UNSTABLE CURRENCIES IN ASIA AND EUROPE

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Emerging Markets : When Will China Devalue the Yuan?

China has been under serious deflationary pressures during the past several quarters. China's retail price index fell 3.5% from January to March this year. Deepening deflation and worries of a declining trade surplus in China are heightening concerns about a currency devaluation at the year-end. Chinese authorities have not yet released their official balance-of-payments figures for 1998, but available figures suggest that many foreign investors are raising questions about the reliability of those numbers.

Although China has reported a $50 billion trade surplus and $45 billion FDI inflow, China's foreign reserves gained by just $5 billion. Chinese authorities make an excuse for this puzzle, saying that exporters' receivables have not been settled yet. Many observers speculate, however, that exporters, worrying over devaluation of the yuan, are not bringing their revenues to China. Furthermore, more than half of the funds reported as FDI are offshore borrowings of Hong Kong subsidiaries of a few mainland Chinese firms.

Some experts argue that devaluation of the yuan would bring about a considerable loss due to the hike in imported raw material prices; however, according to the OECD, a 20% devaluation of the Chinese currency may increase current account surplus by around $12 billion. Still, the Chinese government insists that its will to defend the yuan's value for the Asian market stability is firm. Currently, foreign companies in China are trying to hedge their positions with the concern of yuan devaluation. Major institutional investors, too, are taking devaluation into consideration when they calculate the investment yields from China.

Chinese authorities will not readily devalue the yuan because of political concerns in addition to the economic concerns surrounding the currency devaluation. At the end of 1999, though, devaluation is likely to take place when pressures on balance of payments are strengthened and the Asian economies, including Korea and Thailand, demonstrate a clear sign of recovery. If China's banking authorities should continuously fight against the growing deflation, and if the current account remains as weak as many analysts have forecast, there is no policy option but to change the currency regime.

Clashing arguments exist with regard to the actual devaluation of the yuan, but Korean companies should be prepared for the devaulation, as many of them are trading considerably with China. According to trade experts, a 10% devaluation of the yuan would decrease Korean exports to China by 4-5% and to the rest of the world by 1.5%, taking away $2.5 billion out of the total volume of Korean exports. What is more alarming than the yuan devaluation's direct impact on exports is a possible concurrent devaluation by the Southeast Asian countries of their currencies, in an attempt to maintain their export competitiveness. As a result of this turmoil scenario, the regional trade volume may well shrink and detain the economic integration between China and Hong Kong. In addition, Korean firms engaged in business with the Chinese counterparts have a tendency to keep the Chinese yuan, rather than to convert it into other hard currencies, as the yuan has been so far pegged to the U.S. dollar. Yet in case of devaluation, there will be

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a significant amount of losses, unless the Korean companies prepare appropriate hedging schemes within the next several weeks.

EMU: Obscure Future?

Recently, the next Bundesbank President Ernst Welteke and the new EU Commissioner Romano Prodi expressed their worries over the instability of the EMU system. When the euro was first introduced, European leaders were quite confident of euro's success, especially in its value against the U.S. dollar. On January 4, 1999, the exchange rate of dollar/euro was $1.1877/euro, but six months later it dropped 10% to $1.03/euro. Some even suspect that it will plunge down to $1/euro in the near future, the reason being that some EMU countries have not observed the so-called convergence criteria. For example, Italy has requested for loosening the fiscal deficit criteria from 2% to 2.5% of GDP. All in all, the value of the integrated currency kept falling on account of the discrepancy among the member countries in inflation, unemployment rate and level of fiscal deficit.

Korean firms are faced with problems arising from euro's weakness, similar to those stemming from the yuan devaluation. Many Korean corporations trading with the European counterparts are making transactions in the local currencies, namely the Deutsch mark and French franc. However, the exchange rates of those currencies and the euro are fixed; when the value of euro falls, then the export profitability of the Eurozone tumbles down. By keeping the financial assets, including bills receivable, in local currencies, foreign currency losses can occur. Korean companies need to ready themselves for hedging problems of a $1/euro exchange rate. VIP