Chi on China

IS CHINA JOINING THE CURRENCY WAR?

War should be the politics of last resort. And when we go to war, we should have a purpose that our people understand and support.

Colin Powell

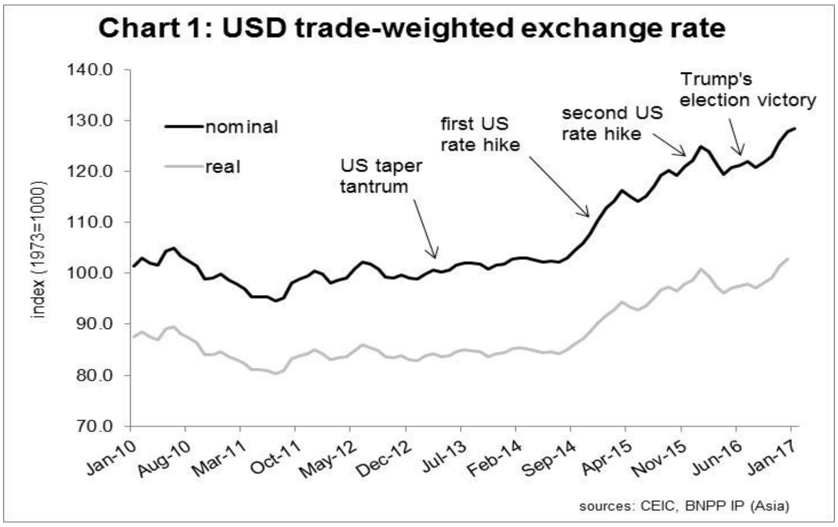
Summary

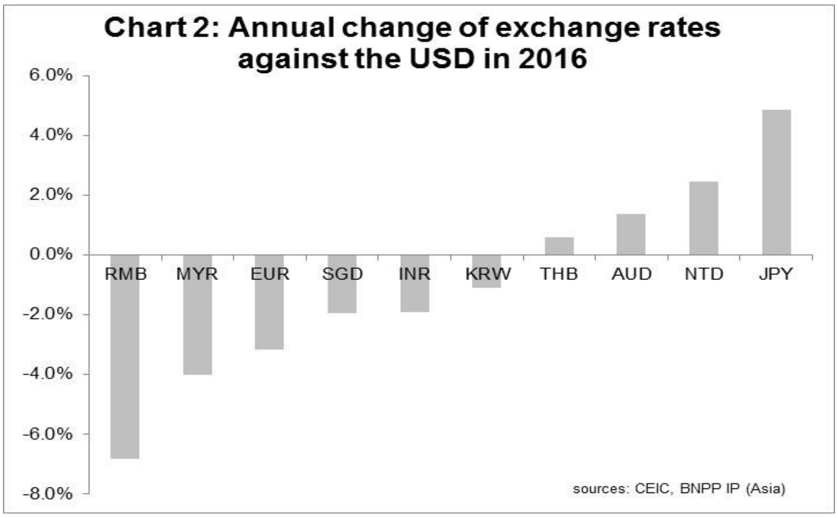
- Among its Asian peers, the renminbi has dropped the most against the USD recently and aggravated Asia's economic challenges in the face of a strong USD. Is China finally joining the currency war, as many critics have long argued for?
- A sharp devaluation of the renminbi would not work as the proponents expect. It would backfire on China's structural rebalancing process and increase international trade tension, encouraging protectionism when global growth is stuck in a low gear.
- The fall in the RMB-USD cross-rate has been a result of market forces from capital flows and Beijing's tactical FX policy shift between targeting the USD and the trade-weighted exchange rate. It is not, in my view, a harbinger of China joining the currency war.

