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How will a stronger Chinese yuan affect luxury?

October 2, 2020

As the yuan propels China toward a Golden Age, what a rising yuan will mean for Western luxury brands and consumers in China? Image credit: Shutterstock

By Adina-Laura Achim

In the 1960s, France's then minister of finance, Valry Giscard d'Estaing, said that the U.S. dollar gave America an "exorbitant privilege." Unfortunately, the Golden Age of U.S. currency is nearing an end. These days, analysts discuss "the new era of weakness" for American currency.

Yet, it is worth noting how as the world focused on the depreciation of the dollar and the rise of the euro, which was "becoming the go-to currency for safety and liquidity," the Chinese yuan has steadily gained in notoriety and power.

Set to become the world's third-largest reserve currency by 2030, according to Morgan Stanley analysts, the RMB has strengthened its position against the U.S. dollar. CNBC highlights how both the onshore and offshore Chinese yuan recorded "a dramatic strengthening" last week, from levels above 6.8 against the U.S. dollar.

"We've recently firmed up in particular, our Chinese renminbi forecast from 6.7 to 6.5 on a 12-month view," said Timothy Moe, the co-head of Asia macro research and chief Asia-Pacific equity strategist at Goldman Sachs on CNBC's "Squawk Box Asia."

As the yuan propels China toward its own Golden Age of "exorbitant privilege," one has to wonder: What will a rising yuan mean for global luxury brands and consumers in China?

Impact on luxury consumption

Oversimplified, a stronger national currency means consumers have greater purchasing power, so it is expected that traditional shopping habits will be modified, and consumers will spend more.

According to "The Wealth Effect," individuals spend more when they have higher disposable income, or when their portfolio value rises.

Consequently, if consumers see their currency gets them Western goods more cheaply than before, they will buy more.

This scenario leaves Western brands with two options: either keep prices at current levels and sell more products or hike prices to reclaim exclusivity.

Let us not forget that luxury brands perpetuate an aura of exclusivity through the right pricing model.

As such, these brands need to remain "inaccessible" for the masses. Even in this confusing age, when luxury is forfeiting its heritage and exceptionalism, if everyone can afford Louis Vuitton bags, the affluent class will shy away from the French brand.

Consequently, luxury brands will hike their prices, trying to reinstate exclusivity. They have even done this in the recent past.

In the summer of 2014, when the U.K. pound hit a five-year high against the euro and the dollar, luxury brands hiked their prices to protect their brands and margins.

In China, luxury brands can justify their price-hike strategy with the excuse of currency volatility. They can point toward various moments and precedents when Beijing has devalued its currency to increase the competitiveness of China's exports and gain an edge in global trade.

Considering the tense situation with the United States and the ongoing trade war, it is likely that China might attempt this strategy again. From the perspective of a luxury brand, this shows that the RMB is not a stable currency.

As such, luxury labels need to protect themselves from currency volatility and foreign exchange risks.

The impact on Chinese luxury labels

Chow Tai Fook, Shang Xia, Shanghai Tang, Moutai and Kweichow are homegrown success stories. But the majority of Western consumers have low awareness of China's own luxury labels.

With weak brand names, most Chinese luxury labels fail in the Western market. But a rising yuan brings even further disadvantages for these labels because exports appear more expensive and less competitive.

In other words, the number of exports will decrease, bringing a decline in business cycles.

Eventually, manufacturing jobs will be lost, and the government will have to subsidize the domestic luxury sector or encourage domestic demand through targeted policies that could penalize Western luxury brands, such as new tariffs and taxes.

Surge in shopping-centric trips to Western fashion capitals

Since the RMB will get them a little further than in the past, Chinese travelers will go on more overseas shopping-centric trips, and they will increase their spending during their vacations.

This new, elevated experience means room upgrades and perks from flying business class, as well as more shopping sprees at designer stores in Europe or the U.S. In other words, luxury stores will see a surge in Chinese buyers.

We foresee that Chinese travelers will purchase more luxury goods in traditional luxury markets because they'll benefit from favorable conversion rates.

In return, top luxury labels will capitalize on this trend and spike their prices for accessories and entry-level items to keep up with the growing demand.

This pricing strategy will discipline the market and penalize Western consumers who are already suffering under their current economic situation.

Since luxury labels will become even more expensive for Western buyers, they will experience a consumption downgrade, moving from luxury to premium brands or even lower, more affordable options.

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