COVER STORY

STRONGER YUAN AROUSES CONCERN

Unilateral appreciation of the renminbi goes against China's sound economic growth By Lan Xinzhen

"Our exports last year were 4 percent higher than those in 2012, but we didn't make much money," Li Haifu, owner of Beijing Haifu Trading Co. Ltd., told *Beijing Review*.

Sitting in Dahongmen area, Haifu is mainly engaged in the production of curtains and beddings, with most of its products being exported. According to Li, for exported products, the U.S. dollar is used at all stages from ordering to settling, and it takes four months for the company to collect the payment for goods. Owing to fierce competition in the textile market, the prices charged cannot be too high. When making quotations, Li's company aims to earn only a small profit, but when collecting money, they have found that because of the yuan's appreciation and price hikes in raw materials, the profits were much lower than they had anticipated when receiving orders.

"Last year we exported two batches of products, with one batch only covering the costs but making no profits," Li said. However, to maintain his business, he has to receive orders even if profits are nonexistent.

Substantial appreciation of the renminbi has dampened the competitiveness of Chinese export-oriented companies. According to figures released by the Bank for International Settlements on January 15, the effective exchange rate of the renminbi rose 7.89 percent throughout 2013. That is to say, if a company received an order of export at the beginning of the year and collected money at the year's end, they would lose 7.89 percent of the profits owing exclusively to exchange rates.

Zhang Monan, an associate researcher with the State Information Center, said exchange-rate liberalization is an important step on the road to the renminbi's internationalization. However, this stage progressed too rapidly in 2013. Over the year, the renminbi exchange rate against the U.S. dollar hit record highs 41 times, which was unprecedented since China initiated the exchange rate reform in 2005.

Zhang thinks the renminbi will continue to appreciate in 2014 for two reasons. Firstly, the continual liquidity expansion of offshore renminbi will further increase the yuan's appreciation. Secondly, the tightened money supply within China's financial system since last year will cause earning-rates differences between Chinese and U.S. treasury bonds to continue expanding, which will also help push the renminbi to appreciate.

That means in 2014, Li and bosses of other export-oriented companies will continue to suffer from the pressure brought about by the renminbi's appreciation.

Unilateral appreciation

The renminbi's appreciation is easy to understand against the backdrop of the quantitative easing policy introduced by the U.S. Federal Reserve (Fed). But after the Fed announced it would begin a drawdown of quantitative easing in December last year, it is hard to say if a stronger yuan will bring joy or sorrow to the Chinese economy.

One of the goals for China's exchange rate reform was to ensure that the renminbi was no longer pegged to the U.S. dollar but instead to a basket of currencies. Viewing the current situation, this goal seems to have been reached: In 2013, the renminbi exchange rate did not fluctuate because of changes in U.S. dollar supplies or fluctuations of the U.S. dollar's exchange rate against those of other currencies. Overall, the U.S. dollar seems to be imposing a reduced influence on the renminbi exchange rate.

A commonly accepted opinion among industrial insiders is that the growing demand for renminbi in the international market and the improving Chinese economy are the main reasons for the renminbi's appreciation.

According to a report released on January 23 by the Society for Worldwide Interbank Financial Telecommunication (SWIFT), in both November and December of 2013, the Chinese currency was one of the top 10 most-used currencies for payments in terms of value. In December 2013, the yuan's market share was 1.12 percent, ranking eighth, while in January 2012, its market share only ranked 20th at 0.25 percent.

"The fact that between November and December 2013, other currencies grew 7 percent whilst the renminbi grew 15 percent, however, might suggest that use of the Chinese currency is becoming business as usual for the world's financial institutions and corporations," said Franck de Praetere, head of Payments and Trade Markets, Asia Pacific, at SWIFT.

Adverse impact

All of the above begs the question of whether or not China will benefit from the yuan's continual appreciation in the international market. Li said he is a "victim" of the renminbi's appreciation, therefore he doesn't wish for the renminbi to increase its value.

Wang Yong, a macroeconomic researcher with CITIC Securities Co. Ltd., also thinks the competitiveness of Chinese export-oriented companies will be attenuated and that China's position as the workshop of the world will be weakened by the renminbi's appreciation. To address the increasing costs, many manufacturing companies have begun to move their factories from the coastal areas of south China to the inland areas or even other countries such as Cambodia, Bangladesh and Viet Nam.

