MGMT S-5650
International Business

Case Study Review

# CHINA'S MANAGED FLOAT

## 20July 2011

# Case Overview

- 1994 – Value of Yuan pegged to USD ($1=CNY 8.28)
- By early 2005 pressure to alter its exchange rate policy, due to
  - American manufacturers decreasing competitive power
  - Job losses
  - Increasing trade deficit (US$ 160 billion in 2004)
- Attempt to impose a 27.5% tariff on imports from Senators Charles Schumer and Lindsay Graham if China does not agree to revalue its currency against USD
- Chinese surplus – purchase of USD to maintain the exchange rate
- Chinese abandon the peg – link to a basket of currencies
- Gradual revaluation of Yuan
- U.S. Trade deficit hitting a new record in 2005 – another try to impose tariffs, however Chinese managed to convince by moving progressively towards a more flexible EX policy

# Question 1
Why do you think the Chinese government originally pegged the value of the Yuan against the U.S. dollar? What were the benefits of doing this for China? What were the costs?

**Benefits**

- Trade and investment increase (limited speculation and uncertainty avoidance)
- Easy trade with less develop nations
- Structured well to make products for export
- Rising standards of living and overall economic growth
- Reduce likelihood of currency crisis
- Surplus of dollar helps finance annual deficits and overall debts
- Pushes down interest rates

**Problems / Issues**

- Maintaining fixed exchange rate required large amounts of reserves
- Buying dollars when going down relative to other currencies (Euro, Yen)
- Importing Inflation
- Increase in monetary supply
- Prevents government from using fiscal or domestic monetary policy for economy stability
- Trade deficit, import power increases
- Risk of currency devaluation( eg. Thailand)
- Stuck at bottom of value chain, manufacturing department

Question 2
Over the last decade, many foreign firms have invested in China and used their Chinese factories to produce goods for export. If the Yuan is allowed to float freely against the U.S. dollar on the foreign exchange markets and appreciates in value, how might this affect the fortunes of those enterprises?

- Companies will need to pay the workers more
- Raw Materials In + Chinese Labor = Exports *** Production Cost increases
- Profits will decrease
- Exports Slowdown
- Become unattractive to investors vs. other low-cost labor markets
- Competitive advantage

## Q3. How might a decision to let the Yuan float freely affect future foreign direct investment flows into China?
## Q4. Under what circumstances might a decision to let the Yuan float freely destabilize the Chinese economy? What might be the global implications of this be?

- Loss of competitiveness, therefore
  - Threat to key industries
  - Higher import (raw materials) prices
  - Higher costs
  - Drop in Revenues
  - Less FDI / Portfolio investments
- Limited exports, therefore
  - Current account balance
  - Unemployment
  - Social issues
- Decreasing Purchasing Power
- FX reserves (China, the largest creditor of the US with $1.15 trillion in long-term US Treasury securities)
- Foreign Reserves in USD vs Euro

## Question 5
*Do you think the U.S. government should push the Chinese to let the yuan float freely? Why?*

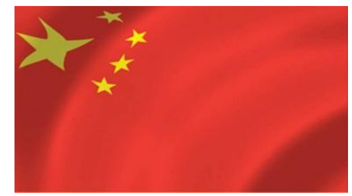
- Not push, rather explain benefits to China:
  - Decrease price of imports
  - Increase purchasing power of consumer (which may stave off political instability)
  - A more valuable yuan would shift growth and make it more consumption-driven
  - A stronger currency could decrease inflationary pressures which are now being seen in several Chinese markets

## Question 6
*What do you think the Chinese government should do? Let the yuan float, maintain the peg, or change the peg in some way?*

- Controlled incremental appreciation seen as a smart way to go:
  - Let exporters adjust by not suddenly making their goods internationally uncompetitive
  - Maintain stability in the marketplace
  - A rising currency would reduce the need to continually increase holding of USD, which in itself can be risky due to insecurity regarding American economy
- Note that a strengthened yuan would make the large Chinese holding of USD less valuable domestically

## Situation Update

VS



- Treasury Secretary Timothy Geithner: “the most important problem to solve in the international monetary system today.”

Chinese President Hu Jintao: "China and the United States should respect each other's core interests and major concerns," …”country's monetary policy won't be swayed by "external pressure."

# Market Data


1 USD = 6.4664 CNY +0.00540 (0.084%)
Jul 18, 5:00AM GMT+00:00
Compare: Enter currency Add
USDGBP USDJPY USDEUR USDCHF USDAUD USDCAD
Zoom: 1m 3m 6m YTD 1y 5y 10y All
Jul 21, 2006 - Jul 15, 2011
USDCNY -19.19% USDEUR -10.36%
5%
0%
-5%
-10%
-15%
-20%
-25%
2007
2008
2009
2010
2005
2006
2011

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# Questions?