

A stronger yuan will encourage UK trade

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24 Jan 2011, Phil Thornton, Financial Director

Follow the money, Deep Throat famously told journalists chasing the Watergate scandal. Four decades on and the money is clearly in China. Its economy looks set to post another year of red-hot growth in 2011: the World Bank is forecasting its GDP to rise 10 percent. Yet British companies export just three percent of their goods to China and an even lower share of services, particularly from the financial sector. Reasons range from cultural and language differences, regulatory barriers and sheer distance to a mismatch between what the UK produces and what China wants.

Add to that the long-standing bugbear of China's currency regime. The yuan, also known as the renminbi, has been pegged to the US dollar for most of its history and is now in a managed floating system that saw it appreciate 3.6 percent in 2010.

A weak currency makes imports more costly and exports cheaper, contributing to record trade surpluses in China and deficits in the West. The UK runs a £20bn-a-year deficit with China and the US record 2010 deficit of \$181bn (£113bn) will renew threats of protectionist measures that could spiral into a trade war.

Critics, such as Nobel laureate economist Paul Krugman, believe the yuan is still undervalued and have backed calls by the US Congress for a tariff of 25 percent on Chinese imports. But there is growing optimism that Beijing will allow its currency to appreciate in 2011 as part of a policy of fighting inflation and embarking on far-reaching financial reforms.

This offers potential benefits to UK businesses. A stronger yuan will make imports cheaper for Chinese consumers. This should encourage households to buy more imported goods and, potentially, more services. The most recent quarterly data shows that UK goods exports to China rose almost 20 percent in the nine months to September, which could be evidence that the UK is already benefitting. As incomes in China are also increasing, households are likely to demand more Western-style goods, which UK companies are well placed to supply.

“As Beijing tries to engineer a shift away from export-led growth to expansion built on consumer spending, consumer-facing firms - services in particular - should find more opportunities opening up,” says Mark Williams, senior China economist at Capital Economics.

Potential winners

Politicians, too, are following the money. In January, prime minister David Cameron ensured that Li Keqiang, the vice premier tipped to replace Wen Jiabao as China's prime minister, met every senior member of the government during a trip to the UK. Alex Salmond, Scottish first minister, highlighted wind and marine energy technology manufacturers as potential winners. “The economic opportunities for Scotland are enormous,” he said.

The Department for Business, Innovation and Skills says demand from Chinese consumers for high-tech products offers “huge potential”. Demographic and lifestyle changes “are likely to generate demand for more sophisticated medical devices and delivery of healthcare”, it said in a report. And a poll of UK companies by the British Chamber of Commerce in China recently found four in five expected higher demand for their products. One third said that demand would be “substantial”. China “offers real opportunities for investment in the year ahead”, says Guy Drury, the CBI's chief representative in China.

But while exports to China will become cheaper, the cost of Chinese imports will rise, which will add to the pressure UK businesses are already under from soaring commodity prices.

Jonathan Michael, managing director of JMCL Consulting, which advises clients on procurement, warns that importers will struggle to find alternative sources for a range of products and components they rely on from Chinese companies. “It's likely the UK will just have to absorb the inflationary impact of an appreciating yuan,” he says. “So much of our inputs are now Chinese, the potential impact on UK inflation is frightening.”

Michael advises companies to anticipate the appreciation by building its impact into business plans while working with suppliers to share the cost burden. One positive trend is the emergence of the yuan as an international currency traded through Hong Kong. In January, the World Bank issued its first yuan-denominated bond, raising ¥500m (\$76m; £49m), following a lead set by McDonald's and Caterpillar. China has also expanded its cross-border trade settlement pilot scheme to allow transactions from anywhere in the world to be settled in yuan.

Crucially, corporates with operations in China can increase bottom-line profits by adopting the yuan as their currency of choice when settling transactions. Lee Swee Siong, head of global corporate products at Standard Chartered, says the benefits of denominating trade in yuan - higher sales, keener pricing and greater ability to hedge exposure - are compelling, and he adds that finance directors can now consolidate currency exposure and hedge their net position in the foreign exchange market in Hong Kong. "FDs can obtain better rates of conversion for their renminbi obligations, allowing them to re-negotiate terms with trading partners," he tells *Financial Director*.

This may take the form of increased prices, which Chinese buyers may accept as they no longer have to face foreign exchange risk, or more competitive pricing due to the lower cost of goods. "Either way, this can have a direct impact on the bottom line of the organisation," says Lee.

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