



## The return to a policy of revaluing the yuan is welcome, but is not a panacea

On June 19, Chinese monetary authorities announced a return to a more flexible foreign exchange policy. In fact, they are reverting to the same managed currency regime that gave rise to a gradual revaluation of the yuan between July 2005 and July 2008. The few financial institutions that are authorized to trade yuan currency directly for U.S. dollars will be able to do so within a range of +/-0.5% of the rate posted by the central bank of China. That rate will be revalued regularly. The economic and financial crises that shook the globe in the past two years led China to stabilize its currency at approximately 6.83 yuan/\$US, to protect its exporters. Since the recent announcement, the yuan has gained about 0.5% against the greenback.

Many countries were hoping for this change of policy, in particular the United States, which has a substantial trade deficit with China. But we should not allow ourselves to become overly optimistic about this revaluation. For one thing, foreign exchange adjustments will take place gradually, and it will be some time before the expected benefits in terms of equalization of trade balances reach significant proportions. For another, the exchange rate is not the only factor that influences trade balances.

Neither should we expect to see far-reaching effects on global economic growth as a result of this announcement. In the long term, the revaluation of the yuan will primarily serve to a rebalancing of the global economy.

### THE REVALUATION OF THE YUAN WAS EAGERLY AWAITED

The international pressures for China to revalue its currency had been growing for some months. The economic recovery goes hand in hand with a net expansion of international trade, from which China greatly benefits. Between May 2009 and May 2010, growth in Chinese exports was 48.5% (graph 1). The argument whereby the Chinese government needed to protect its exporters was becoming less and less tenable, especially since the Chinese economy is growing again at a significant pace (graph 2 on page 2).

The enormous trade surplus that China manages to achieve, at the expense of the industrialized countries (graph 3 on page 2), particularly the United States, cannot keep growing forever. In the industrialized countries, which are grappling with debt problems, more moderate growth in consumer and

Graph 1 – Renewed high growth in Chinese exports



Sources: Datastream and Desjardins, Economic Studies

government spending will have to be offset by other growth levers, including exports. The depreciation of the euro and

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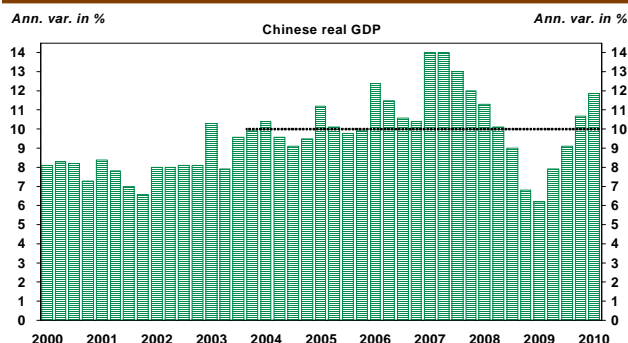
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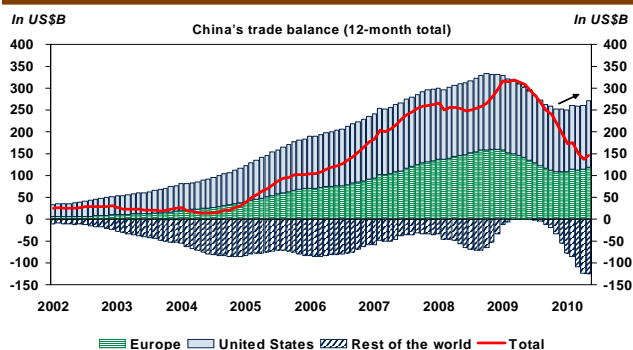
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**Graph 2 – China's economic growth has climbed back above 10%**



