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CHINA

# Renminbi devaluation – economic repercussions yes, but not a new currency war

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On August 11, 2015, the People´s Bank of China took the markets by surprise by fixing the renminbi at 6.2298 CNY versus the US dollar, almost 2% higher than a day earlier. Such a sharp devaluation of the Chinese currency on a single day was last seen in 1994. At the same time, the central bank announced that, in future, its daily fixing would be guided by the closing rate on the previous day, in conjunction with demand and supply conditions in the foreign exchange market. In the days that followed, the central bank then set about implementing the new regime, fixing the currency close to the closing rate for the previous day when the exchange markets opened. This is testimony to a more market-based approach to exchange rate fixing.

We believe that the latest modification of the exchange rate regime is fundamentally a step in the right direction. It increases the flexibility of the exchange rate, exposing it more to the influence of market forces. It also signals the Chinese government's willingness to continue gradually opening up its capital account and move towards a more liberal exchange rate regime.

The timing of the step is interesting from both a political and an economic perspective. From a political perspective, because China has been aiming to get the renminbi into the IMF's special drawing rights basket for some time now. The next routine decision on the composition of this currency basket will be made in the fall. Although the IMF has already welcomed the Chinese central bank's latest move, it does not expect it to have any direct impact on its decision. But the move to more flexibility is certain to prove helpful.

With the devaluation of the currency, the Chinese government also hopes to give the economy a lift. Foreign trade figures, in particular, have been particularly weak of late, with Chinese exports in July down by more than 8% year-on-year.

Many interpret the move as a sign that China is seeking to start a "currency war". We do not believe that this is the intention. After all, the Chinese currency has actually made substantial gains against the currencies of the country's Asian trading partners, in particular, but also against the euro and the yen. Against the currencies of its most important trading partners, the external value of the renminbi has risen by more than 4% since the start of the year, and by as much as 11% compared with a year earlier. Within this context, the devaluation seen over the past few days can be seen more as a correction of the previous appreciation trend, which went hand-in-hand with a loss of global market share.

Given the ongoing economic concerns in China and the country's market share losses, we expect the devaluation trend to continue gradually, at least for the time being. We believe that the renminbi could realistically edge towards a value of 6.8 against the US dollar over the next few weeks. A drastic exchange rate slide or a "currency war" cannot be in China's interests, also given the impact on consumer purchasing power and the possibility of capital outflows. The Chinese central bank will intervene accordingly to keep the exchange rate in check.

As a result, the devaluation is also expected to have only a limited impact on Chinese foreign trade. Exports are likely to rise by a few percentage points (at the expense of China's trading competitors) in reaction to the devaluation already seen and expected to follow. They are, however, unlikely to become one of the main pillars propping up the economy. In 2015, the main impetus looks set to come from private consumption and investment. Encouragingly, private consumption has gained ground on investment activity.

The global economic impact of the renminbi devaluation will vary considerably from region to region. There will not be any major shifts in the intra-Asian trade environment, as most Asian currencies had already depreciated against the US dollar and are now following the development of the renminbi against the US dollar to a lesser extent. The trend towards breaking up the value chain and the increase in intra-Asian direct investment will continue. The impact on the advanced economies is likely to be much greater, particularly in the US, which does a great deal of trade with China and whose currency has already made substantial gains against the euro and the yen. As a result, we can expect the US foreign trade deficit to increase and consumer demand to become even more important to US economic growth. Since consumption is showing some momentum and will likely be boosted by the most recent downward movement in oil prices, we still expect the Fed to implement its first rate hike in September. But the more pronounced the devaluation in the renminbi, the slower the rate at which any subsequent interest rate hikes are implemented is likely to be.

The devaluation of the renminbi will put a damper on Europe and Japan, too, although this will hit some sectors more than others. General economic development in China, however, is more important than the relatively moderate loss in price competitiveness. As long as the Chinese economy continues on a positive trajectory, which is something the modest devaluation is likely to favor, export opportunities to China will remain positive as well. As a result, we do not think that the scale of the negative market reactions to the renminbi devaluation over the past few days is entirely justified.

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