

Yuan Revaluation: Not Necessarily Bad for China

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It's difficult, these days, arguing that the yuan is not undervalued. The widely publicized large current account surpluses and bulging foreign exchange reserves in China suggest otherwise and continue to provide fodder to critics of Beijing's exchange rate policy. While today's revaluation of the yuan was inevitable, given the necessity to rebalance the global economy, the change in Beijing's currency policy need not be detrimental to China.

Why Rebalancing Growth is Important

In fact, a revaluation of the yuan could get China to a more sustainable growth model faster. While China's rise to export prominence was made possible by relatively cheap labour, the latter won't last forever, given the rising domestic wages and the ascent of other low-cost centres (such as Bangladesh and Vietnam). Note also that consumers are still a small part of the economy relative to traditional powerhouses like the US, Japan and Germany (Chart 1). Strengthening its economic base by stimulating domestic consumption further, while not relying too much on exports, is a plus for sustainability of growth. An appreciation of the yuan goes in that direction, with resources being shifted from exporters to consumers who will be benefiting from lower import prices and more choice.

Implications for Trade

The potential harm to exporters, wouldn't be as dramatic as feared. Any appreciation of the yuan will result in a less-than-proportionate increase in the dollar price of a Chinese product in the US. That's because only the

domestic component of the product will be impacted (e.g. the value-added by the producer, reflecting factors of production in China). The foreign component of the price, namely the input prices (such as imports from suppliers), and US costs (like shipping, retailing, and advertising) will be unaffected. Of course, that's assuming that supplier countries like Japan and other Asian nations do not let their currencies appreciate as steeply as the yuan against the US\$, a reasonable assumption given policies during the last yuan revaluation.

Numerous studies¹ have noted that the domestic content of Chinese exports is between 35-55%. Even assuming the upper-bound of that range, a yuan revaluation of similar magnitude to the one seen from July 2005 to July 2008 (i.e. 17% appreciation) would, at worst, raise the price of imports from China by 9%, not significant enough to cripple China's overall exports, especially considering that any appreciation will be spread out over several years.

That might explain why China coped well the last time the yuan was revalued. Trade remained relatively healthy during the 2005-2008 unpegged period, with exports to Asia nearly doubling and sales to North America soaring 70%, while exports to other regions were even more impressive, helped by the yuan's competitiveness (Chart 2). If history is any guide, a small appreciation is unlikely to have major detrimental impacts on China's export market share.

Chart 1
China's Consumption Base Well Below OECD

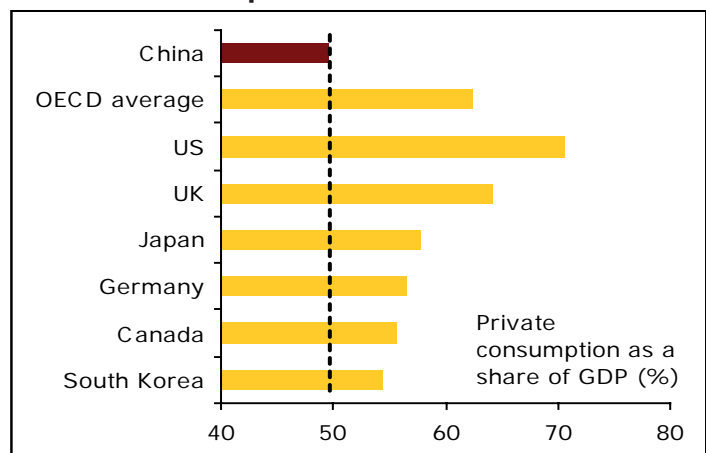
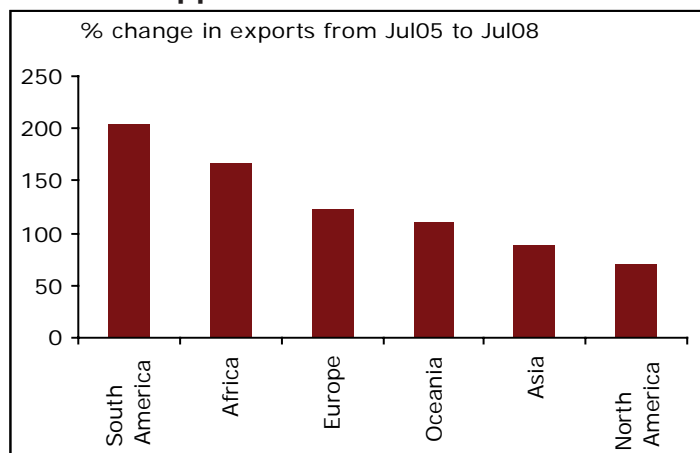


Chart 2
Chinese Exports Performed Well the Last Time the Yuan Appreciated



FX Reserves Accumulation and Asset Price Bubbles

Maintaining the peg has meant that the People’s Bank of China has had to buy US\$ and sell the yuan, not only contributing to the impressive accumulation of foreign exchange reserves, but also causing domestic money supply to soar (Chart 3). That liquidity, together with speculative capital inflows, is fueling inflationary pressures, particularly in the bubbly housing market.

