Saturday June 6, 2015

The Rising Chinese Renminbi

T.K. JAYARAMAN

It was a declaration that surprised the world.

The announcement by International Monetary Fund (IMF) Mission at the end of its visit to China last month that its currency, the renminbi is "no longer undervalued" was the unexpected one.

It was also a significant shift in two-decade old view of IMF that the renminbi was deliberately kept undervalued by China to maintain its exports cheaper to the rest of world. Devaluing one's own currency, as we all know would render the country's exports of goods and services including tourism more attractive to foreigners.

Keeping it undervalued was part of export-driven strategy that helped China to grow at an average annual rate of 10 percent during the past two decades. The strategy, supported by cheap labour and incentives to foreign direct investment to re-locate their factories enabled China to beat the then second largest country Japan to third place.

China's gross domestic product (GDP) is US$10.4 trillion, second only to USA (US$17.5 trillion), whereas Japan's GDP is US$4.6 trillion. Though political might is determined by the size of GDP, standards of economic prosperity depend on GDP per capita. The per capita GDP of USA is US$53, 042, while Japan's is US$38, 663. China's is distant US$6,807.

From a record low of US$ 2.3 billion in December of 1980, China's foreign exchange reserves reached an all time high of US$ 3.9 trillion in June 2014!

Currency manipulator?

Americans never hesitated to use the term "currency manipulator" to describe Chinese action of "drawing unfair trade advantage" from not allowing the currency to rise in value in line with rise in accumulation of reserves of hard currencies.

The IMF Mission noted that China's growth is "transitioning to a new normal, aimed at safer, and higher quality- even, if a bit slower growth". It is designed to reduce inequitable distribution of incomes and disparities among regions. Known as rebalancing growth by stepping up domestic demand rather than relying on exports, the new measures include recent reduction of import taxes by 50 percent on consumer goods including clothing, shoes, cosmetics and other luxury items.

China knows such moves will lead to fall in reserves. But, it also knows that it is a good way of reducing reserves. Any downloading of American dollar holdings will only help USA by depreciating dollar. Most of them have been invested in US treasury bills and bonds. All of them will do down in value, causing damage to China's interests.

China needs USA!

New ambition

China has already proved to the world it is an economic giant.

Now, it should emerge as a responsible superpower as well. One of its ambitions, aside from the long term goal being the number one country, beating USA to second place, is to have renminbi being treated on par with American dollar, the euro, the British pound and the Japanese yen. It wants renminbi be included in the Special Drawing Rights (SDR) basket of IMF.

The SDR is the reserve asset of IMF. IMF members can borrow from IMF in SDR to get out of a balance of payments crisis.

To be part of SDR as a goal requires that the currency should not only be strong but also convertible and be a free floating, flexible exchange rate. The remminbi has fulfilled the first two conditions.

The last requirement is its value has to be determined by market forces, not fixed by a decree.

IMF looks upon China's ambition favourably. China's current account surplus has fallen from 10 percent to 2 percent. The renminbi has appreciated by over 30 percent; from the 2000 exchange rate of 8.70 renminbi to one US$ to 6.21renminbi.

America is not agreeable. It wants the subject should be discussed in G-7 leaders meeting

In the meanwhile, students of economics who are never tired of the ever tasty "Big Mac Index" developed by ***The Economist*** of London since 1986, would hesitate to accept IMF certificate that the renminbi is not undervalued.

The Economist twice a year publishes the Big Mac index, as a "lighthearted "guide to whether currencies are at their "correct" level. The theory of purchasing-power parity (PPP) says in the long run exchange rates should move towards the rate that would equalize the prices of an identical basket of goods and services (Big Mac) in any two countries.

The average price of a Big Mac in America in January 2015 was US$4.79; in China, the actual price was 17.2 renminbi. At the official exchange rate of 6.21 renminbi per one American dollar, it was equivalent to US$2.77. ***The Economist*** says that the renminbi was undervalued by 42 percent in January.

The next Big Mac index will be out in July, about four weeks from now.

Until then: "Bon Appetit!"