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China's Exchange Rate Policy and International Competitiveness (Export) 1994-2005 : IS IT A LESSON FOR VIETNAM ?

by

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CHINA'S EXCHANGE RATE POLICY AND INTERNATIONAL COMPETITIVENESS (EXPORT) 1994-2005 : IS IT A LESSON FOR VIETNAM ?

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Abstract[1]

This paper aims to examine China's exchange rate policy in the period 1994-2005 and its international competitiveness (export), especially the context of China in the end of 1993. The paper shows that the "wise" exchange rate policy (1994-2005) helped China to reverse from a country with trade deficit to surplus trade one in the period 1994-2005. In addition, this policy has strengthened China's international competitiveness through a rapid productivity improvement. The paper investigated the situation in China before implementing the Yuan "shock" devaluation policy in 1994 is relatively similar to the current situation in Vietnam. The exchange rate policy therefore provides good experiences for Vietnam to overcome the current issues and create fundamentals for improving international competitiveness (export) and trade balance.

Keywords : Exchange rate, Vietnam, China, International Competitiveness, Trade, Export
JEL classification: F13, F31 and F33

[1] This views expressed in the publication are those of the author and do not necessarily reflect those of these institutions

1. Introduction

China has had remarkable economic achievements and become a “miracle” economy in East Asia, following Japan and South Korea. The GDP growth remained highest in the world, having an average annual rate of 10.1% (ADB, 2010) between 1994 and 2009. The GDP per capita (current price in US dollar) rose from 466 (1994) to 3734 (2009) (IMF, 2010). These incredible economic fruits are resulted from different reasons. The paper shows that the “shock” yuan devaluation policy in 1994 and then peg the yuan to the dollar until 2005 helped China to reverse from a country with trade deficit to surplus trade one (Figure 2). More importantly, this policy has strengthened China’s international competitiveness through a rapid productivity improvement. Labour productivity (defined and measured as output per employee) growth gained an annual average of 14.34%[2] between 1994 and 2009, which is higher than economic growth (10.1%) in the same period. The export increased by an average of 18.4%, from 121 to 1201 USD billion between 1994 and 2009 (ADB, 2010).

The paper explored the situation in China before implementing the yuan devaluation policy in 1994 is relatively similar to the current status in Vietnam. The “wise” exchange rate policy therefore provides good experiences for Vietnam to overcome the current issues and create fundamentals for improving international competitiveness (export) and trade balance.

The remainder of the paper is organized as follow. Section 2 examines China’s exchange rate policy and international competitiveness from 1994 to 2005. Section 3 presents the current status of Vietnam’s exchange rate policy and its international competitiveness. Section 4 shows a relative comparison of the circumstance of China in 1993 and the current status of Vietnam. Finally Section 5 concludes.

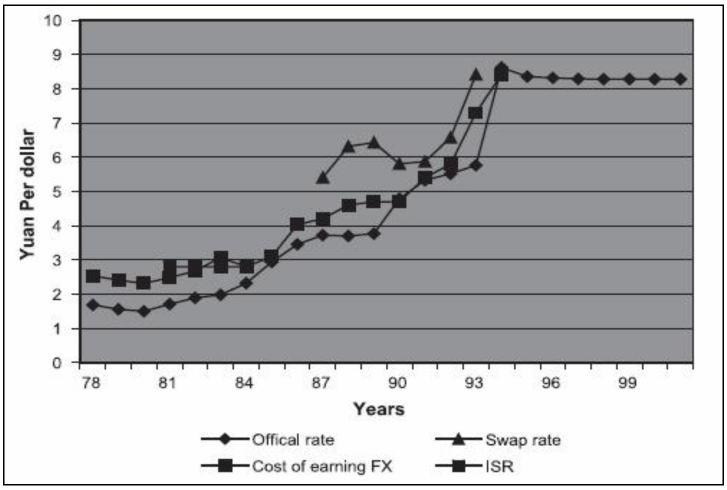
[2] The author’s calculation based on data of Key Indicator for Asia and Pacific, ADB 2010

2. China's exchange rate policy and international competitiveness (1994-2005)

In line with comprehensive economic reforms began 1978, China's exchange rate policy has gradually transformed from one that was centrally planned to one that is more market-oriented. The entire process has been accompanied by a gradual liberalization of the current account, inward direct investment aimed at strengthening productivity and China's international competitiveness as well as the establishment of a capital control mechanism targeted at protecting the domestic fragile financial sector (Yi, 2008).

