

FICCI

FICCI Quick Survey on
Yuan Exchange Rate Flexibility

August 2010

Background

Just before the meeting of the heads of state of the G20 countries in Toronto, Canada in June 2010, authorities in China announced that they would impart greater flexibility to their exchange rate management. This announcement caught the attention of policy makers worldwide.

Evidently, in the run up to the G20 meeting in Toronto, Canada, there was significant international pressure building on China to review its exchange rate stance as many believed that China's exchange rate policy was one of the factors that were holding back global growth from gaining momentum. Voices of dissent were particularly sharp in US and EU, both of which were finding it difficult to manage their large trade deficit with China. Leaders from US and EU had indicated that discussion on exchange rate management and attended global imbalances would be one of their priorities at the G20 summit. By announcing its decision to make Yuan exchange rate more flexible just days before the G20 summit, China was able to deflect some of the criticism it was facing.

This signaling on part of China to end the dollar peg and its willingness to let the Yuan appreciate has evoked a mixed response from leaders worldwide. In its initial reaction the international community welcomed this move. However, soon there were apprehensions expressed on whether this move was an indication of China's intent to meaningfully contribute to the global rebalancing effort or was it only to steer attention away from this issue ahead of the crucial meet at Toronto. This skepticism arose because China did not promise a one off revaluation against the US\$ or a free floating currency. Details that followed subsequently showed that China would continue to manage its currency through heavy intervention by its central bank.

Nevertheless, this development merits attention and calls for an evaluation of what implications would a more flexible Yuan entail. It is also important to recall that in the past China has expressed a desire to broaden the global reserve / vehicle currency pool. And in the process it proposed the use of Renminbi alongside other reserve currencies like the US\$ and the Euro. To get the process kick-started, China introduced cross-border transactions using Yuan in Shanghai and Guangdong in July last year to reduce reliance on the US dollar. Now, China has decided to expand settlements of international trade using Yuan to other provinces and cities, which is a testimony to China's ambition of taking Yuan to a more globalized platform, one day. Hence, the decision to have greater flexibility in exchange rate management could have a bearing on this as well. Additionally, any sideways movement in Yuan's value will also affect the competitiveness of exporters from other countries.

To gauge how leading economists from India are viewing China's announcement of having a more flexible exchange rate and what they think could be the ramifications of such a move, FICCI conducted a quick survey amongst and had detailed discussions with a group of economists. The feedback gathered from and views expressed by economists are presented in the following pages.

The findings of the survey represents the views of the leading economists and do not reflect the views of FICCI.

Survey Highlights

♣ Economists' views on significance of China's announcement of having a more flexible currency

- ▶ Majority view is that China's announcement to return to the pre-crisis arrangement of managing its currency is merely a token of 'intent' rather than a firm commitment to strong action on the exchange rate front.
- ▶ While a more flexible Yuan would help in correcting global imbalances and safeguard fragile global recovery, **this latest announcement** by People's Bank of China would do little to address the issues at hand as PBoC will continue to 'manage' the currency.
- ▶ To have a more meaningful rebalancing of the global economy, China should first allow a one off appreciation of at least 8 to 10 percent and then follow it up with a floating currency regime.

♣ Economists' views on the intent behind China's decision on Yuan flexibility – A conscious effort to invigorate domestic demand or a move to douse trade tensions

- ▶ Both domestic compulsions and external pressure were responsible for China to allow its currency to float within the intra-day trading band of +/- 0.5 percent. It is an occasion when global objectives coincided with Chinese objectives and this was the trigger for the announcement.
- ▶ Domestically, a stronger exchange rate would
 - ✎ Help in transforming the growth structure from being export led to domestic consumption driven as imports would become cheaper
 - ✎ Help tackle the inflation situation, which is increasingly becoming a cause for concern
- ▶ Externally, by allowing its currency to be a little flexible, China has managed, albeit temporarily, to douse trade tensions with the US and EU as well.

