



Chinese devaluation - why now?

Last Tuesday, The People's Bank of China (PBoC) shook global markets from their relative slumber with a sudden and unexpected devaluation of the Chinese Yuan. The move initially knocked the currency 2% weaker against the US dollar and there were further falls next day as the market got in on the act helping to drive the exchange rate down to a 4-year low. After a few days of confusion, the currency settled around RMB 6.40 against the dollar thanks to intervention by the PBoC who initially appeared surprised by the market's negative reaction.

However, in the absence of any clear communication, the knee-jerk reaction was understandable because if the devaluation was going to be first of a determined effort to force the currency lower still, then it would have had serious consequences globally. But why is China doing this now? In our view, the move primarily reflects an ambition to achieve reserve currency status for the Yuan and we would view that as a positive development.

Inclusion in the International Monetary Fund (IMF) basket alongside the US dollar, Yen, Euro and Sterling

would be a major development and an internationalisation of a currency considered to be an emerging market. In trading volumes, the Yuan has overtaken the Australian and Canadian dollars in terms of trade payments and looks set to overtake the Japanese Yen, which is already in the basket. The IMF will be making their decision, as they do every 5 years, later in December and, the way things stand, the decision to admit the Yuan is hanging in the balance. On the one hand, Christine Lagarde, head of the IMF, is down on record saying that inclusion is more a question of “when, not if”. On the other hand, the IMF have just announced that a delay in the review of Yuan inclusion, and this may have been what forced the PBoC to act.

One possible obstacle to inclusion at the top table could still be that the currency is not free floating. Up until 2005, the currency was pegged to the US dollar but, since then, the exchange rate has been controlled under a managed float – but it is not what the IMF consider fully convertible.

However, the Chinese State Council has committed to widening the bands within which the Yuan trades and re-fixing, as they did last week, may be an expression of the will to allowing the exchange rate to be more market driven as it would be consistent with an economy that is slowing and where exports are falling but where, on a real effective exchange rate basis, the Yuan had strengthened 3% this year – dragged up by the stronger US dollar. The IMF might be inclined to view this favourably and that may help if they are also considering bending the rules to allow Yuan inclusion, subject to a majority vote.

In that context, whilst it is true that a 3% move in a few days is the biggest since the mid-1990's, the Chinese authorities are keen to convince us that this is only a one-off adjustment to put right short term imbalances. We should also remember that the Yuan is about 14% stronger against the US dollar than it was last summer because it is this unwelcome strength that has made Chinese exports less competitive.

Of course, weakening the Yuan significantly from here would be helpful if all the Chinese authorities were worried about was exports. But it wouldn't be the panacea for getting the whole economy growing again. Furthermore, a currency war consisting of competitive devaluations around the Asia Pacific region would be bad for everyone and may not achieve much as a result. This would be quite an uncomfortable development because it would ultimately export deflation to the USA through cheaper goods, which would imply lower interest rates (the 2-year US Treasury yield fell from 0.69% to 0.65% on the news) and, therefore, a weaker US dollar (the global US dollar index fell 1% from recent highs).

Finally, if we are right in believing that China's main objective is to get the Yuan IMF accredited as a reserve currency, material depreciation would not be helpful to the cause.

In conclusion, we do not believe that the Chinese authorities have suddenly decided to tackle falling exports by pursuing a significant weakening their own currency. The move, we believe, is part of a much wider trend of financial deregulation and reflects an ambition for IMF inclusion in the basket of reserve currencies. TAM client portfolios have

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