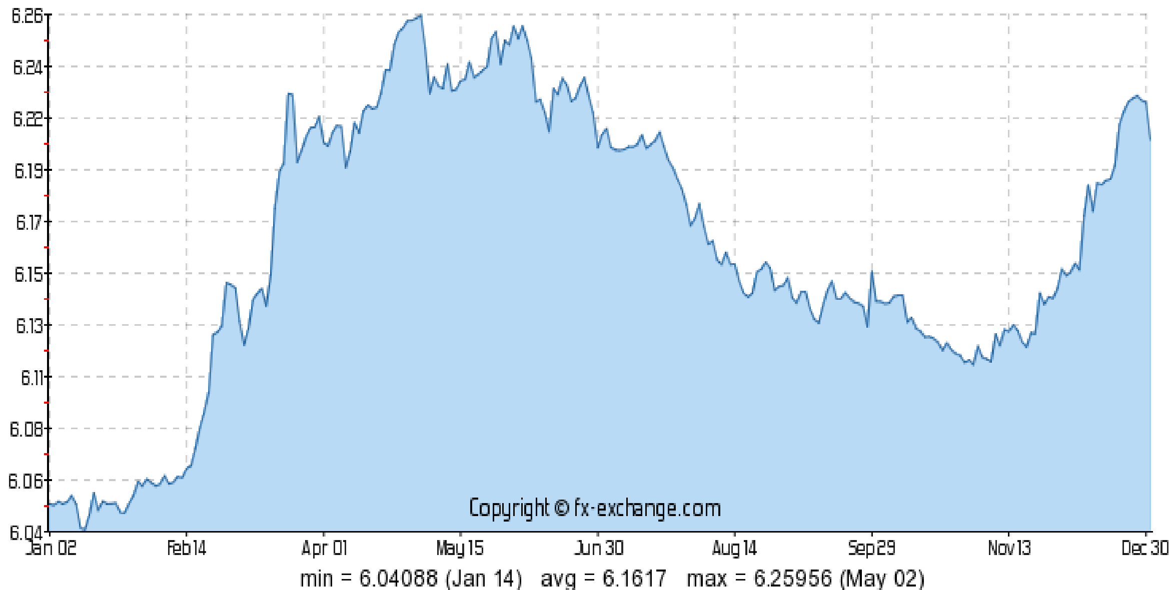
## Foreign Exchange & Balance of Payment

**Figure 1: US Dollar to Chinese Renminbi Yuan (CNY) in 2014**




Source: *fx Currency Exchange*

**Extract 1: Yuan depreciation poses risk to Chinese economy**

A weaker yuan was once one of the magic pills for China's economic boom. It was considered such an effective stimulus to Chinese exports. Some still argue that the Yuan, after years of appreciation, is still undervalued. The central bank, People's Bank of China (PBOC) initiated its campaign to tighten liquidity and raise interest rates last year, hot money flowed into China, which built up the market's one-way yuan appreciation sentiment. By sending the speculators a message that the yuan can depreciate, as well as the recent lowering of short-term interest rates, PBOC has tried to stem the inflow of hot money.

Adapted from *Globalrisk Insights*, 6 March 2014

**Extract 2: US warns China after Yuan depreciation**

The US has warned Beijing not to go back to manipulating its currency, following a sharp depreciation of the Yuan since the start of 2014. The US comments highlight concern in Washington that China will be tempted to respond to a slowing economy by holding down its currency in order to boost exports. Such moves could lead China to reduce global demand at a time when several other regions of the world, such as the eurozone, are weak. That in turn could hamper US growth. The Obama administration thinks that moving away from exports, via a more fairly valued currency, is in China's own interests and has generally sought to avoid pushing too hard. "To secure its own long-term growth and contribute more to global growth, China needs to shift to a growth model that relies more on consumption and less on investment and exports," said the Treasury official.

Adapted from *Financial Times*, 8 April 2014

**Extract 3: Why countries wage currency war**
The U.S. dollar has been on a tear this year, rising against the currencies of virtually all major developed economies. What we're seeing around the world is intense -- and in some cases, deliberate -- devaluations. One reason for the devaluations is that, when economic growth is weak -- as it has been globally for five years -- governments feel tremendous pressure to increase exports and reduce imports to restore growth.

The European Central Bank, for example, wants to depress the euro to keep deflation at bay. The euro's earlier strength drove down import prices, forcing domestic producers who compete with imports to slash their prices. As a result, consumer price inflation moved steadily toward zero. It was a mere 0.4 percent in October versus a year earlier. The euro-zone economy remains stagnant, with a third recession since 2007 a possibility. Unemployment is high. Youth unemployment tops 25 percent in many countries; it exceeds 50 percent in Spain and Greece. Meanwhile, consumer sentiment, which never recovered from the last recession, is again dropping.

On the other side of the globe, Japanese Prime Minister Shinzo Abe is curbing deflation and reviving the economy. The use of monetary easing and yen-cheapening is to spur exports, retard imports and reverse the growing foreign-trade deficit. Fiscal stimulus, is difficult to carry off in view of Japan's already high government deficit and debt. Still, the Abe government is discussing some less-disruptive structural reforms that could raise Japan's growth potential. A cut in the top corporate tax rate to below 30 percent from above 35 percent, in line with the 29 percent average among developed nations, is one possibility. Also under consideration are "special economic zones" that would give companies the freedom to cut the red tape that constrains everything from hiring and firing to land ownership and management.

