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Surprise China devaluation marks escalation of currency war

By Jamil Anderlini in Beijing

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According to conventional wisdom, wars are easy to start and difficult to end. Similarly Beijing's devaluation, the biggest one-day currency move since 1993, represents the latest skirmish in an emerging battle which, analysts warn, may be hard to reverse.

The move marks a shift in China's historical policy during times of economic stress. In the late 1990s, the country was widely credited with containing the destruction from the Asian financial crisis because it held fast to the renminbi exchange rate in the midst of competitive devaluations throughout the region.

In the global financial crisis of 2008, Beijing also refused to devalue even as its exports, a key driver of the economy, evaporated overnight.

But now, in the midst of a pronounced and persistent Chinese economic slowdown and continued appreciation pressure resulting from the renminbi's "dirty peg" to the soaring US dollar, China's leaders have decided to take the plunge.

"This shows how desperate the government is over the state of the economy," said Fraser Howie, a China analyst and co-author of *Red Capitalism*. "If they were trying, as the central bank said it was, to bring the exchange rate back into line with market expectations then they have failed miserably as the market is now just expecting further devaluation."

In its announcement of the devaluation just before markets opened on Tuesday morning, the People's Bank of China went to considerable lengths to insist this was a one-off move and part of a broader shift to a more market-orientated exchange rate mechanism.

The PBoC said it would calculate the daily renminbi fix — the rate it sets the currency each morning and from where it is allowed to move as much as 2 percentage points in either direction — by taking more notice of market forces, including movements in global currency markets.

"The People's Bank of China has orchestrated a clever combination of a move to weaken the renminbi with a shift to a more market-determined exchange rate, blunting foreign criticism of the renminbi devaluation," said Eswar Prasad, the former IMF country head for China.

"China's move will reverberate in global currency markets and signals that one of the last holdouts among the major economies may be throwing in the towel and joining the fray in trying to use currency policy as a tool to counter weak growth."

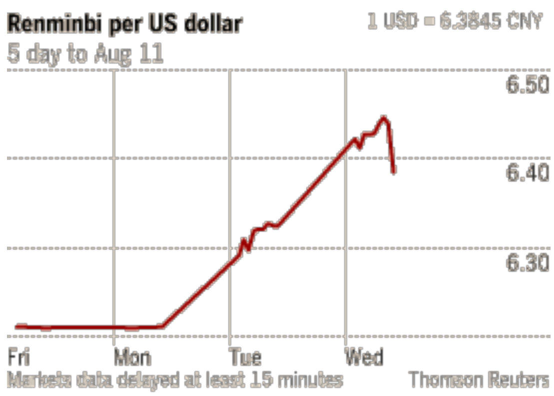
Virtually all analysts agree that a revival of China's declining exports will require a much more significant depreciation than Tuesday's "one-off" move.

Tom Orlik, Bloomberg chief Asia economist, estimates a 1 per cent depreciation in the real effective exchange rate boosts export growth by 1 percentage point with a time lag of three months.

But the renminbi's inflation-adjusted, trade-weighted exchange rate against all currencies was up 3.6 per cent in the first half of this year and up 10.3 per cent since the start of 2014, according to figures from the Bank for International Settlements. As recently as last month, numerous senior officials and government experts were insisting that China would not devalue the renminbi.

In late March, Chinese Premier Li Keqiang told the Financial Times: "We don't want to see further devaluation of the Chinese currency, because we can’t rely on devaluing our own currency to boost exports.

“We don’t want to see a scenario in which major economies trip over each other to devalue their currencies,” Mr Li continued. “That will lead to a currency war, and if China feels compelled to devalue the RMB in this process, we don’t think this will be something good for the international financial system.”



The change in official thinking in the months since the premier all but ruled out Tuesday’s move comes as China’s economy slowed a lot more than Beijing expected. Exports, in particular, have declined, following an 8.3 per cent year-on-year drop in July.

Last month’s bursting of a year-long equity market bubble and the government’s scramble to prop up stocks further unnerved China’s leaders and appear to have convinced them to break the longstanding taboo of devaluation.

Apart from the danger of a currency war with other countries, Beijing must also be wary of political pressure from Washington where the perceived undervaluation of the renminbi has been a constant source of trade friction.

Another problem is that depreciation is likely to exacerbate capital flight, which has already become a serious issue this year for the first time in more than a decade.

“The devaluation in the renminbi is not large enough to improve China’s export competitiveness, but it is large enough to create a sense that Beijing may have fundamentally shifted its currency policy,” said Stuart Allsopp, head of country risk and financial markets strategy at BMI Research. “The risk now is that investors see the yuan [another term for the renminbi] as a one-way bet weaker and start to position against the currency, raising the prospect of more substantial yuan weakness and more economic uncertainty.”

Additional reporting by Gabriel Wildau

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