Sources: Datastream and Desjardins, Economic Studies

**Graph 3 – China's trade surplus with the United States and Europe is up again**



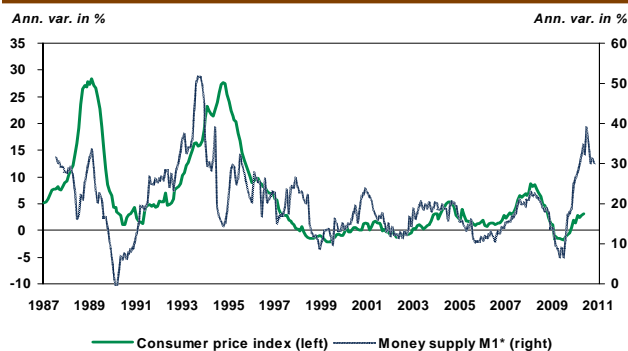
Sources: Datastream and Desjardins, Economic Studies

the U.S. dollar against the currencies of emerging countries, and the yuan in particular, will make these adjustments easier.

### CHINA WILL ALSO GAIN BENEFITS

The revaluation of the yuan will not be entirely a bad thing for China. Given that its economy is showing signs of overheating, this initiative will make it easier to control its growth and avoid an acceleration of inflation (graph 4).

**Graph 4 – The vitality of the Chinese economy and monetary growth threaten to accelerate inflation**



\* Six months ahead. Sources: Datastream and Desjardins, Economic Studies

On a more structural view, a higher yuan will expand the purchasing power of the Chinese, and this should help accelerate the growth of domestic demand through consumer spending. Investment in the services sector could also benefit from the revaluation of the yuan, while the attraction of the manufacturing sector, which is more export-oriented, could wane. Moreover, the net effect on exporting companies should be lessened by the lower cost of the supplies they import.

### THE REVALUATION OF THE YUAN WILL NOT SOLVE EVERYTHING

Even though China is revaluing its currency, many countries are still afflicted with serious debt problems which, if they are not resolved, could be detrimental to the anticipated adjustments in trade balances. A connection can be drawn between trade imbalances, household debt and sovereign debt. All other things being equal, a country in which households and governments become overburdened with debt will be more likely to see its trade balance deteriorate. In fact, according to economic theory, foreign trade can be interpreted as being the equivalent of flows of capital between countries. When local savings are unable to finance the excessive indebtedness of governments and households, a net inflow of foreign capital must take place to restore balance (see box 1 on page 3).

It is therefore important for a country that carries a major, recurring public deficit to reduce it. Some excesses in the private sector are also to be banished. For example, during the previous economic cycle, American households took on a large amount of debt to support residential construction; but that also resulted in a greater need for foreign capital. In fact, for some countries, the entire dynamic of economic growth needs to be revised to pave the way for a new phase of sustainable expansion over the longer term, in tandem with the rebalancing of trade flows.

### TIME FOR ADJUSTMENT, AND THE J CURVE THEORY

Contrary to when the yuan was revalued in July 2005, the recent announcement did not trigger any marked movement in the exchange rate (graph 5 on page 4). The adjustments will be spread over a long period, and consequently it will be difficult to notice any appreciable effect in the short term. Forward contracts on the yuan are counting on an appreciation of just 2% in the next 12 months (graph 6 on page 4), but if the pace of adjustments matches that recorded between 2005 and 2008, the yuan could gain approximately 10% against the greenback between now and the end of 2011.

Even if the revaluation of the Chinese currency were to take place even faster, it is by no means certain that, in ideal conditions, the adjustment in trade flows would accelerate

**Box 1 - Fluctuations in the trade balance analyzed from another viewpoint beside the exchange rate**

Analytically, we can show that, for a given country, the trade balance fluctuates according to private savings, investment and the government deficit.

