



## Research Notes

### Yuan flexibility a step closer / 21 June 2010

The Peoples Bank of China has announced that it is close to allowing the Chinese Yuan to appreciate via a managed float against a basket of currencies. This is an important and necessary step. It will help the Chinese authorities control inflation and, just as importantly, assist the rebalancing in global growth we need to see for a sustained economic recovery.

In a November 2009 research note (*The Yuan and Global Rebalancing*) we outlined the rationale for an appreciation in the Yuan.

To reiterate a well worn argument: for the new-look global growth environment to be sustainable, we must see a reduction in the large imbalances that built up over the last few years.

For those imbalances to reduce, we need countries with big current account deficits (such as the United States, the United Kingdom and New Zealand), to export their way out of recession. In order for these countries to have export-led recoveries, we need countries with large current account surpluses (such as China, Japan and Germany) to grow domestic demand.

Exchange rates should reflect these fundamentals. The countries with large current account surpluses (that also need to grow consumption) should have appreciating exchange rates. This will help boost domestic demand by making imports cheaper. The countries that need to grow their exports need a weaker exchange rate to make themselves more globally competitive.

In the specific case of China, the global economy needs China to consume more. An appreciation in the exchange rate will aid that shift in investment in the tradeable sector to the non-tradeable sector of the China economy to support growth in consumer demand.

An appreciation in the exchange is a necessary, but not sufficient condition for a rebalancing in growth in China. China also needs to introduce policies that reduce the need for households to save so much for education and healthcare. Significant social reform is required in China.

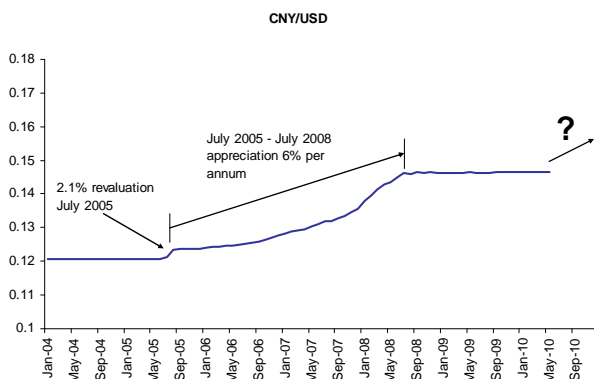
While that shift in the balance of growth in China will take time to play out, an appreciation in the CNY will also have the more immediate effect of helping keep a lid on building inflation pressures.

#### Why now?

The Yuan's gradual appreciation was put on hold during the GFC. Since then it has been reluctant to move on the exchange rate, citing the unsustainability and fragility of the global economic recovery. With the global recovery looking more secure and with domestic economic conditions in China strengthening, that argument has run its course.

Higher interest rates will be required in China long before they will be needed in the United States. This would have made the maintenance of the peg to the USD increasingly untenable. In our view a relaxation of the peg was always going to be a precursor to higher interest rates in China.

But there is also a political imperative. In a subsequent April 2010 Research Note (*Yuan Policy Change Imminent?*) we argued it was likely the Chinese would make a move on



Source: AXA GI and Bloomberg

exchange rate policy before the Toronto G20 Leaders Meeting. That meeting is next weekend.

Political tension has already been manifesting itself. Earlier this year US Treasury Secretary Timothy Geithner was under pressure from the US Congress to formally “name” China as a currency manipulator in his semi-annual report to Congress on the exchange rate policies of major US trading partners.

This would have unleashed a chain of events that would have led to trade restrictions – such a move would have been extremely unhelpful for the rebalancing of global growth and the nascent economic recovery. After what we described as a “new world geo-political reality check”, Geithner postponed his report to Congress and instead embarked on an “unscheduled” trip to China.

China will have wanted exchange rate policy off the Toronto agenda. At the previous G20 Summit in Pittsburgh, the G20 launched the “Framework for Strong, Sustainable and Balanced Growth”.

That Framework committed G-20 countries to evaluate their national policies to ensure they were collectively consistent with more sustainable and balanced global economic growth. At next weekends meeting, leaders will be reviewing the results of the mutual assessment and consider policy options for a more balanced global economy.

It was likely that the Yuan peg to the USD would have seen some robust discussion as part of this process. The China authorities have now somewhat defused the issue.

Exchange rate inflexibility is a major impediment to a sustained global recovery. A move to a more flexible exchange rate regime, especially in an economy as important as China, is a welcome move. That’s especially the case for an economy such as New Zealand which has a shiny new free trade agreement with what is already our third largest trading partner.

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