

China Indeed not Only Benefits From Rising Yuan, But Also Suffers From it

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Faced with both external and domestic pressures, China changed its exchange rate policy in 2005 from a single fixed peg to the US to a basket of currencies, to allow the Yuan to rise with market changes and till now it has risen above 15% against the US dollars. Some say rising Chinese Yuan is making China loses its competitive advantage as an exporting country. However, China has been progressing steadily for the past twenty years or so through the use of weak Yuan often at the expense of countries who used floating currency. Now, China starting its third stage of growth since 2005 is allowing more flexibility into the economy and therefore a rising Yuan can be seen as a blessing in disguise for China in the long term. As such, the pros and cons are further discussed.

Pro 1 - Cheaper Imports

China's industrialization has seen an increase in the foreign imports of high technology equipments and raw materials. A stronger Yuan can thus counterbalance the price difference in which making the imports of high technological equipments and machinery more attractive. For consumer goods, the society can get to enjoy a wider range of goods at a reduced equilibrium price.

Pro 2 - Countering Inflation

With a low Yuan in the past, China has been keeping its inflation at a relatively high rate and has been suffering from the effects of inflation. Therefore a rising Yuan is now helping China to counter the effects of inflation. Interest rate which has been low for the past years has pushed the consumers into investing in real estate which offers much higher returns. Furthermore, the little emperor syndrome akin the one-child policy is contributing to inflationary pressures as more wealthy parents go out of their way to please their little emperors with the things that they want to buy. With such demands coming from the society, increasing interest rates will not help much. Thus the next best remedy will be looking into the curbing effects of a rising Yuan for inflationary pressures.

Pro 3 - A more productive China

In the short run, rising Yuan are giving Chinese exporters a hard time with reduced profits. However this is forcing China's economy to rise to the challenges to hedge against exchange rate risks through cost efficiencies and technological innovation. Currently, as an export driven country, China's economy is susceptible to world market changes especially with her major trading partners. A rising Yuan not only makes the export sector more productive, it also creates the incentives for manufacturers to focus on China's domestic market. Furthermore, manufacturers and exporters will be forced to compete on quality and

differentiated products as compared to having the cost advantage. In the long run, firms in China will be able to move their products up the value chain, thus generating a larger profit margin.

Con 1 - Export challenges

Currently, still largely dependent on export, China requires high export growth to sustain job opportunities for its large population. A rising Yuan will make Chinese goods less attractive to foreign importers, thus reducing the demand and in turn, firms will look into cutting cost by reducing labour. Unemployment rate will increase and this may affect China's social security. Therefore the Chinese government is ensuring that the rising in Yuan is on a gradual rise, instead of an abrupt one, which may cause China's economy to come in a standstill.

Con 2 – Chaos in a relatively young financial market

A rising Yuan may well put some chaotic pressures into China's developing financial market. All this while, financial and banking services have been a financial tool for the government for the development of state owned enterprise. Only after the entry into WTO, efforts were then seen to develop the financial markets. Furthermore, the lack of awareness of hedging against financial risk is putting many Chinese firms at great risk. Contrary to firms in developed economies, they do not resort to financial derivatives such as currency swaps and foreign exchange futures or even hedge against potential foreign exchange losses. As such, the Chinese government needs to ensure a gradual movement of Yuan to protect China's financial market. Failure to do so will result in an economy downfall with disastrous effect on social security.

Source: Desmond Wang, Starmass International



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