The yuan exchange rate, used as an accounting tool in financial planning under the central planning economy, had long been fixed at overvalued levels. After 1978 when the reform and open-up policy began, the official yuan rate was devalued repeatedly over a fairly long period in response to economic fundamentals. Figure 1 shows the policy of the official USD/Yuan exchange rate, indicating that the rate of yuan per dollar increased over time and stabilized at a constant level after 1994. A dual-track system, co-existing of an official exchange rate and an internal settlement rate (ISR) for foreign trade-related transactions was introduced in 1981. The foreign exchange swap market rate was also gradually developed to replace the ISR in foreign trade-related transactions in 1986 (Lin and Schramm, 2003). The dual-track exchange rate policy became a barrier to trade activities and inward FDI flow. The dual-track exchange rate system therefore was eliminated in 1994 when the Chinese authorities unified the official rate with the swap rate (Yi 2008).

Figure 1: China's USD/RMB Exchange Rate (1978-2001)



Source: Lin and Schramm, 2003

In the late of 1993, in the context of trade deficit by 13,3 percent of the export and adopting a reform model of establishing a socialist market economy[3], the most comprehensive reform of the official exchange rate system was adopted since the inception of economic reform 1979 (Lin and Schramm, 2003). China carried out a exchange rate shock, devaluing its yuan by 50 percent in Jan.1994. The yuan official and swap market rates were unified at the swap market rate of yuan 8.7 per US dollar. In line with the devaluation shock, China implemented a variety of foreign exchange control measures aimed at setting up a single national foreign exchange market, and at promoting for its international competitiveness. The foreign exchange retention scheme was abolished and the foreign exchange swap business for domestic enterprises ended accordingly. Under the new policy, domestic enterprises were required to sell all their foreign exchange receipts to designated foreign exchange banks. Foreign exchange controls on imports were also lifted. Domestic importers could purchase foreign exchange needed for imports through designated foreign exchange banks upon presentation of import contracts and valid commercial documents. Foreign Funded Enterprises (FFEs) were allowed to continue operating in the swap market to meet their foreign exchange demands without having to through the banking system. In order to replace the old swap market, the inter-bank foreign exchange market started operation through China's Foreign Exchange Trading System (CFETS) based in Shanghai in April 1994. China also accepted the obligations under Article VIII of IMF's Articles of Agreement in 1996 and attained the goal of current account convertibility (Yi 2008).

The 1994 exchange rate policy impacted immediately on China's international competitiveness. The export increased rapidly by 32% and 23% in 1994 and 1995 respectively (ADB, 2010), especially since then the exports of machinery have expanded rapidly (Uni, 2007). Figure 2 shows China reversed dramatically from a trade deficit country in 1993 to trade surplus one since 1994. This success is largely due to the "daring" 1994 yuan devaluation policy and the exchange rate control measures as well as tight monetary policy against the rising inflation.

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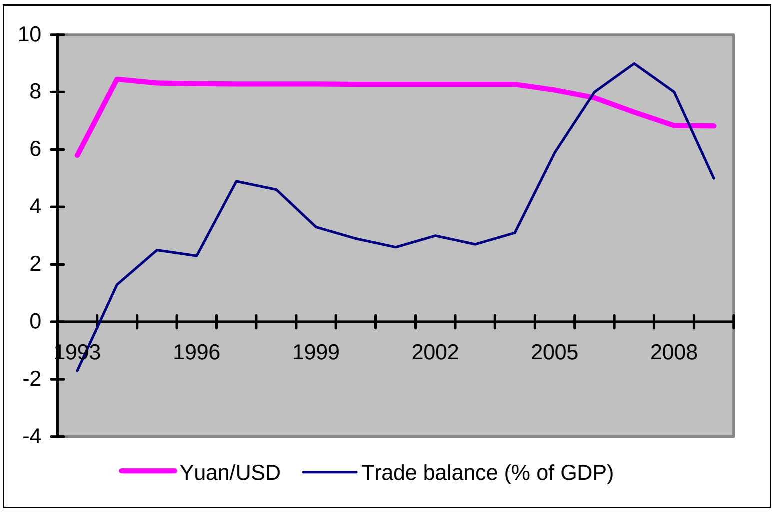
[3] The Third Plenum of the Fourteenth Party Congress stated its most comprehensive reform package, covering major aspects of the economy including taxation, banking, foreign exchange, foreign trade, investment, and state-owned enterprises (Lin and Schramm, 2003)

Figure 2: USD/Yuan Rate and Trade Balance



Source: ADB, 2010

Under the exchange rate policy in the period 1994-2005, the Yuan exchange rate was allowed to float within a very narrow band of ± 0.3% around the reference rate announced by the People's Bank of China (PBC) for inter-bank transactions, given a fluctuation of ± 0.15% for retail transactions. A bilateral monopoly characterized the inter-bank market structure. The Bank of China (BOC) controlled the bulk of the retail foreign exchange transactions and about 70% of inter-bank transactions while the PBC was the largest buyer of foreign exchange, accounting for about 60 to 70 percent of the total purchase volume (Lin and Schramm, 2003). The total foreign exchange reserves therefore reached to 819 USD billion (2005), or 36 percent of GDP from a small amount of 21.2 USD billion in 1993, or 3.5 percent of GDP (ADB 2010).