The first step is to define a country's savings (national savings), which come from both individuals and businesses (private savings) and the government (public savings). Private savings are the portion of income that is neither spent, nor used to pay taxes. Public savings are the difference between the government's expenditures and its revenues. When the government runs a deficit, public savings are negative, and vice versa. The equation below sums it all up:

$$S = S_p + S_g \Leftrightarrow S = (GNDI - C - T) + (T - G) = GNDI - C - G$$

Where "S" represents the total savings of a country;

" $S_p$ " represents private savings;

" $S_g$ " represents public savings;

"GNDI" represents the gross national disposable income;

"C" represents consumption;

"T" represents taxes;

"G" represents government spending.

To tie this in with the trade balance, we must first start with the fundamental equation illustrating the equality between the income and the expenses of an economy, that is  $GNDI = C + I + G + CA$ , where "I" represents investment and "CA" represents the current account balance (a broader definition of the trade balance, including interest and dividend payments between countries, as well as net unilateral transfers).

If we rearrange the components of this last equation, the current account balance becomes equal to revenues less consumption, less investment, less government spending.

$$CA = GNDI - C - I - G$$

Starting from the savings equation, we can replace  $GNDI - C - G$  with national savings "S". Thus a country's current account balance depends on the difference between national savings and investment.

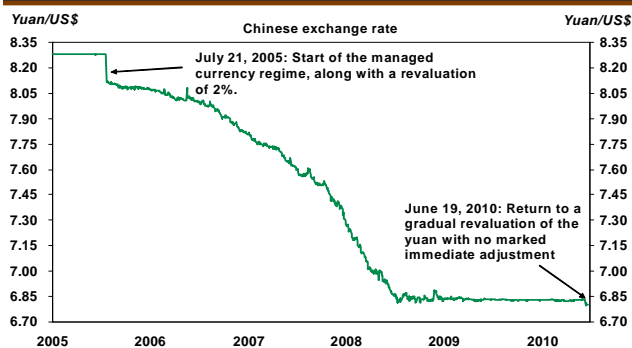
$$CA = S - I$$

In other words, if investment is greater than savings, the country is forced to borrow from abroad to finance the current account deficit. Conversely, if a country's investment is less than its savings, the country will lend its surplus savings abroad. By separating national savings into two categories, i.e. private savings and public savings, we obtain the following relationship between the current account, private savings, the public deficit and investment:

$$CA = S_p + S_g - I$$

The latter equation shows that a government that does not have firm control over its spending ( $S_g$  is negative) exerts a negative influence on the current account balance. Similarly, excessive consumer debt will reduce private savings ( $S_p$ ) and will also accentuate foreign capital requirements. The level of investment can also have an impact on foreign capital flows. An increase in investment expands capital requirements, while a cutback reduces those needs. However, it is acknowledged that relying on foreign capital to finance investments is less problematic, since that capital helps raise the potential for economic growth.

**Graph 5 – In 2005, the introduction of a new currency regime triggered an immediate revaluation**



Sources: Datastream and Desjardins, Economic Studies

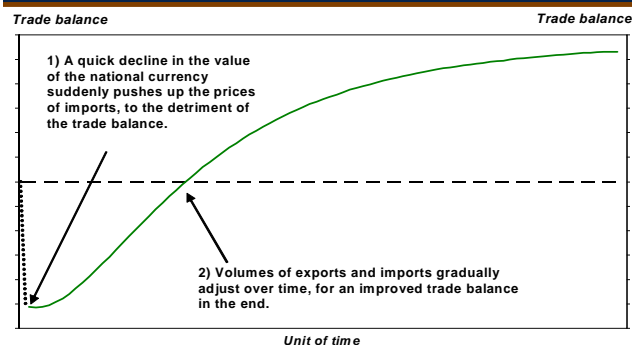
**Graph 6 – Forward contracts on the yuan suggest a moderate revaluation of the Chinese exchange rate**



Sources: Datastream and Desjardins, Economic Studies

proportionally, at least in the short term. Apart from the structural problems (i.e. debt) that may be plaguing certain countries, the immediate effect on the trade balance is rarely positive. According to economic theory, the trade balance deteriorates initially, before a net improvement occurs. Graphically, the pattern of the trade balance over time normally resembles a J-shaped curve (graph 7), hence the expression “J curve”.

