

Date: 19 October 2007

Subject: H2 Economics

Topic: Market Failure

Question Source: Compilation of Selected 2007 Prelims Questions

*The undervalued yuan is one important cause of China's rising inflation and huge trade surplus with America. Many foreign economists argue that the government should revalue the yuan's peg, widen its trading band or shift from a dollar peg to a basket of currencies. - Asia Times 7 July 2002*

*Discuss whether 'the undervalued yuan' is the only cause to 'China's rising inflation and huge trade surplus with America'*

China's currency, the yuan, has been pegged to the US Dollar at USD1 = 1 Yuan until 2005 and deemed as 'undervalued' as the large volume of goods exported by China warrants a higher value of yuan, which would be reached if not for the fixed exchange regime that the Chinese government has instituted. Having an undervalued currency encourages demand for Chinese exports to rise and causes imported inflation for China as it experiences high cost of imports from its trading partners. The high demand for Chinese goods because of its low price has been blamed as being responsible for China's huge trade surplus.

To begin, the rising inflation in China, a country which typically has inflation well under control is caused only partly by the 'undervalued yuan'; it is also caused by the rapid growth they experienced in recent times that have created bottlenecks in the economy and raised the wages. 'Undervalued yuan' serves to fuel the inflation by raising the (X-M) component of the aggregate demand coupled with rising domestic consumption due to expanding middle class. The result is a demand-pull inflation as illustrated.

[AD-AS diagram showing AD shift and AS constant, causing demand-pull inflation]

As observed from the diagram above, the rapid growth in national income illustrated is brought about by aggregate demand rises from the exporting sector as well as the domestic consumption. Since yuan doesn't appreciate (a feature of fixed exchange regime), the high demand for exports is not damped by rising prices in terms of foreign currency. This growth also causes rise in general price level due to the upward sloping aggregate supply in short run brought about by supply bottlenecks from the economy nearing full employment. At the same time, prices of imports remain high since the yuan value remains constant despite rise in national income.

The 'undervalued yuan' is also blamed for the mounting trade surplus China has with America since American consumers' high demand for cheap Chinese goods caused their imports to exceed exports with China and resulted in persistent trade deficits on the side of America. As China uses a fixed exchange rate regime, this balance of trade disequilibrium is not automatically corrected. The low value of yuan will continue to encourage America to import Chinese goods and incur a growing deficit. Nonetheless, the 'undervalued yuan' cannot be the only cause of this huge trade surplus; America's eroding comparative advantage in manufacturing and slow restructuring in their industries have led to weakening exports. Take for example, the American steel industry have been too reliant on protection to maintain their operations. These have contributed to the mounting trade deficit that it is currently experiencing. The American consumer's low saving rates also plays a part in their 'over-consumption' of imports.

Thus, while the 'undervalued yuan' do have a part to play in China's rising inflation and huge trade surplus with America, it can hardly be considered the sole cause of these problems.

*Comment on the implication of a revaluation of the yuan on Singapore's economy*

The Chinese yuan have long faced revaluation pressure with China's mounting trade surplus with America and developed countries' claims of China dumping cheap goods into their economies. Expectations of yuan's revaluation put further pressure for the value of the yuan to increase. As an increasingly dominant trading partner of Singapore, China's revaluation of yuan would have much impact on Singapore's economy depending on the degree of appreciation the yuan undergoes after revaluation, relative to the movements of the Singapore Dollar.

The revaluation, an increase in value of the Chinese yuan will impact on the Singapore economy through our imports from China, our exports to China, the two way tourism. These changes will in turn affect Singapore's balance of trade with China and our national income growth.

Revaluation of yuan, without a corresponding rise in the value of the Singapore dollar to offset the relative effect, would result in Singapore's exports to China appearing cheaper in terms of yuan to the Chinese. With the growing middle class in China and their rising national income, consumption is already rising in China. The rise in value of yuan, resulting in cheaper Singapore goods for the Chinese would definitely help increase the quantity demanded for our exports. From the theoretical perspective, Singapore's exports are largely price inelastic and thus the revaluation of yuan does not raise our export revenues.

On the other hand, Singapore imports a large variety of price inelastic goods from China as well, since we rely on many low value Chinese intermediate goods as inputs for our exporting sectors. At the same time, a large volume of our foodstuff is imported from China. As these are basic necessities, their demand is price inelastic, thus the revaluation of yuan, which makes our imports from China more expensive, would eventually raise our import expenditure from China. At the same time, because we also rely on Chinese inputs for production of our domestically consumed goods, revaluation of Chinese yuan would result in imported inflation as the prices of our goods rise to account for the rising cost of production due to increased cost of raw materials in terms of Singapore Dollars.

Finally, the revaluation of yuan which makes Singapore's goods cheaper in the perspective of the Chinese would increase the flow of tourist from China to Singapore. The combination of reduction in export revenue and import expenditure for Singapore with China would result in a growing trade deficit with China, which the increase tourist inflow into Singapore cannot possibly offset. As such, the revaluation of yuan has largely negative implications on Singapore. As China is one of Singapore's emerging exporting market and increasingly important trade partner, given Singapore's economy as one being driven by trade, the revaluation of yuan can affect our national income adversely.

Since the (X-M) takes up a third of our national income, falling net export revenue from China can reduce our rate of growth unless it is cushioned by rising export revenues with our other trading partners like the European Union. Fortunately, the Monetary Authority of Singapore pursues a policy of long term gradual appreciation of the Singapore Dollar. As long as the appreciation of Singapore Dollar is steadily ahead of the revalued yuan, the adverse impact of the revaluation on Singapore's economy would be extremely minimal and virtually non-existent. Keeping up with the appreciation of Singapore Dollar also maintains and increases our export expenditures since majority of our exports are price inelastic. The strong Singapore Dollar also keeps our imported inflation and maintains the low cost of our imports.

In general, the implications of a revaluation of yuan on the Singapore economy are largely negative but Singapore has the appropriate policy tools to manage these impacts and minimize the implications.