

Timid China, Brave India?

Or, Cautious China, Foolhardy India?

Two weeks back, in a move which pre-empted possible pressure on China about its exchange rate policy at the G20 Summit in Toronto, the Peoples Bank of China, the central bank, announced that it would “*proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility*”. Since then, the Yuan has appreciated just 0.6% in USD terms. To be sure, the word used is “flexibility” which, in theory at least, means movement either way; indeed a fall in dollar terms could occur should the currencies of its largest market, the European Union, slump.

The objective of the move, as enunciated in question and answer format on the central bank’s website, is “*to stabilize the RMB exchange rate basically around an adaptive and equilibrium level, and in the meantime, improve China’s BOP situation, and achieve economic and financial stability*”. One answer emphasizes that “*While furthering the exchange rate regime reform provides a great deal of potential for future benefits, efforts would also be needed to minimize possible negative impacts. First, it is important to avoid any sharp and massive fluctuations of the RMB exchange rate. As China’s BOP is now moving closer to a more balanced position, prices of labor, raw materials, land and other capital goods have become higher, which raises the cost of China’s export. The **basis for a large-scale RMB appreciation does not exist as the RMB exchange rate is moving closer to its equilibrium level.....the RMB currency reform would be gradual, in view of varied degrees to which the corporate sector would respond to changes of the exchange rate.** The purpose is to maintain an orderly process of industrial upgrading, maintain the international competitiveness of Chinese enterprises... **A large fluctuation of the RMB exchange rate would bring considerable shocks to the domestic economic and financial stability, which is not in China’s fundamental interest**”*. The concern about the competitiveness of the real economy, particularly its tradables sector, is obvious. So is the objective of the flexibility, in effect gradual yuan appreciation. “*Further reforming the **exchange rate regime will also be supportive to job creation**, particularly in the service sector. Exchange rate floating will turn Chinese exports to be high value-added product based. **More jobs will be created** by extending the production chains through improved division of labor. In particular, the exchange rate will help improve resource allocation between the tradable and non-tradable sectors, and thus enable the service sector to absorb surplus labor from other sectors, particularly, tradable sectors*”. How cautious (timid?) the Chinese are in allowing exchange flexibility, how conscious of the impact of the exchange

rate on the real economy, despite having the world's highest surplus on current account and exports, its fastest growing economy, and low inflation.

Contrast that with our brave attitude to the exchange rate: remember we allowed the rupee to appreciate almost 6.5% in April 2007, from a level which many thought was reasonably neutral in real effective terms. Last year too we allowed the rupee to appreciate more than 12% in nominal dollar terms, even as we had double digit inflation and a gargantuan trade deficit. And, of course, we never refer to the competitiveness of the real economy while discussing the exchange rate policy: we talk of intervention to smoothen volatility, but aver that we have no level in mind, etc. Clearly, we are far braver than the Chinese: but are we wiser?

G20 in Toronto

If China pre-empted one issue by its well-timed announcement on exchange rate policy, overall the G20 Toronto declaration seems to have moved well away from the ringing call for “global solutions to global problems” given by the first summit in November 2008. As the crisis of autumn 2008 recedes from the summiteers’ memories, national priorities and differences are coming into sharper focus. This was most clearly seen on the issue of fiscal consolidation where there were two different groups: U.S., Japan and India preferring a more gradual process, Europe, with Greece and PIIGS still weighing heavily on its mind, preferring a faster track. The major issues clearly are the risks of inflation vs deflation and of financial markets confidence in sovereign paper.

A related issue is global imbalances; recent macro-economic developments in Europe clearly raise some question marks. Both the sharp fall of the euro and fiscal consolidation will reduce domestic demand and imports, and increase the competitiveness of exports. One has seen estimates of \$ 300 bn as the EU surplus on current account in 2010! If Europe, China, Japan are all to register large surpluses, who is the buyer of last resort? The U.S.? For how long, without causing a run on the dollar? And if not the U.S., who? Will trade protectionism gather momentum, taking the global economy once again in the direction of recession/deflation? The G20 Summit has provided few clues to answers to these major issues: more on this in a subsequent article.

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