China should allow a one off appreciation of at least 8 to 10 per cent and then follow it up with a floating currency regime say Indian economists in a FICCI Survey

New Delhi, August 7, 2010. While the Indian Rupee has seen sizable sideways movement in its value against the US$ in recent weeks, the Chinese Renminbi simply refuses to budge from its position despite China's announcement to impart greater flexibility to its exchange rate management.

Between June 19, 2010, the day when China surprised the world with its sudden announcement to end Yuan's dollar peg and August 6, 2010, the Indian Rupee first depreciated against US$ by 2.6 per cent and then appreciated by as much as 2.8 per cent. While the Rupee has been gyrating all this while, the Chinese Yuan has been sitting tight moving up by just 0.9 percent against the US$ during this period.

It is in this context that **FICCI's recent quick survey** of leading economists on the theme **'Yuan Exchange Rate Flexibility'** becomes important. The survey, which sought views of economists on this topical macroeconomic issue and which is now resonating geo-political overtones, has thrown up some interesting findings.

First point to note is that economists from India do not view this latest announcement by People's Bank of China as one carrying merit. The majority view is that China's announcement to return to the pre-crisis arrangement of managing its currency is merely a token of 'intent' rather than a firm commitment to strong action on the exchange rate front. Economists have pointed out that to have a more meaningful rebalancing of the global economy, China should first allow a one off appreciation of at least 8 to 10 per cent and then follow it up with a floating currency regime.

The second point relates to the motivation behind China's decision on Yuan flexibility. According to the polled economists, China has made this move to invigorate domestic demand as well as deflect some criticism it has been facing from the international community for doing little to support global economic recovery.

Domestically, a stronger exchange rate would serve two purposes. *One*, it would help in transforming the growth structure from being export led to domestic consumption driven as imports would become cheaper. *Two*, it would help tackle the inflation situation, which is increasingly becoming a cause for concern.

Additionally, by allowing its currency to be a little flexible, China has managed, albeit temporarily, to douse trade tensions with the US and EU as well, according to economists.

China's decision can thus be described as a marriage of convenience with both domestic and external compulsions being addressed to an extent through this move.

In the context China's decision to impart greater flexibility to its exchange rate, one may recall that in the past China has expressed a desire to broaden the global reserve / vehicle currency pool. And in the process it proposed the use of Renminbi alongside other reserve currencies like the US$ and the Euro for settlement of international trade. Given this background, FICCI also asked the economists about their views on Yuan being an additional reserve currency.

Feedback received from participating economists shows that the process for making Renminbi a global reserve currency cannot be immediate and will need a lot of effort and time. We may have to wait for at least a decade before Renminbi becomes a global reserve currency. Chinese government will have to make a number of structural changes before Renminbi can be considered for entry into the elite league of global reserve currencies. According to the surveyed economists, for making the Renminbi eligible for the global currency status authorities in China will have to take the following steps.

- Pursue inclusion of Yuan in the SDR basket
- Establish direct currency exchange mechanism and settle trade in Yuan with different countries, especially its close trade allies
- Improve the depth of its bond markets
- Make Yuan a convertible currency on the capital account
- Ensure domestic trade and investment practices are at par with those of the advanced economies of the world
- Strengthen the financial sector

Finally, FICCI asked the participating economists on what macroeconomic impact would a change in the value of Yuan have on India. The surveyed economists pointed out that in the next one to two years, they see the Yuan appreciating against the US$. In fact there is a consensus that over the next twelve months the Yuan might move up (appreciate) by about 5 per cent. There is feeling among economists that benefits will accrue over a longer period of time to developing economies, including India, as they will be able to garner a proportionately higher share of the gains resulting from global recovery in trade.

Further, in case of India, the Renminbi appreciation will be of particular significance as it could help correct, at least partially, the growing trade deficit with China. Indian manufacturing units in the heavy engineering and power segments will also become more competitive vis-à-vis imports from China if Renminbi were to appreciate as expected. Economists have also pointed out that an appreciating Chinese currency will also give a boost to Indian investments in China and possibly open up new markets for service sector exports.

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