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China's Got Talent

China's future managers are in huge demand – and they know it

- Reacting to the Rising Renminbi
- E-vehicles in the China Market
- Executive Resilience
- Arnaud Vaissié, International SOS
- Singapore
- Wine and Spirits

Reacting to the Rising Renminbi

The renminbi's likely slow appreciation will allow international businesses in China time to adjust their activities accordingly

By Sophie Chen

DESPITE A LARGE TRADE surplus and international pressure, the appreciation of the renminbi continues at a sedate pace. Foreign investors will not need to make drastic changes in the near future as they adjust their operations in line with the latest developments.

A Time for Change?

Since July 2005, China has moved into a managed floating exchange rate regime based on market supply and demand with reference to a selection of currencies, but appreciation froze when the severe economic and financial crisis hit the global economy. With the impact of the crisis fading away, the Chinese government has become more controlling even though they face mounting pressure.

When the People's Bank of China announced their intention "to proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility" on 19 June this year, the announcement provoked further discussion on the renminbi's appreciation. These discussions have grown into a lively international debate.

"Due to pernicious unemployment and the mid-term election, politicians are becoming more vocal on this issue. Many European countries are instituting austerity measures to cut costs associated with unsustainable social security programmes, leaving many EU members wondering – sometimes in a public setting – why one of their major trading partners is not also doing their share to ensure a balanced global recovery," says Timothy Lamb, director of FDI Services at JLJ Group.

The renminbi's appreciation has become a global issue, but progress is nonetheless slow.

"The global economy has improved in general, especially in China. But the recovery is fragile and many countries are worried that if their currencies are overvalued, their prospects of a continued recovery will be worse. As a result this has become a global issue, rather than a bilateral issue between China and the United States. Currencies in many emerging markets have appreciated a lot against the US dollar, whereas the renminbi has 'only' appreciated three per cent," says Fredrik Hähnel, general manager of Skandinaviska Enskilda Banken AB (SEB) in Shanghai.

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China's large trade surplus is another contentious factor. "China's exports have surpassed pre-crisis peak and China's monthly trade surplus remains quite large. This makes China stand out while the United States still suffers from high unemployment rate. Also, it is in China's interest to allow the yuan to strengthen. The recent surge in international commodity prices posed a challenge for the Chinese government in keeping its inflation within the targetted range of three per cent," says Li-Gang Liu, head of China Economic Research, Global Markets, Australia and New Zealand Banking Group Limited (ANZ).

The huge trade surplus does suggest that the renminbi is undervalued, and the country's inflation has been on the rise. Nonetheless, taking into consideration economic and social stability, it is still very unlikely that the Chinese government will bow to international pressure to allow a single leap in appreciation in the very near future.

"Economic growth will pick up quickly. More investment in China is expected. In the next year, the exchange rate will probably rise around five per cent instead of a larger rise, like ten per cent, as the Chinese government has to take into concern social instability. A gradual appreciation would be more practical," says Liu.

"China's current exchange rate system prevents the renminbi from appreciating too fast, which would be bad for the domestic economy. On the other side, if the renminbi becomes more international, it would help to become independent from the US dollar in foreign trade," says Prof. Horst Loechel, director of the German Centre of Banking and Finance at China Europe International Business School and chairman of the Shanghai International Banking and Finance Institute.

A Quiet Reaction

"If the value of the renminbi was to rise dramatically, you would most likely see many of these firms begin to scramble to identify other emerging markets for their operations. Those working in sectors with very low margins would be particularly keen to go elsewhere," says Lamb.

However, until China takes more drastic action, foreign investors, which focus on export with thin margins, have little to react to, and they do not need to make sweeping changes. "A higher value for the renminbi means that the prices of goods and services produced in China will be higher on the world market. The likely outcome of an appreciation is therefore that foreign companies in the labour intensive export sector will look for other destinations. But it won't happen right now," says Prof. Loechel.

"The renminbi will appreciate slowly, so the immediate impact on the economy will be modest rather than significant. I expect local businesses, rather than foreign owned organisations, will bear the brunt of the impact," says Adrian Foster, head of Financial Markets Research, Asia-Pacific, Rabobank.

MNCs will still be able to leverage their advantages to continue to make the most of China's low costs, vast potential markets and high economic growth. "Foreign businesses tend to have better recognised brand names and sell on higher margins," says Foster.

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"MNCs can easily adjust with their more flexible strategies. Apart from keeping low labour intensive operations in China and increasing productivity to remain competitive due to the raising cost, they could also focus on producing high value and high technology products," says Liu.

Flexible MNCs could also change the direction of foreign investment, helping to optimise China's industrial structure, and to promote investments in the tertiary industry.

"With the increasing value of the remminbi, the economic structure of foreign direct investments in China will change too. Low value or labour intensive sectors will become less important. More capital intensive businesses with a higher focus on the domestic market will move to China, and production facilities for exports will decrease. I expect also more foreign companies in the technology and service sectors," says Prof. Loechel.

"The rise in value of the renminbi will help the economic structure to rebalance. Although China is doing well in the export sector, the service sector still needs to catch up. The appreciation will lead more foreign investments in the service sector and also increase the Chinese residents' purchasing power, which will stimulate domestic consumption," says Liu from ANZ.

The data from the Ministry of Commerce shows that foreign investment in China's service industry maintains substantial growth this year. There were 8,477 newly established foreign-invested enterprises in the service sector in the first eight months, up 22.32 per cent; the actual use of foreign investment was USD29.741bn, an increase of 36.75 per cent.

"China as a manufacturing base for the world will be challenged by other emerging markets. However, China's market size in itself will make companies develop the local market instead of focussing on export. That is already happening today. MNCs continue to invest in China and many do so to get an increased foothold in what many companies see as the most exciting market in the world right now," says Hähnel from SEB. SBR