

# **Balance of Payments Surplus and Renminbi Revaluation Pressure**

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## **Summary**

Pressure to revalue the renminbi (RMB) stems from both outside and inside China, and has important political as well as economic ramifications. However, models in the existing literature are only concerned with devaluation crises, including the balance of payment crises in Latin American countries, the European exchange-rate-mechanism (ERM) crisis in 1993, and the Asian financial crisis in 1997. They are silent in explaining the current revaluation pressure on the Chinese renminbi in an economy with strong growth and persistent balance of payment surpluses.

Based on a simple theoretical exchange rate model, this paper shows how persistent balance of payments surpluses build up appreciation pressure on a fixed exchange regime in a partially-open economy such as China. A deregulated market interest rate may work as an automatic stabilizer to release some of the appreciation pressures, but it cannot fully eliminate the appreciation pressure because of the zero interest rate floor. Strategic options for the government include improving the quality of domestic assets by reducing the non-performing loans of the banking sector, so that the substitutability of domestic and foreign assets will rise and the exchange rate will be stabilized. Secondly, more foreign currency loans may be issued through the state-owned banking sector to promote economic growth and increase income while at the same time reducing the level of foreign reserves.