THE STORY OF THE CHINESE YUAN

The Story of the Chinese Yuan

– By Prof. *Simply* Simple ™

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You would have read in several newspapers about the pressure on China to appreciate its currency – Yuan.

Let's try and understand the reason why China likes to keep its currency undervalued.

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Throughout the 1990s, China was highly successful at maintaining a currency peg against the US dollar (USD) using a government monopoly.

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But earlier this year, China said it would allow a more flexible Yuan, signaling an end to the currency's peg to the USD.

The move has helped deflect criticism from global economies, who have blamed China for relying on an undervalued currency to promote exports.

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By reducing the value of its currency against the USD, China stands to gain in the following ways:-

1. **Its exports become more competitive.**
2. **It attracts higher foreign investment.**

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So how does this happen?

As always, an example will help us to understand.

Let's presume the exchange rate is USD 1 = Yuan 100

Now if a good costs Yuan 200 in China, a buyer in the US would have to pay USD 2.

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Now if China were to devalue its currency to USD 1=Yuan 200, what would happen???

Quite clearly the same product which was costing Yuan 200 in China would now cost the American buyer only USD 1 instead of USD 2.

While such drastic changes in exchange rates normally do not happen in real life, use of this example was to explain the concept.

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So you can see why Chinese exporters would always be happy with a weak Yuan. This is one of the reasons why Chinese goods have been selling across the world. Most countries find it inexpensive to buy from China.

As China gets access to larger global markets, it further gains from economies of scale which if may pass on to its customers, thereby, making their goods even more competitive.

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And now let’s look at the second advantage, that of attracting foreign investment (foreign capital)

Let’s say, I am a US investor looking for avenues to invest my money.

I would naturally seek a destination where I can get good returns.

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And good returns are dependent on the following:-

1. A large market that can absorb the production easily at a good price.

2. Low cost of the factors of production like land and labour.

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Now China offers both:

1) **It's a large market due to its population. It also has access to global markets for finished goods.**
2) **Due to its depreciated currency the cost of land and labour for a foreign investor works out to be very attractive.**

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Let’s again fall back on our example.

Say the cost of land in China was Yuan 100,000 & the exchange rate was USD 1 = Yuan 100.

This land would then would have cost USD 1000.

If China were to depreciate its currency to USD 1 = Yuan 200, then the land would cost USD 500.

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Again in the example, we have shown a case of extreme depreciation which is not the case in a practical scenario.

However the impact is similar.

A depreciated Yuan makes both land and labour inexpensive for a foreign investor.

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But then why do other countries, let's say a Singapore not devalue its currency.

Actually they too can. But then this move may not attract as many foreign investors into Singapore as it does into China.

Now why does this happen??????

Think about it

or

go to the next slide…

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The reason is clear. Singapore cannot offer a market as large as China. And hence simply depreciating its currency will not be enough for Singapore to compete with China.

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Now one must understand the flip side of depreciating its currency. A depreciated currency makes China's import more expensive.

But quite clearly, China's exports surpass its import requirement and hence the trade-off is in China's favour.

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The second challenge is of rising inflation. As the Yuan depreciates, the central bank will have to print more Yuan to balance the surge in dollars through increased trade.

But as China has abundant land and labour, they are able to off-set the inflationary pressures by higher productivity through economies of scale.

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It is also interesting to note that unlike India, China is not a democracy.

Hence, it is a nation where the people's voice against inflation could be silenced.

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Thus it makes sense for China to depreciate its currency and laugh all its way to the bank.

But such a situation is not conducive politically and strains relations between China and other nations.

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After all China takes away a larger proportion of global markets on one hand and global capital on the other depriving other nations from their share.

Hence there was global pressure on China to appreciate its currency.

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Hope you have now got some idea as to why China was under pressure to appreciate its currency and how currency depreciation can be used as a tool by nations to increase their competitiveness.

However, the underlying fact is that if one wants to benefit from such policies one will have to have the prowess to manufacture quality products in the first place.

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Hope you have now understood the larger role of currency exchange rates in trading strategies vis-à-vis China.

Thinking of Investment

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