The disparities in interests between Chinese government and foreign interests group are the underlying root of RMB's revaluation dispute. The on gonging global financial crisis fuels the contention on the topic and generates great pressures and appeals spurring China to make an adaption. However, there is no consensus for Chinese authority on either conceptual recognition or empirical actions, making it difficult to see an end of the dispute.

Though US-dollar had been a long term yardstick for RMB exchange rate, Euro has its part in the game. Euro has increased its international weight and become the second most fundamental international currency after a decade's development. Accordingly, the influences of Euro in NDF market have grown. Apart from affecting through NDF market, Euro's direct impacts towards RMB's exchange rate had increased dramatically by July 2008 under the relative floating system. The increasing influence of Euro in the basket currencies against RMB implies the contradiction in the criticisms attributing the undervaluation of RMB to the return of dollar-pegged system. The two-year suspension of basket currency had intensified the appreciation pressure for RMB and led to a restart of flexibility reform. It is foreseeable that Euro would take impacts more actively in the future "managed floating" exchange regime.

In contrast to the US's noisy voices and movements, EU seems to be somewhat indifferent to China's exchange rate dispute. All in all, EU's stance of keeping low profile is subjected to deliberated considerations pondering economic as well as political factors both domestically and internationally. Varying from ideological topics like human right or Tibet problem, the exchange rate is mainly a practical issue that is much easier to negotiate. EU could pursue to gain more benefits through win-win cooperation with China in the issue under a soft stance. This point does not present in the essay and more researches in the future are needed.

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[1] Europe's trade deficit (including services) with China in 2009 was 128 billion Euros. (European Commission, 2010)

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