**Graph 7 – Theoretical representation of the J curve**



Source: Desjardins, Economic Studies

The immediate effect of a depreciation of the currency (decline of the dollar against the yuan) is an increase in the cost of imports: in the short term, the quantities of goods imported do not adjust instantaneously, and the total value of imports rises. As for exports, other countries do not rush overnight to the less expensive products from the countries where the relative value of the currency has declined. It is these two short-term trends that initially produce deterioration in the trade balance. It takes some time for imports to adjust downwards and for exports to increase significantly. At the same time, higher demand for the exported products can push their prices up and further delay the boom in exports, while national producers adapt to this new demand.

**LACK OF SUBSTITUTES FOR IMPORTED GOODS**

The lack of substitute products, manufactured in the countries that import Chinese products, could prove to be a major impediment to the improvement of trade balances. During the last economic cycle, the manufacturing sector atrophied in most of the industrialized countries, while it expanded rapidly in China. That country currently specializes in the production of many common consumer goods, while the industrialized countries have focused on the provision of services. In order for the revaluation of the yuan to produce beneficial effects, reinvestment will be needed in the industrialized countries to expand production capacity for certain goods that are currently imported from China.

However, we should not expect a massive return of industries that have relocated to China. Even with a significantly revalued yuan (which will take a few years), gaps in the areas of regulation and wages will continue to favour keeping, and setting up, many businesses in China. The industries that produce goods with high value added and that are not labour intensive will be the most likely to expand their investments in the industrialized countries.

**TOWARDS A MORE BALANCED DISTRIBUTION OF GROWTH**

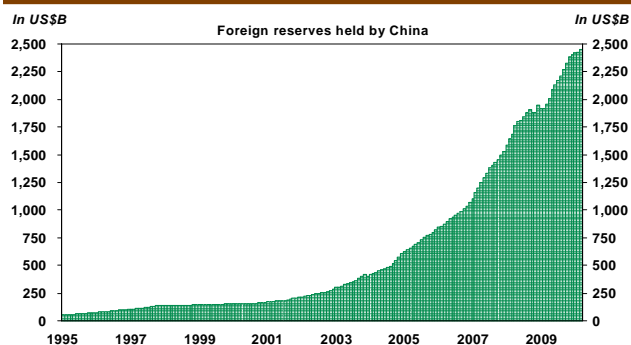
The return to a policy of revaluation of the yuan is welcome, but does not constitute a panacea. In the short term, the pace of revaluation should not be fast enough to cause any rapid change in trade balances. Those changes will also depend on the speed with which the industrialized countries reduce their need for foreign capital. Moreover, it will also take time before the quantities of imported and exported goods adjust to the new exchange rate.

In the longer term, the revaluation of the yuan does open the door to a rebalancing of the global economy; in fact, a new dynamic may take hold. Rather than relying on excessive household and sovereign debt, the industrialized countries will be able to count on stronger growth in their exports.

Business investment could also accelerate in those countries. Meanwhile, China and other emerging countries will be able to continue their economic development by relying more on the potential offered by their own pool of consumers.

In terms of implications for the financial markets, the revaluation of the yuan is one step towards a floating exchange system, but there are still many steps to be taken. The Chinese policy of sterilizing capital flows so as to ensure the maintenance of an undervalued exchange rate, while avoiding too strong a monetary expansion, will remain in place. This means accumulating reserves of foreign currencies, most of them in U.S. dollars (graph 8). Chinese demand for American securities helped to keep interest rates low in the U.S. over the past decade, and is not likely to fade away overnight. However, in the longer term, it will decline as the Chinese exchange rate approaches a balanced value. Always difficult to estimate precisely, a revaluation of about 20% should take place before that level is reached.

**Graph 8 – Sterilization operations will continue in China**



Sources: Datastream and Desjardins, Economic Studies

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