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The Rocket Fuel Behind China Shock 2.0: Weak Currency, Deflation

Flat to falling prices coupled with inflation elsewhere, lower exchange rate turbocharge China's export boom

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Chinese yuan is counted at a bank. Compared with a basket of its major trading partners' currencies, China's yuan has fallen 6% from a recent peak two years ago. PHOTO: CFOTO/ZUMA PRESS

SINGAPORE—In explaining China's recent export surge, which has alarmed business leaders and politicians in the U.S. and Europe, many have blamed the country's lavish manufacturing subsidies and bulging industrial capacity.

But there is another factor at play: China's currency, and inflation—or its absence.

China's real effective exchange rate, which adjusts for differences in inflation between China and its major trading partners, is back to where it was in 2014, unraveling a decade of steady appreciation.

This real-terms weakness of China's currency, also known as the renminbi, is turbocharging China's overseas sales at the expense of other exporting nations.

It is also heaping extra pressure on other economies and their currencies, especially in Asia, which are simultaneously feeling the strain from a strengthening U.S. dollar.

For the U.S., which has clashed with China over the yuan in the past, the currency's inflation-adjusted slide means goods made in China are even cheaper than before, a trend reflected in weak import prices. That makes Chinese products keenly attractive for Americans, blunting U.S. officials' goal of reducing reliance on Beijing.

"There is still an enormous incentive to use the Chinese supply chain," said Brad Setser, senior fellow at the Council on Foreign Relations. "China is incredibly competitive at this exchange rate."

Compared with a basket of the currencies of its major trading partners, China's yuan has fallen 6% from a recent peak in March 2022, according to data from the Bank for International Settlements, an international group of central banks. The fall reflects sluggish growth in China's economy, which is wrestling with a drawn-out real-estate crunch and subdued consumer spending.

Deflation's hidden benefit

China's real effective exchange rate—which adjusts not just for whom China trades with, but also for differences in their inflation—has tumbled 14% in the same period. China is flirting with deflation, which most economists see as a bad thing because it weighs on spending and makes debts harder to bear. But it has a hidden benefit by making Chinese exports even more competitive on world markets, especially when inflation is high in the U.S. and elsewhere.

The gap between China's nominal and real exchange rates is the widest since the BIS data begin in 1994.

The U.S.'s corresponding real exchange rate has risen 6% since early 2022.

The yuan's real depreciation "is clearly contributing to higher exports" from China, said Krishna Srinivasan, director of the Asia and Pacific department at the International Monetary Fund.

Chinese export volumes in February were around 10% higher than in March 2022. World export volumes were up only 1.4% in the same period, according to data from the CPB Netherlands Bureau for Economic Policy Analysis.

Foreign officials worry about a repeat of the China shock of the early 2000s, when pro-market reforms in China and its entry into the World Trade Organization fueled an export boom that was a boon for consumers but crushed competing industries in the U.S. and elsewhere.

U.S. Treasury Secretary Janet Yellen in April warned China that its ballooning manufacturing capacity, fueled by state-directed investment, threatened jobs elsewhere. China has decried such criticism as a smokescreen for protectionism.

Other Asian nations bear the brunt

China's growth in exports has come in large part at the expense of its Asian neighbors, many of which compete directly in products such as electronics, steel, basic semiconductors and furniture.

Emerging Asian export volumes have fallen almost 2% over the two years that China's have risen 10%, CPB data show. Even Japan's export volumes have weakened, despite a sharp currency depreciation, hurt in part by China's growing clout in autos.

That signals weaker growth ahead and pushes down those countries' currencies against the dollar, worsening the depreciation pressure that is mounting across Asia from a strong dollar.

The Korean won has lost 5% against the dollar since the start of the year, while the Malaysian ringgit has slipped 3% and the Vietnamese dong has fallen 4.5%.

Indonesia's central bank delivered a surprise interest-rate increase in April, citing a weakening rupiah and the risk of resurgent inflation. Tokyo has spent tens of billions of dollars of foreign-exchange reserves to defend a tumbling yen.

Because so much of the yuan's competitiveness is coming through inflation differentials, it complicates foreign efforts to reverse it. In 2019, when the U.S. under President Donald Trump labeled China a currency manipulator, it called for Chinese officials to stop intervening in foreign-exchange markets and let the yuan rise.

But now, Chinese officials are working not to weaken the currency but prop it up, many analysts say, or at least ensure that depreciation is gradual and managed. Chinese officials worry a sharp depreciation would trigger capital flight and push up the cost of key imports such as oil.

Why old remedies might not help

That means renewing calls for Beijing to loosen its grip on the exchange rate would likely result in an even weaker yuan and greater pressure on other countries' exports and currencies.

"The world would have an even bigger challenge competing with China," said Frederic Neumann, chief Asia economist at HSBC.

Reversing the real yuan depreciation could be done by boosting inflation in China, but that would likely require more aggressive fiscal stimulus, which Beijing has resisted in part because of fears of adding to large debt. More drastic steps to bring down inflation in the U.S. and elsewhere, such as raising interest rates, might also help but would in the near term put further downward pressure on the yuan versus other currencies.

"For the time being, Beijing and Washington may be united in wanting the yuan not to fall too much in value against the dollar," said Eswar Prasad, a professor of economics and trade policy at Cornell University.

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