

The Long March

There are several indications in recent months pointing towards a greater internationalisation of the Chinese yuan. This should be no surprise of course: it the world's largest exporter; holds the world's largest reserves of foreign exchange at something like \$ 2.5 trillion; its inflation rate is comparable to that in its major trading partners; and has replaced Japan as the world's second largest economy (even at the nominal exchange rates). Given the continued rapid growth of the economy, the 21st century could well turn out to be the "Chinese Century", with the Middle Kingdom coming back to occupy its leading place in the global league of nations. As part of the process, the yuan could well aspire to be the reserve currency to rival the dollar, over the next few decades. Earlier, one was looking at the euro to assume this role gradually, but the recent problems in the eurozone make it more likely that its prospects of doing so have dimmed somewhat.

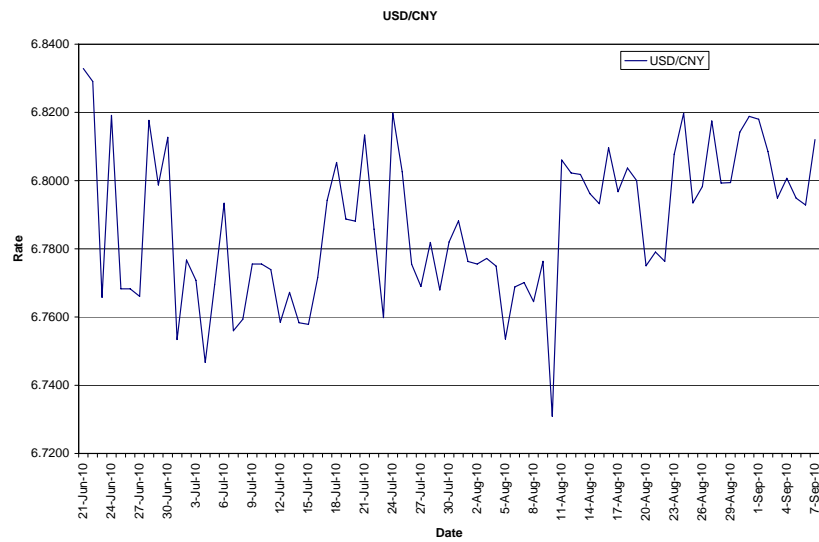
China took one major step on June 20th by announcing that the exchange rate would henceforward be managed more flexibly in relation to a basket of major currencies. Broadly speaking, it has been doing so as the accompanying graph shows: the day-to-day movement seems to be governed more by the dollar's changes against the euro and the yen, rather than any "secular" appreciation of the yuan. Against the dollar, the yuan has appreciated just 0.02 CNY (0.29%) by 7.9.10, even as it has registered much larger falls against both the euro and the yen. (One wonders what the basket of currencies is and the proportion of various currencies in it.) Meantime, the Chinese surplus is once again growing and the US's concerns on the subject were surely expressed when a US delegation under Lawrence Summers, President Obama's top economic advisor, visited Beijing last week-end. Global imbalances would obviously be a topic for informal and formal discussions leading to and at the forthcoming G20 Summit in Seoul a couple of months from now. Exchange rate apart, there is one other development, certainly blessed, if not provoked, by the Chinese authorities, to reduce the competitiveness of its exports – large wage increases which surely add to the yuan costs of the labour intensive export industry.

Exchange rate policy apart, many regulatory changes have been effected permitting greater use of CNY in China's trade as well as the off-shore capital market. In mid-2009, Chinese exporters in five locations were permitted to use yuan as the invoicing currency for trade with neighbouring countries. A year later, the list of Chinese centres has been increased to 20, and for trade anywhere. (Most of the Indian contracts for import of Chinese power plants are denominated in the yuan.) The Chinese central bank has established yuan-based swap lines of credit with many central banks in the ASEAN region. Hong Kong residents are allowed to convert up to HK\$ 20,000 every day in yuan. The restrictions on yuan accounts in Hong Kong have been lifted and financial institutions in Hong Kong are free to introduce yuan-denominated investment products – as also invest in the on-shore bond market. In effect, every effort is being made to create an off-shore yuan market in Hong Kong.

The historic Long March led to the establishment of a communist regime in China. The long march to make the yuan as one of the two or three or four major global currencies has just begun.

Tailpiece-1: A study of corporate results in the first quarter of 2010-11 suggests that they are facing an increase in material wage and interest bills. BHEL and Larsen & Turbo have lost Rs. 65,000 crores of orders to Chinese suppliers in the 11th and 12th plans, and the power ministry is seeking a duty of 21% on import of Chinese equipment. The government, in the recent trade policy review, has extended "export sops" of Rs. 1000 crores, which works out to a princely relief of 0.1% of exports or say 4.5 paisa per \$ and, the trade deficit continues to mount at \$ 10 bn+ every month, and export growth is slowing down. Any comments about the exchange rate policy are superfluous.

Tailpiece-2: Apropos last Monday's article on the environmental policy, perhaps the biggest threat is not industrial projects, power plants or airports, but population growth about which all over political masters and most of the NGO are silent.



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