♣ Economists' views on whether Yuan could actually depreciate instead of appreciating as widely felt

- ▶ Unanimous view amongst economists is that the general trend for Yuan's value has to be one of appreciation. Economists have ruled out the possibility of the Yuan depreciating at least in the next couple of years. Possibly over a longer time horizon, chances of Yuan depreciating exist and this would happen only if China's growth were to witness a setback.

♣ Economists' views on Yuan / Renminbi as an additional global reserve currency

- ▶ The process for making Renminbi a global reserve currency cannot be immediate and will need a lot of effort and time. We may have to wait for at least a decade before Renminbi becomes a global reserve currency.

- ▶ Chinese government will have to make a number of structural changes before Renminbi can be considered for entry into the elite league of global reserve currencies. Steps China needs to take for making Renminbi eligible for global reserve currency status include –
 - ✎ Pursue inclusion of Yuan in the SDR basket
 - ✎ Establish direct currency exchange mechanism and settle trade in Yuan with different countries, especially its close trade allies
 - ✎ Improve the depth of its bond markets
 - ✎ Make Yuan a convertible currency on the capital account
 - ✎ Ensure domestic trade and investment practices are at par with those of the advanced economies of the world
 - ✎ Strengthen the financial sector

♣ **Economists' views on macroeconomic impact on India of ongoing currency readjustment by China**

- ▶ Going by past experience, when China allowed the Yuan to appreciate by almost 21 percent between 2005 and 2008, most of the economists FICCI spoke too said that even this time the pace of appreciation is not going to be very different. In fact there is a consensus that over the next twelve months the Yuan might move up (appreciate) by about 5 percent. There is feeling among economists that benefits will accrue over a longer period of time to developing economies, including India, as they will be able to garner a proportionately higher share of the gains resulting from global recovery in trade.
- ▶ In case of India, the Renminbi appreciation will be of particular significance as it could help correct, at least partially, the growing trade deficit with China.
- ▶ Indian manufacturing units in the heavy engineering and power segments will also become more competitive vis-à-vis imports from China if Renminbi were to appreciate as expected.
- ▶ Finally, an appreciating Chinese currency will also give a boost to Indian investments in China and possibly open up new markets for service sector exports.

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 **Economists' views on significance of China's announcement of having a more flexible currency**

FICCI asked the surveyed economists on how significant they think is China's decision to impart greater flexibility to its exchange rate management. And the majority view on this is that China's announcement to return to the pre crisis arrangement of managing its currency is merely a token of 'intent' rather than a firm commitment to strong action on the exchange rate front.

Most of the economists FICCI spoke to further mentioned that while a more flexible Yuan may help in correcting the global imbalances and safeguard the fragile global recovery, the respondents were apprehensive that **this latest announcement** by People's Bank of China may not sufficiently address the problem as the Chinese currency would still be managed by the central bank.

To have a more meaningful rebalancing of the global economy, China should first allow a one off appreciation of at least 8 to 10 percent and then follow it up with a floating currency regime, according to majority of the economists who participated in the FICCI survey. It was also mentioned that China would continue to have a firm grip on its exchange rate and will decide on any further changes in tune with the needs of its domestic economy.

 **Economists' views on the intent behind China's decision on Yuan flexibility – A conscious effort to invigorate domestic demand or a move to douse trade tensions**

The economists FICCI spoke to accepted both the above mentioned hypothesis. It was said that both domestic compulsions and external pressure were responsible for China to allow its currency to float within the intra-day trading band of +/- 0.5 percent. It is an occasion when global objectives coincided with Chinese objectives and this was the trigger for the announcement.

Taking the domestic reasons first, it was pointed that officials in China are trying hard to transform the growth structure in the economy from being export led to domestic consumption driven. A stronger exchange rate would help in this transformation as it makes imported goods cheaper and spurs domestic demand.

Also, authorities in China are getting concerned about the inflation situation. Although inflation rate in China is way below the rate prevailing in some of the other Asian nations, yet in May 2010 the uptick in consumer prices was to the tune of 3.1 percent (a 19 month high!), a rate higher than what the government had forecast. Moreover, food prices were up 6.1 percent and wholesale prices of manufactured goods went up by 7.1 percent and so a mechanism had to be put in place to control inflation. By de-pegging its currency and clearing way for its appreciation, China may also be able to tackle the inflation situation to some extent.

