



China

WHAT DID THE RENMINBI APPRECIATION MEAN FOR CONSUMERS IN RURAL CHINA?

CONTEXT

The Chinese renminbi (RMB) has been a contentious issue both in the policy circles and the research community for the past several years. Partly in response to the pressures from its trading partners, but more because of domestic considerations, in July 2005, the People's Republic of China decided to peg its currency to a basket of currencies instead of only the United States dollar and initiated the process of RMB appreciation. Since then, the Chinese currency has appreciated by more than 30 per cent against the dollar.

This decision has marked a momentous step in China's trade liberalization. Although the impact on the country's trade flows, labour market and economic growth has been widely analysed, the effects of exchange rate movements on consumers and poverty in China have not yet been addressed in the existing literature. Has the appreciation of the renminbi lowered expenditures and hence made Chinese households better off? Has it favoured the poor or rich households in China?

To contribute to bridging this gap in the literature, our analysis focuses on the impact of the RMB appreciation on domestic prices, and consequently on the household welfare in rural China. Generally speaking, a stronger RMB may well curtail domestic inflation in China. Consumers would find cheaper foreign goods in the markets, which, in turn, would exert downward pressure on prices of similar domestic goods. Chinese importers of foreign raw materials and components would also benefit from lower prices. Consequently, it could be assumed that the RMB appreciation is good for domestic consumers because they pay less for their regular consumption.

Nevertheless, the appreciation is expected to have a differentiated impact on households, depending on the type of goods that they consume and the region where they live. The reason for these differences is that the RMB appreciation may significantly reduce consumer prices of some goods while having only a limited impact on prices of other goods. Its impact on prices may also be stronger in some regions than in others. Consequently, the effect of the RMB appreciation is likely to differ among households. An investigation of the welfare impact of the RMB appreciation has not been undertaken in China so far, and its findings could be useful for the design of poverty reduction policies in the coming years in the event of a further appreciation.

METHODOLOGY AND DATA

The empirical approach implemented in our study is similar to Kraay (2008) and consists of two steps.

In the first step, we estimate the impact of the RMB appreciation on consumer prices of different goods in different provinces, using monthly data across 22 provinces in China between 2004 and 2011. We work with seven types of goods, namely food, clothing, transportation and communications, medical care, education, housing, and durable goods, which correspond to expenditure categories in the household survey that we use in the second step. To measure the variations in the effect of exchange rate changes on domestic prices across regions, we use an index

of “marketization” for each province, which reflects the proximity of the province to international markets.

In the second step, we simulate the impact of price changes on household welfare in terms of a relative change in total household income. Data from the 2002 China Household Income Project Survey for rural areas are used in this part of the analysis. Due to data limitation, we only consider the consumption effect, namely, the direct effect of price changes resulting from exchange rate movements. Finally, we use non-parametric regressions to describe how changes in the prices of final consumption goods affect the different types of households.

FINDINGS

Our estimates show that the RMB appreciation reduces consumer prices of all goods, except for medical care and durable goods. For instance, a 10 per cent appreciation lowers food prices on average by 3.5 per cent and housing prices by even more – 4.8 per cent. Conversely, prices of clothing only fall by 0.3 per cent and those of education, transportation and communications by 0.9 per cent as a result of the appreciation. We also find retail prices to be more responsive to exchange rate changes in provinces with a more developed market economy. This can be expected because provinces with a more developed market economy are also located in coastal regions, and are thus more closely linked to foreign markets.

In general, the RMB appreciation benefits all households by reducing their expenditures. The average welfare gain from a 10 per cent appreciation amounts to 1.4 per cent of household expenditure. However, welfare gains vary by household income level and region. We find that rich households derive larger benefits from the RMB appreciation than poor households. This can be explained by the differences in consumption patterns between these two groups of households. Poor households, in particular those in rural China, spend less on food and housing, which become cheaper as a result of the appreciation. They also consume a substantial part of self-produced food, which is excluded from our calculations.

What did the renminbi appreciation mean for consumers in rural China?

However, they usually spend more on medical care whose price does not decrease with the RMB appreciation.

The study finds no big difference in welfare gains between poor households and rich households in the coastal provinces. One possible reason is that both types of households have similar food consumption patterns. Poor households do not consume much self-produced food; instead, as they can easily find jobs in rural enterprises or as migrant workers in cities, they buy a large proportion of food in the market. Another reason is that medical care and the educational system are well developed in coastal regions and poor households can thus get better financial support than those inland. In inland provinces, however, the welfare gains of the richest households are about twice those of the poorest households. This is because poor households there, unlike those in coastal

regions, usually produce a large proportion of food for self-consumption and are less well covered by national medical care and education.

Finally, our results suggest that the welfare impacts of the appreciation are greater on households with the same level of per capita income in coastal areas than in inland provinces. This is because coastal provinces are more integrated with international markets and hence more responsive to the appreciation.

It is important to remember that due to data limitations, our analysis does not consider the effect of the RMB appreciation that occurs through wages, in particular in the exporting sectors, and income from self-production. This may lead to a possible overestimation of total welfare effects of the appreciation.

POLICY RECOMMENDATIONS

Our findings show that poor households in rural areas of inland provinces gain less from the RMB appreciation. The design of anti-poverty policies should therefore take into account regional heterogeneity, in particular the consumption patterns of local residents and the level of development of the market economy. These factors, according to our research, play an important role in shaping the welfare impact of exchange rate changes.

The Chinese government should therefore provide direct assistance, such as subsidies, to poor rural households in inland provinces and pay attention to the fundamental factors that drive inflation. It should also step up market development reforms to establish market-driven pricing mechanisms that would increase the pass-through effect of the RMB appreciation on prices in inland provinces. Furthermore, given the limited gains that poor rural households in inland provinces derive from lower prices induced by the appreciation, the government should pay attention to labour market effects that are likely to affect the poor. Such effects are related to the negative impact of the RMB appreciation on the Chinese manufacturing export sector, which employs a large number of unskilled workers who are more likely to be from poor households.

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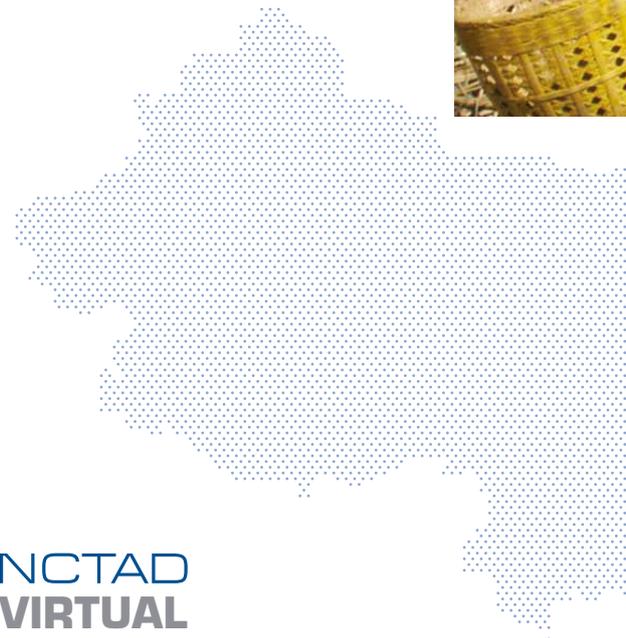
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