Adapted from *The Bloomberg,* 23rd November 2014

**Extract 4: China is preparing for a currency war**
The idea that central banks in China, Japan, the US and the eurozone have deliberately attempted to devalue their currencies to improve competitiveness has since taken hold. Many others, however, insist currency wars remain very much alive and thriving, to the detriment of investors and savers in emerging and developed markets. Investors are bracing for further surprising, unwanted monetary policy shifts in the belief that volatile markets since the start of the year are likely to encourage central bankers to employ protectionist tactics.

Some are sceptical about whether the ceasefire will last. David Riley, head of credit strategy at BlueBay Asset Management, the London-based hedge fund company, says: "Markets have decided that, by accident or design, there is a ceasefire in the global currency war. Currency wars leads to "protectionism and trade barriers which will be detrimental to global trade and economic activity", says Abi Oladimeji, head of investment at Thomas Miller Investment, the London-based wealth manager. "This in turn will undermine investor confidence and result in higher volatility. "So long as the global economy stays gloom, the temptation to adopt 'beggar-thy-neighbour' policies will persist."

Adapted from *The Financial Times*, 3rd April 2016

**Questions**

(a)(i) From Figure 1, describe the change in the external value of Chinese Yuan in 2014. [1]

(ii) With the help of a diagram, explain a possible reason for the change in the external value of Chinese Yuan. [3]

(b) Explain how People's Bank of China tried to stem the inflow of hot money. [2]

(c) In view of the problems faced by different economies, assess whether, on balance, currency war can ever be justified. [10]

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## Suggested Answers

**(a)(i) From Figure 1, describe the change in the external value of Chinese Yuan in 2014. [1]**

The external value of Chines Yuan has fallen or depreciated in 2014

**(a)(ii) Explain a possible reason for the change in the external value of Chinese Yuan. [2]**

As stated in Extract 2, slowing EU and US economy leads to decrease in demand for China export and this would that there is lower demand for Yuan. Consequently, the exchange rate of Yuan depreciates

**(b) How can People's Bank of China stem the inflow of hot money. [2]**

The inflow of hot money from other countries can be curbed by raisng interest in China by the central bank. This fall in interest rate would mean a fall in hot money as the return on saving for the foreigner or foreign firms is lower.

**(c) In view of the problems faced by different economies, assess whether, on balance, currency war can ever be justified. [10]**

**As currency will affect the trading price of import and exports, it is often used by government to raise their export demand to raise national income.**

1. **Currency war is justifiable**
   **1.1 Increases real GDP to promote economic growth**

- Devaluation → Enhances Economic Growth, employment, deflation
- Use AD/AS explain how it can achieve the different macroeconomic goal
- Extract 4: US, EU & Japan trying to revive their current growth
- By depreciating, the price of export goods will be cheaper the importing nation and increase the production for the exporting nation as the all in external value of currency makes price of exports relatively cheaper in terms of foreign currency and price of imports relatively more expensive in terms of domestic currency. Given that price elasticity of demand for exports is usually elastic due to availability of substitutes from international trade, Marshall Lerner's condition is satisfied, there is an increase in net export which increases in AD and real GDP, achieving actual economic growth.

   **1.2 To solve youth unemployment with higher level of production**

- Extract 4: Unemployment is high. Youth unemployment tops 25 percent in many countries; it exceeds 50 percent in Spain and Greece.
- By increasing export, the economy raises Increase in output and there will be an Increase in demand for labour. Since these production are for mass production, there will be labour intensive economies and increases employment, solving youth unemployment

2. **Why currency war is not justifiable**
   **2.1 Persistent devaluation of currency will make it ineffective as interest rate has to be increased that leads to more capital inflow, rendering the effort on depreciation ineffective**

- Extract 5: Currency wars remain very much alive and thriving, to the detriment of investors and savers in emerging and developed markets. There may be rise in interest rate to curb inflation and the volatile markets are likely to encourage central bankers to employ protectionist tactics.
- Devaluation of money would lead to inflation which would reduce the real interest rates from savings discouraging savers. The decrease in money supply available for loanable fund would increase interest rate eventually increasing the cost of borrowing, decreasing investments and consumption of big ticket items. The rise in interest rate would dampen the impact of devaluation strategy.

**2.2 The act devaluation will create adverse impact of the trading partners**

- Extract 5: This in turn will undermine investor confidence and result in higher volatility. “So long as the global economy stays gloom, the temptation to adopt ‘beggar-thy-neighbour’ policies will persist.” This implies that the trading partners continues to import and loses the production capacity in the economy which leads to unemployment and slow growth.
- The persistent devaluation of currency will eventually lead to undervaluation of currencies across economies. In the long run, a persistent trade deficit from trading partners due to currency war would is not sustainable and would eventually lead to a fall in net export and experience a slowdown in actual economic growth via the decrease in AD.

Conclusion

In conclusion, this strategy is only suitable for export dependent to increase export competitiveness to drive economic growth, employment or even the reduction of deflation. However, the justification is only for devaluation and in the short run. In the long run, persistent devaluation across economies lead to a currency war which would eventually offset the benefits of the devaluation, therefore not justifiable.

Lastly, whether the justification of currency war is justifiable depend on the key problem the economy is facing. For countries that depend on trade, it has no alternative solution but to adopt this strategy.