

Chinese (Ex) Chequers

As the storm abates after the financial hurricane, most countries badly affected by the recession are in a reflective mode. The reasons attributed to the crisis are manifold: greed, profligacy, lax supervision and creation of global imbalances. The last factor has however generated the maximum global political and economic heat; with US (and other deficit nations) viewing an artificially undervalued yuan by Chinese authorities as the root cause of their economic misery. On the other hand, China feels it is wrongly being targeted for its superlative economic performance and that it alone should not be unfairly asked to shoulder the responsibility of removal of global imbalances.

China is accused of following a deliberate policy of pegging its yuan (or renminbi) to the dollar along with subsidising its export sector. This protectionist policy makes its exports highly cost effective which serves to boost its own exports while threatening other countries' domestic and exportable sectors. This explains why today the Chinese goods account for one-third of the world's surplus. This burgeoning foreign exchange balances by China is invested in sovereign US securities on account of the fact that the dollar is viewed as a safe haven. Thus Chinese manufacturing excellence is used to finance the huge current account deficits of the US. The large surpluses on the current account make monetary management for the Chinese authority in a fixed exchange rate regime more difficult as the latter attempt to sterilise the impact of increased money supply to prevent inflation or creation of asset bubbles. At the same time, the huge holdings of dollar securities by the Chinese gives rise to what Paul Krugman famously called the Chinese dollar trap: Further investments in US holdings raises the spectre of default by a weak US economy; on the other hand drawing down of such large scale US holdings will cause the value of its assets to crash.

Differences abound in the extent to which the Chinese yuan is underestimated. While some analysts put the figure at a 40% undervaluation vis-à-vis the dollar by following the Current Account Deficit Method, there are some others who believe that the

undervaluation is not more than 12% by following the Purchasing Power Parity Method. Moreover, studies have estimated that Chinese revaluation of the yuan from its current fixed level of 6.32 yuan per dollar will not reduce the US deficit considerably. After all, US has an equally important role in reigning in its huge expenditure (both domestic expenditure and imports). With shifts in geo-political power, China is seeking to assert itself more on the world platform through amassing huge foreign exchange balances by becoming the factory for the world.

At the same time, it is equally true that keeping its exchange rate at a low rate is harming its competitors in Asia namely India and the South East Asian countries. Hence, China must be persuaded to maintain the level of yuan at more realistic (read market related levels). The impact of a sudden revaluation will be difficult to bear for its export sector, a gradual revaluation increases the possibility of speculative attacks on the currency. A calibrated measure is perhaps what is required. It is suggested that while the US consumer should rein in its excess spending, the Chinese should be encouraged to spend more. There have also been suggestions of putting its vast foreign exchange balances to better use, utilise the reserves to build a social security net for its people. This move will not generate global imbalances and the associated recycling of funds between China and US. Creation of regional reserve arrangements should help to end the hegemony of the dollar which is no longer the strongest currency by virtue of its intrinsic value.

Apart from negotiations with China to adopt less 'beggar thy neighbour' policies, India should gear up to outshine the Chinese at their quest for economic dominance. Access to cheap and timely credit, setting up of Special Economic Zones, creation of quality hubs are some measures that are urgently needed to boost our export sector. Interestingly, a lion's share of our exports is provided by the SME sector. We have already examined the issues and challenges facing our SMEs some issues back. In this edition, we will delve into role of CMAs in the growth of SME sector.