While the current account was liberalized in 1996, the 1997 Asian Financial Crisis inversely led China to maintain tight controls on its capital account. Due to uncertainties over the yuan value and unauthorized capital outflows resulting from the weak outlook for the Chinese economy, the illegal capital flight was a major concern of SAFE[4] during that time (Yi, 2008). On 1st Dec 1998, the PBC permanently shut the swap centres for FFEs because they were possibly used as vehicle in capital flight. Subsequently, the foreign exchange market was unified and all transactions for domestic enterprises and FFEs were conducted on the inter-bank market. Despite the massive devaluation of currencies in Asian neighbouring countries, the Chinese authorities were committed to remain the stability of the yuan exchange rate. Sufficient foreign exchange reserves, stringent restrictions on capital outflows

[4] SAFE stands for State Administration of Foreign Exchange

and relatively solid fundamentals supported the authorities to successfully maintain the yuan exchange rate at 8.27 yuan per the dollar until July 2005.

China's capital account liberalization focused on initially on encouraging inflows of foreign direct investment. Most restrictions in this area have been lifted (Lin and Schramm, 2003). This stable exchange rate policy has created the confidence of foreign investors to invest further in China and enabled the economy to gain access to modern technological and managerial resources and enhance its international competitiveness. China has become the largest recipient of FDI flows in the developing world, stock of FDI in 2009 reached to 473 USD billion, from 63 USD billion in 1993. Even thought the Asian financial crisis impacted negatively on FDI flow, the inward FDI flow still increased in China (UNCTAD, 2007). As a result, the productivity has improved vibrantly, an annual average growth of 14.34%[5] between 1994 and 2009, especially the high productivity growth of export goods.

3. Vietnam's current exchange rate policy and its international competitiveness

In the late of 1988, Vietnam started its exchange rate reform policy. The multiple official exchange rate system[6] was eliminated and unified to one official exchange rate announced by State Bank of Vietnam (SBV). The official exchange rate was stated relying on the parallel black market exchange rate (Nguyen Van Tien, 2010) in the period 1988-1991. In 1991 the SBV set up two its foreign exchange centres, one based in Hanoi and another ones in Hochiminh City and the central exchange rate was relied on the bidding rate of the two centres. Until 1994 the inter-bank market was established to replace two exchange rate centres and the official rate was based on the inter-bank rate.

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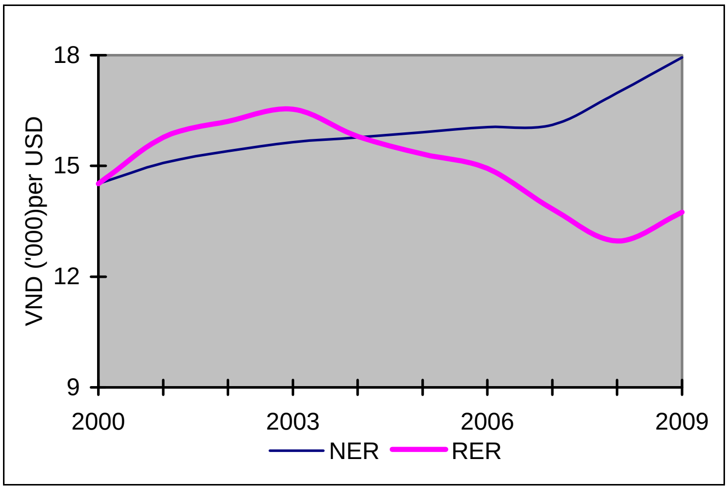
[5] The author calculated labor productivity by using data from ADB, Key Indicator for Asia and Pacific 2010

[6] Before the reform of exchange rate 1988, three types of official exchange rates coexisted, including non-tradable exchange rate, tradable exchange rate and the rate for remittance and internal accounting.