Global Sources Ltd. conducted a survey last December with over 500 Chinese companies. The result shows that renminbi appreciation is the most pressing challenge they face in 2014. In comparison, in the 2012 survey, the exchange rate problem ranked only fourth on the list, coming after rising costs, price wars and the decline in orders from Europe and the United States.

Continual appreciation of the renminbi also imposed heavy pressure on domestic consumer consumption. Fuelled by expectations of renminbi appreciation, the international hot money market has engaged in a veritable frenzy of yuan speculation. This money has entered China through its capital market, resulting in increased inflation. In recent years, the Chinese Government has formulated measures to control prices, which have to date had taken some effect. However, since the renminbi is still in the process of appreciation in the international market, there is still space for hot money to speculate in renminbi. Particularly after the Chinese economy has recovered, the new round of price hikes will further knock down the domestic purchasing power of the yuan.

Wang said China should watch out for the unilateral appreciation of the renminbi. A cautionary example is Japan after the Plaza Accord in 1985. The accord made the Japanese yen's exchange rate against the U.S. dollar rise remarkably, and the Japanese economy then promptly entered into recession for more than two decades. The United States has long claimed that the renminbi is artificially undervalued, but this remains a very aberrant opinion.

Ye Shumei, a manager of Beijing Youth Travel Service Co. Ltd., welcomes the yuan's appreciation. "The number of outbound travelers hit record highs again in 2013, and many Chinese go abroad for shopping. This is because of the appreciation of the renminbi," Ye said.

She thinks if the renminbi continues appreciation against the U.S. dollar in 2014, she will yield even better results.

Wang thinks the biggest benefit of the yuan's appreciation is that it contributes to the currency's internationalization. In the last decade, China has been making the renminbi a more international currency. Owing to its continual appreciation, the yuan has become more attractive in the international market, particularly while the U.S. dollar continues to depreciate. To date, China's central bank has signed bilateral currency swap contracts with 22 countries and regions with a total value of nearly 3 trillion yuan ($491.8 billion).

FLOATING CURRENCY: Pictured is the exhibition hall of the Ninth Beijing International Finance Expo held from October 31 to November 3, 2013

Flexibility needed

Starting this year, China will comprehensively deepen reforms. Various reforming measures, including exchange rate reform, will also be further accelerated. How to guarantee national interests and avoid damaging people's interests during the reform process is a big challenge for decision makers.

Zhang said that unilateral appreciation of the renminbi indicates that China is still unfamiliar with the operations of the international monetary market and has no targeted measures. When China's trade surplus shrinks and its economic growth slows down, massive inflow of hot money has become the most powerful force pushing up the renminbi exchange rate. This also means the appreciation of the renminbi carries hidden risks.

Unilateral appreciation has not occurred because the yuan's influence in the international market has increased. In the past year, the renminbi appreciated with the price of damaging China's national interests as well as those of export-oriented companies and Chinese people in general. Export-oriented companies have enough grounds to demand that decision makers adopt powerful measures ensuring a stable exchange rate for the renminbi.

Zhang thinks that in the short term, China should make the renminbi exchange rate more flexible.

On the other hand, China should also accelerate the launch of derivatives such as renminbi exchange rate futures and options, establish a market-oriented price formation mechanism for the renminbi exchange rate, adopt a uniform exchange rate between offshore and onshore renminbi and avoid speculation caused by the long-term price distortion in the offshore and onshore markets, Zhang added.

In the middle and long term, China should reconsider its strategy for renminbi internationalization that relies on the offshore market, Zhang thinks. Capital export, such as overseas investment, trade credit and issuance of renminbi bonds by foreign institutions, may be a better way to export renminbi.

Zhang Ming, Director of the Department of International Investment of the Institute of World Economics and Politics under the Chinese Academy of Social Sciences, said the Chinese Government is expected to continue its reform of the renminbi exchange rate formation mechanism this year, and the central bank may announce its decision in the first half to expand daily fluctuation of the yuan exchange rate against the U.S. dollar from 1 percent to 2 percent or even higher.

This means that the central bank will further relax intervention with the renminbi exchange rate, thereby allowing fluctuations to better reflect changes in market demand. Robust appreciation of the renminbi in 2013 may yet be avoided. ■

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