Finally, the recovery and upturn of the Chinese economy has become more solid with enhanced economic stability and thus the time was right for moving forward with reform of the exchange-rate regime.

Externally, as mentioned earlier, the pressure on China from the international community to end the currency peg was increasing by the day. By allowing its currency to be a little flexible, China has managed to douse trade tensions with the US and EU as well.

China's decision can thus be described as a *marriage of convenience* with both domestic and external compulsions being addressed to an extent through this move.

 **Economists' views on whether Yuan could actually depreciate instead of appreciating as widely felt**

There is an alternate view that instead of appreciating, the Yuan, once it is allowed greater flexibility to move, may actually depreciate. FICCI asked the participating economists on what was their take on this alternate view. And the responses received show **that economists unanimously believe that the general trend for Yuan's value has to be one of appreciation. Economists have ruled out the possibility of the Yuan depreciating at least in the next 1-2 years. Perhaps, over a longer time horizon, chances of Yuan depreciating exist and this may happen only if China's growth witnesses a setback.**

Economists' views on Yuan / Renminbi as an additional global reserve currency

As mentioned earlier, China has in the past expressed desire to widen the basket of reserve currencies being used the world over. There have been direct references to inclusion of Renminbi in this expanded set of currencies. Some analysts and commentators have linked this latest move on part of the Chinese as a reaffirmation of their desire to promote Renminbi as a global reserve currency. FICCI asked the participating economists on how they viewed this particular issue.

The feedback received from the surveyed economists shows that as far as the march for making the Yuan / Renminbi a global reserve currency is concerned, China is only just lacing up its boots. The process for making Renminbi a global reserve currency cannot be immediate and will need a lot of effort and time. **We may have to wait for at least a decade before Renminbi becomes a global reserve currency.**

According to the surveyed economists, China's economy still has to prove its resilience as it passes through phases of crests and troughs of the economic cycles. Further, **the Chinese government will have to make a number of structural changes before Renminbi can be considered for entry into the elite league of global reserve currencies. Some of the steps China needs to take for making Renminbi eligible for global reserve currency status include –**

- ♣ Pursue inclusion of Yuan in the SDR basket
- ♣ Establish direct currency exchange mechanism and settle trade in Yuan with different countries, especially its close trade allies
- ♣ Improve the depth of its bond markets
- ♣ Make Yuan a convertible currency on the capital account
- ♣ Ensure domestic trade and investment practices are at par with those of the advanced economies of the world
- ♣ Strengthen the financial sector

Once all of the above measures are taken we can expect Renminbi to become eligible for consideration as a global reserve currency.

Economists' views on macroeconomic impact on India of ongoing currency readjustment by China

As mentioned earlier, the People's Bank of China has clearly indicated that it would continue to manage the Yuan through intervention in foreign exchange market. Any sudden and sharp change in the value of the Yuan is completely ruled out. Going by past experience, when China allowed the Yuan to appreciate by almost 21 percent between 2005 and 2008, most of the economists FICCI spoke too said that even this time the pace of appreciation is not going to be very different. **In fact there is a consensus that over the next twelve months the Yuan might just move up (appreciate) by about 5 percent.**

There is feeling among economists that benefits will accrue over a longer period of time to developing economies, including India, as they will be able to garner a proportionately higher share of the gains resulting from global recovery in trade.

In case of India, the Renminbi appreciation will be of particular significance as it could help correct, at least partially, the growing trade deficit with China. Economists have also pointed out that Indian manufacturing units in the heavy engineering and power segments will also become more competitive vis-à-vis imports from China if Renminbi were to appreciate as expected. Further, an appreciating Chinese currency will also give a boost to Indian investments in China and possibly open up new markets for service sector exports.

The respondents also emphasized on the point that India must remove some of the infrastructure barriers to growth of its manufacturing sector, if we are to leverage the relative strengthening of the Yuan and have some competitive advantage over China.