Figure 3: NER and RER, USD/VND (2000-2009)
(Basic year: 2000=100)



Sources: Author's calculation from data ADB, CIA, 2010

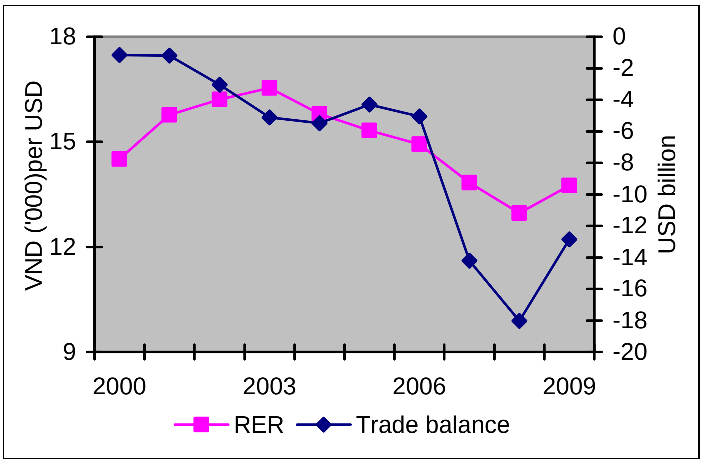
Since 1999 the central exchange rate has been determined daily by the average of the inter-bank rate in the previous transaction day. The determination process of this average inter-bank rate, however, has not been transparent and contained a large extent elements of the subjective will of the SBV because it is merely a technical procedure without analytical linkage with economic fundamentals (Pham and Nguyen, 2008).

Since the beginning of the exchange rate regime reform, Vietnam has devalued repeatedly its currency, from 8125 Vietnamese dong (VND) per USD in 1990 to 14028 VND in 1999 and reached 18932 VND in 2010. Figure 3 shows while the NER[7] has increased over time, the RER[8] has declined sharply, especially since 2006. These two opposite trends have made the gap between the NER and the RER wider. In comparison with 2000, Vietnam's CPI (2009) was as high as 99,5 percent and America's CPI (2009) was as high as 23,7 percent, while the NER increased by 23,6 percent. The VND (2009) therefore appreciated by 23,7 percent compared to 2000. At the same period the pace of the VND's appreciation was higher compared with other neighbouring countries' currencies such as the Singapore dollar, the Korea Won, the Malaysia Ringgit and the Thai Baht. This real appreciation of the VND has deteriorated Vietnam's international competitiveness and trade balance (Nguyen, Dinh, To, Le, Pham, 2010). As a result Vietnam's trade deficit has become worse, especially in recent years (see Figure 4)

[7] NER stand for the USD/VND bilateral nominal exchange rate
[8] RER stand for the USD/VND bilateral real exchange rate

In reality Vietnam has yet had a dual-track system, which has coexisted of the official exchange rate (announced by the SBV) and unofficial rate (the parallel black market rate). The scale of the parallel market transactions has not yet estimated, but the parallel market rate has been being as a signal for the SBV's exchange rate policy. The changes of the official exchange rate were followed by the changes of the parallel market rate. This reflects passive reactions and the weaknesses of the SBV.

Figure 4: RER and Trade Balance (2000-2009)



Source: ADB and CIA, 2010

4. A relative comparison between Vietnam and China

We examine and compare the context of China in the end of 1993 before implementing the 1994 exchange rate shock and the current situation of Vietnam, and found out that both circumstances are relatively similar in term of development strategy, trade balance, foreign reserves, exchange rate regime and inflation (Table 1).

Table1 A relative comparison between Vietnam and China

Indicators	Vietnam (Currently)	China (end 1993)
Development strategy	Transition economy	Transition economy
	Export-led growth	Export-led growth
Exchange rate	Managed float	Managed float
	Pressure of depreciation of the VND	Pressure of depreciation of the Yuan
Trade balance	Deficit (22,5% of Exp)	Deficit (13,3% of Exp)
Foreign Reserves	Small volume (22,9% of Imp)	Small volume (20,4% of Imp)
Inflation	High (11,75%)	High (14,7%)

5. Conclusion

Obviously, the 1994-2005 exchange rate policy helped China to enhance its international competitiveness and productivity rapidly. The huge devaluation of the yuan in 1994 indicates the PBC is “daring”, “decisive” and “wise” because of the sensitive context of high inflation in the end of 1993 (14,7%). In line with the devaluation of the yuan, the PBC strengthened stringent foreign exchange control measures. In order to deal with the high rising inflation after the devaluation, the PBC made efforts to tighten the monetary policy and a good cooperation between the exchange rate policy and the monetary policy has been made by the PBC, while the SBV was reluctant to decide its exchange rate policy and monetary policy in sensitive contexts and finally a “neutral” policy was frequently opted for. In fact that the SBV’s exchange rate policy has played a limited role in enhancing Vietnam’s international competitiveness and productivity in recent years. The experience of the PBC therefore provides good lessons for the SBV.

Currently the rising inflation and a widening trade deficit due to the overvalued VND as well as low exchange rate credibility are expected to pressure on the VND depreciation. This current situation is relatively similar to China’s circumstance in the end of 1993 (Table 1). Hence the 1994-2005 exchange rate policy will be a good experience for Vietnam to deal with these current issues.

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