Revaluation of the Chinese Yuan: What Will Happen After this Hike?

On 21 July 2005, China agreed to revalue its currency, the yuan. This decision wasn't a surprise (see our article in PRIVATE 4/2005). The question now is predicting whether this decision will have an impact on supply and demand.

By Geoffroy Dedieu
Head of European Desk
MeesPierson Asia, Singapore

The most tenacious "hawks" in the U.S. Congress insist on a 25% appreciation of the yuan against the U.S. dollar in order to correct a Chinese trade surplus which they deem unfair. In reality, the United States profits, as does Europe, from low Chinese production costs. Western consumers are the biggest winners. Numerous companies in the U.S. and Europe sub-contract in China and can therefore remain competitive in their markets.

As pointed out previously, the controversy over the yuan is mainly political. But as far as world trade is concerned, just like judo, it's the force exerted by the adversary that must be channelled. In China they know all about judo! And here's precisely how the situation could turn to the Americans' disadvantage.

By "forcing" the government in Beijing to revalue the yuan, the U.S. would like to make Chinese products more expensive and thus less attractive. In fact, it is American consumer demand that could suffer due to a tightening up of credit. Furthermore, the Chinese have all become a little richer in dollar terms – a 2% increase overnight!

Chinese consumer goods will not become unaffordable for the sake of a few extra cents. The 2.1% revaluation of the yuan can be partially absorbed by manufacturers, importers or distributors. Only a few sectors where profit margins are very small will be affected slightly (electronic components), because it will be more difficult to absorb the price increase. For shoes and T-shirts, western consumers will hardly see any difference in the shops.

On the other hand, China's sustained buying of American treasury bonds has made it possible to keep the cost of credit low in the U.S. China went for "T-Bills" in order to recycle its trade surplus and keep the parity of the yuan at 8.27 to the dollar. But in switching to a floating exchange rate controlled via a basket of currencies on 21 July, China has partially freed itself from this need to buy US dollar denominated bonds. It will now be a basket of currencies, the content of which will remain secret like in all countries that rely on a basket of currencies – in Singapore, it is a state secret.

The lending rate in the U.S. could therefore increase and consumers, who are still largely in debt in 2005, are going to have to cut spending. The "hawks" are going to obtain a reduction in Chinese imports at the cost of a general reduction in consumption in their country. Bear in mind that the Washington government and American households have long spent too much, and this forced regime will cure part of their phenomenal debt.

In fact, China will now also buy euros and yen, therefore reducing the lending rate in Europe and perhaps revitalizing European market consumption! Europe is going to benefit from the pressures put on the Chinese currency.

For private investors, it will be necessary to review bank balances in U.S. dollars and protect themselves from foreign exchange losses. The value of the greenback is volatile. It could shrink because there will be less demand for this currency.

Now in 2005, the public and private deficits in the U.S. help keep the supply of the U.S. dollar at a high level. China's foreign currency reserves exceeded US$700 billion at mid-year, of which more than US$100 billion had been accrued since the beginning of the year. At this rate of growth, the rebalancing in favor of other currencies rather than the dollar will be realized without a reduction in reserves (without a massive sale of dollars) but rather through the preferential buying of euros, yen, the pound etc… The risk of capital loss is nevertheless important to the government in Beijing, which does not want to see the value of "its own" dollars fall sharply. •

Protection from Foreign Exchange Losses

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