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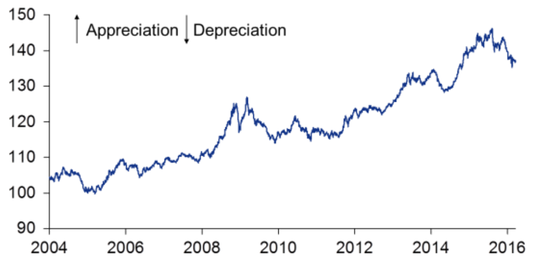
Gradual **yuan** depreciation is not bad news

One of the main headaches that has been plaguing financial markets in recent months is the possibility of further devaluation of the Chinese yuan. It would make Chinese exports even more competitive and is therefore seen as a risk that reinforces deflationary pressures on world markets. The recent devaluation however does not compensate the significant appreciation of the Chinese currency during many years before. Since the gradual relaxation of the exchange rate peg with the US dollar in the summer of 2005, the Chinese currency soared by 37% until early 2014. Over the same period, it shot up by almost 29% against a trade-weighted basket of important trading currencies. During this spell, whopping current account surpluses, large capital inflows from abroad and frequent interventions by the Chinese central bank to keep a lid on any further appreciation led to a massive increase in foreign reserves to almost USD 4,000bn (mid-2005: USD 711bn).

It is only over the past two years that the upward pressure on the yuan has subsided and given way to a devaluation. Fears of a marked slowdown in the Chinese economy and the lack of transparency and poor communication of exchange rate policy by the central bank have prompted hefty capital outflows by residents and foreigners alike. The Chinese central bank is now selling reserves – mainly dollars – to curb the slide in the yuan. Since the August 2015 decision by the People's Bank of China (PBoC) to give market forces more influence on the exchange rate, the yuan has tumbled about 5% against the US dollar and in trade-weighted terms. The devaluation would certainly have been steeper still had the central bank not chucked loads of dollars onto the market. In 2015 alone, currency reserves plunged by more than USD 500bn.

Nominal effective exchange rate (index, 2005=100)



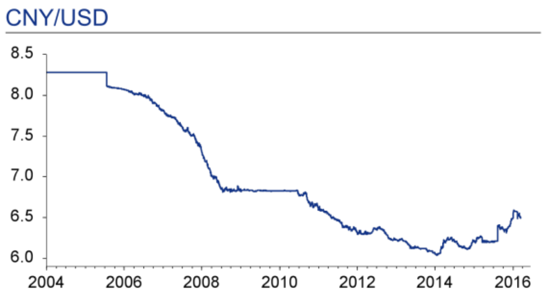
Sources: Thomson Reuters Datastream, own calculations.

So far, the PBoC has stuck to its strategy fleshed out in December 2015 to manage the exchange rate of the yuan against a basket of currencies and not just against the US dollar. In doing so, it does not set an explicit exchange rate target but retains a degree of flexibility that allows for further depreciation. The alternative strategy of setting a fixed rate and hoping that capital outflows would then come to a halt would hardly be credible in the present situation of heightened uncertainty.

The PBoC would then run the risk of an even more rapid depletion of its currency reserves should the markets have no faith in the fixed rate. Currency reserves could quickly fall to critical levels and finally force the PBoC to unpeg the exchange rate in a stress situation. Violent market reactions would have to be expected and, with regard to the forgone currency reserves, this would be the most expensive option.

The more likely, and economically more propitious, strategy is for the Chinese central bank to allow a further gradual depreciation of the yuan, thereby limiting the depletion of its reserves. Additional capital controls or measures to push up bank rates are also measures it might employ to protect its reserve base, if capital outflows remain too strong.

In the more likely scenario we believe the yuan could drop to around 7 yuan to the dollar this year or next. This would bring a number of advantages for China: a boost to competitiveness that would stimulate exports, an uptick in inflation that is currently well below the official goal of 3%, and, last but not least, a more market-driven exchange rate would chime with the Chinese government's objective to further internationalize the use of its currency.



Source: Thomson Reuters Datastream.

Following years of a rising yuan, a gradual downward movement would be manageable for the global economy and would not signal China's entry into a currency war. While the growth of US and European exports to China would be weakened and price pressures on global markets increased, this would still be preferable to a situation of a hard landing of the Chinese economy. Such a hard landing cannot be prevented solely through currency depreciation – but rather also requires some reform of the State Owned Enterprises and measures to prevent an even bigger credit bubble – but exchange rate flexibility certainly does help. It stimulates higher nominal growth and generates jobs in the country. Therefore, a gradual depreciation should not be bad news for the financial markets.

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