The PBoC has already raised reserve requirements and imposed restrictions on loans for home purchases and the next step is naturally to raise interest rates. But higher rates would encourage even more capital inflows, which would complicate efforts to rein in asset prices. Allowing the yuan to appreciate, after strengthening capital controls, will help limit speculative flows and reduce the need for abrupt rate hikes to contain inflation. Keeping rates low, while controlling bubbles using alternative measures, will continue to support consumption and investment in productive projects, an important element in rebalancing global growth towards stronger Chinese domestic demand.

Moreover, a stronger yuan, over the longer term, will help reduce the rate of foreign exchange reserve accumulation as China runs smaller current account surpluses, lessening the need to invest in US Treasuries. The latter are not expected to provide stellar returns in coming years, given the amount of supply that will come on the market as the US attempts to finance its massive budget deficits.

Ripple Effects Beyond China

The appreciation of the yuan will invariably impact foreign markets, with varying consequences. America, widely viewed as the main beneficiary of a stronger yuan, may in

fact not immediately see the benefits. In addition to the expected increase in Treasury yields as Chinese demand for US debt wanes, the long-awaited improvement in the US trade balance with China might take some time to materialize. America may substitute the more expensive Chinese imports with products from other low cost centres. Moreover, a yuan appreciation may cause commodity prices to take off, as was the case the last time China let its currency appreciate, raising America’s bills for commodities over the near to medium term.

Rebalancing the global economy evidently entails a reduction in the US current account deficit. The declining trade weighted US\$ since 2002 has helped in that endeavor, but it was mostly the euro, yen, C\$ and A\$ doing the heavy lifting (Chart 4). A revaluation of the yuan will diminish the pressure on those other currencies to appreciate, giving the export sector in their respective economies a well-needed shot in the arm.

All told, a somewhat stronger yuan does not necessarily suggest a sudden marked slowdown in Chinese and global growth. We suspect that revaluation, as in the 2005-2008 period, will only happen gradually, with a 3-5% yuan appreciation per year, which would have minimal negative impacts on Chinese trade and hence employment. Chinese authorities could facilitate the rebalancing of the global economy by accompanying the yuan revaluation with further moves to develop a social safety net that would reduce the need for private precautionary savings, giving a nudge to the world’s greatest hope, Chinese consumers.

1: “How Much of Chinese Exports Is Really Made in China?” by Koopman et al. (March 2008); “Estimates of U.S.-China Trade Balances in Terms of Domestic Value-Added” by Lau et al. (October 2006); “US Direct Investment in China” by Fung et al. (2004); “The Estimation of Domestic Value-Added and Employment Induced by Exports” by Chen et al. (June 2001)

Chart 3

Reserve Accumulation Contributes to Inflation

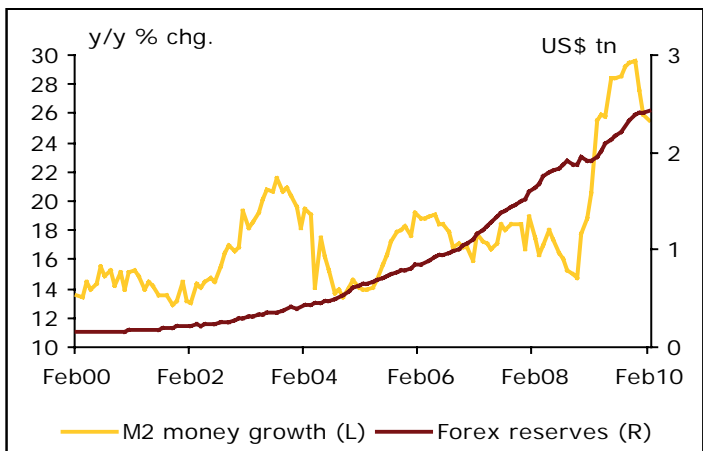


Chart 4

Global Rebalancing Burden Shared Unequally

