China’s economy continues to decelerate, with both long-term and short-term structural factors working to slow the real GDP growth rate and challenge policy makers. There are opportunities, too, as a more balanced valuation of the RMB opens a window for a faster pace of market reforms, should the Government decide to move in that direction.

Long-Term Factors: Diminishing Returns, Aging, and Rural-Urban Migration

Another consequence of the one-child policy has been that both the population and labor force have stopped growing. China has been able to compensate for the lack of total labor force growth through massive rural-to-urban migration that has resulted in a 3% or so growth in the urban labor force even with zero population growth. This rural-urban migration has underpinned China’s real GDP growth, but it will start to diminish in the next decade as the rural population shrinks to less than 70% of the total. Without the rural-urban migration, China’s economy loses the dependable support of about 3% real GDP growth per year.

RMB Strength, Exports, and Incentives for Market Reforms

One of the short-term challenges for China’s economy is the strength of the RMB and its impact on Chinese exports. The RMB is managed within a range against the U.S. dollar. So, U.S. dollar strength also leads to RMB strength when compared to the euro, yen, and most emerging market currencies. U.S. multinationals will suffer a little from the strong dollar, but they hedge some of their currency risk and have huge operations outside the U.S. On the other hand, domestic Chinese exports are taking a big hit from the strong RMB.

Indeed, the pendulum of incentives for market and currency reforms has swung dramatically in the last ten years. Back in 2005, in the midst of its massive infrastructure-led export boom, if China had allowed the RMB to float freely, it almost certainly would have surged higher by 30%, 40% or more versus the U.S. dollar. In 2005, such an abrupt currency appreciation would have disrupted the economic growth model and sent China into a deep recession, with serious repercussion for the rest of the world.

Indeed, while the Chinese government still appears to manage the volatility of the RMB within a relatively narrow, although widening, range, if the RMB were to be freely floated today, little would happen.

A decade later in 2015, the RMB is some 30% higher than it once was against the U.S. dollar (Figure 2), and has experienced an order of magnitude greater appreciation versus the yen and euro. Indeed, while the Chinese government still appears to manage the volatility of the RMB within a relatively narrow, although widening, range, if the RMB were to be freely floated today, little would happen. Indeed, given the deceleration of the Chinese economy
and the increasing desire by Chinese companies and wealthier individuals to invest abroad, the RMB might well fall in value if freely floated today. This means that a more rapid embrace of market reforms, allowing for a de-linking of the RMB to the U.S. dollar, could lead to a modestly weaker currency and give exports a much needed lift. Put another way, in 2015 it can now be argued that embracing market reforms will slow the long-term deceleration of the Chinese economy.

All examples in this report are hypothetical interpretations of situations and are used for explanation purposes only. The views in this report reflect solely those of the authors and not necessarily those of CME Group or its affiliated institutions. This report and the information herein should not be considered investment advice or the results of actual market experience.

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