Managing Exchange Rate - Chinese Model

What is the issue?

\n\n

For long, China has been accused of engaging in unfair trade practice by manipulating its currency to its own advantage.

\n\n

What has been the practice of China?

\n\n

\n
- In the past three decades the China has been largely oriented to keeping the currency “competitive” by devaluing.
\n
- They have done this largely to favour the country’s exports.
\n
- Such specific moves, at times, have destabilised trade patterns for other countries.
\n
- e.g The RMB devaluation of 1994 is recognised to have led to declining export competitiveness of major Asian exporters, eventually becoming one of the significant factors leading up to the Asian crisis of 1998.
\n
- This had created a scenario where even the slight depreciation of the RMB relative to the US dollar being met with howls of protest.
\n

\n\n

Is China still practising devaluation?

\n\n

\n
- In the 2000s and after the Global Financial Crisis (GFC), the efforts of the Chinese authorities seem to have been directed towards encouraging the RMB to appreciate rather than sustain a lower value.
\n

\n\n



\n\n

\n
- The figure shows that even after the Global Financial Crisis (2008) broke out, RMB appreciated in relation to the US dollar until 2015.
\n
- However, post 2015, until 2017 there has been depreciation, which recovered only recently
\n
- This period of RMB depreciation is widely associated with “capital flight” from China.
\n

\n\n

What is “capital flight”?

\n\n



\n\n

\n
- Figure 2 shows that, from early 2014 onwards, capital account of China moved sharply from showing substantial surpluses (inflows of capital) to balance and even deficits (net outflows).
\n
- Current account was remaining surplus.
\n
- This was seen by many economists as a capital flight i.e a large-scale exodus of financial assets and capital from the nation
\n
- But this raises a question that why there would be so much capital flight from an economy that still generated substantial current account surpluses.
\n

\n\n

What was the reason for the perception?

\n\n

\n
- The perception of capital flight was mainly due to the net drawing down of foreign exchange reserves by China.

\n

\n\n



\n\n

\n

- It is been seen as measure by Chinese authorities to shore up the currency through open market operations in the face of such capital flight.
\n

\n\n

What is the actual scenario?

\n\n

\n

- The actual explanation of drawing down forex reserves indicate more strategic thinking on the part of Chinese policy makers.
\n
- It is noted that the foreign reserve holding of China generated very low returns.
\n
- It also generated excessive dependence on the US economy especially when held in US dollar securities like Treasury Bills.
\n
- Therefore, there has been a push to diversify foreign asset holding, through more variety in the composition of reserves, and through increased foreign investment in different forms.
\n
- Moreover, many of these investments, as well as more import payments, were settled in RMB rather than in US dollars.
\n
- This was done to serve the further purpose of enabling the gradual internationalisation of the RMB by providing other countries access to this currency.
\n
- So there may have been some capital flight out of China, but major reason has been the strategic shift in the Chinese pattern of foreign asset holding.
\n

\n\n

\n\n

Source: Business Line

\n\n

Quick Facts

\n\n

Devaluation vs Depreciation

\n\n

\n
- Money is devalued when the government lowers the worth or value of its currency.
\n
- Money depreciates when the currency exchange market is willing to only pay less than before for a specific country’s currency.
\n
- The difference between the two lies in **who or what is allowed to change the value** of a currency.
\n

\n\n

\n\n

\n\n

\n