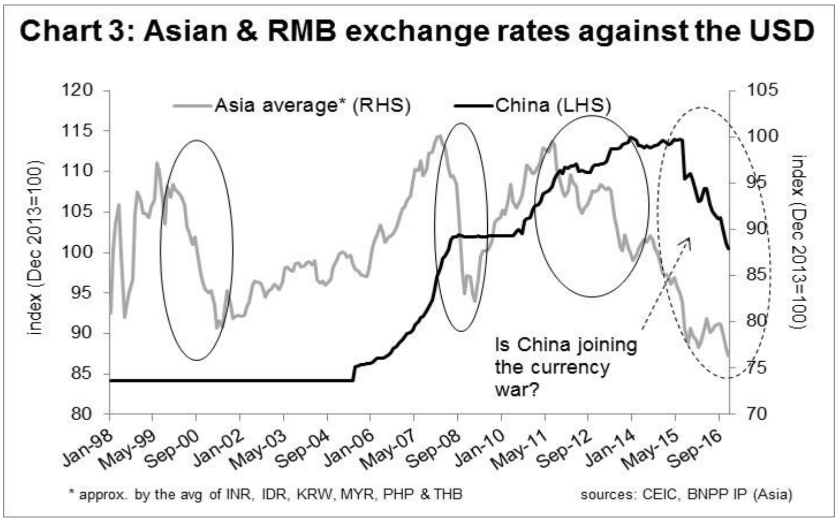
The USD has risen steadily since the US Federal Reserve started to scale back Quantitative Easing (the taper tantrum) in late-2013. Subsequent Fed rate hikes and the victory of Donald Trump in the US presidential elections have accentuated the USD bull-run (Chart 1). As a result, most Asian currencies have fallen, with some more sharply than others, against the USD with the renminbi dropping the most (Chart2).

Squeezing Asia

In the past when the renminbi was held steady against a strong USD, Asia's currency depreciation provided a competitive boost to the regional economies. Since the 1998-99 Asian Financial Crisis, there have been three periods of sharp Asian currency depreciation: the bursting of the US high-tech bubble in the early 2000s, the US subprime crisis in 2007-08, and the sell-off around the 2013-14 US taper tantrum. In each of these cases, the renminbi either stayed put or continued to rise when the Asian currencies fell sharply against the USD (Chart 3).







However, this economic boon has turned into a bane this time, as the renminbi has led the currency sell-off in Asia and squeezed the competitiveness of Asian exporters. The rule of the game seems to have changed, prompting suspicion that China might have finally succumbed to the pressure of currency devaluation after holding out for so long.

Devaluation - be careful with what you ask for

Despite recent changes in the capital flow dynamics in China's capital account, renminbi devaluation is still not in China's best interest[1]. Devaluation could backfire on China, which is the world's second largest economy that runs one of the world's largest trade surpluses. Developing economies that devalued successfully were much smaller in size, so the global system could easily absorb the increase in their exports. They also devalued after their overvalued currencies had caused persistent large current account deficits.

There is no evidence for an overvalued renminbi[2]. Rather than boosting growth, a weak currency makes a current account surplus country more precarious. This is because in deficit countries, where the shortage of domestic savings forces them to fund domestic investment by foreign savings, slowing growth destroys confidence and scares off foreign capital. This contraction in foreign funding, in turn, forces domestic investment to fall. Currency devaluation may help offset or cushion this negative impact on growth in deficit countries by increasing savings.

Devaluation reduces real household disposable income and, hence, consumption, so that its share of GDP falls. By the definition of national income accounting, the share of savings must rise. Typically, this happens when the devaluation increases the profitability of the tradable goods sector (i.e. exports), which increases the saving of this sector (in addition to the increase in household saving due to the fall in consumption). In other words, currency devaluation redirects income from consumption to savings. The rise in domestic savings reduces the country's dependence on foreign capital and, thus, boosts investment even when foreign inflows decline.

However, devaluation does not work for surplus countries the same way because they do not suffer from saving deficiency; and China's national savings are excessive at 50% of GDP. Devaluing the renminbi would thus depress the already-low domestic consumption and increase the country's already-excessive investment and reliance on exports to release the excess capacity. The point is that for surplus countries, devaluation replaces consumption demand with investment demand and trade surpluses.

From China's perspective, this result would certainly go against the purpose of its economic rebalancing from investment-led to consumption-led. So Beijing should resist renminbi devaluation. But keeping a stable, and dear, renminbi also means pains for China's export sector, especially when it is losing the advantage of cheap labour cost to its Asian neighbours. Well, this is typically the cost of structural rebalancing, and a bullet that Beijing has to bite.

From a global perspective, in a world with growing trade tensions and persistent weak demand, if Beijing were to pursue a devaluation policy, it would likely ignite more currency wars, encourage trade protectionism and risk turning back the process of globalisation. Hence, even though strategic positioning argues that Beijing should choose to join the currency war, practically it has not and will not[3].

[1] See "*Chi Time: Renminbi Devaluation Not China's Best Option*", 7 May 2014.

[2] See "*Estimates of Fundamental Equilibrium Exchange Rates*", William Cline, Peterson Institute for International Economics, May 2016.

[3] See "*Chi in China: Will China Join the Currency War*", 19 August 2015.

Market forces

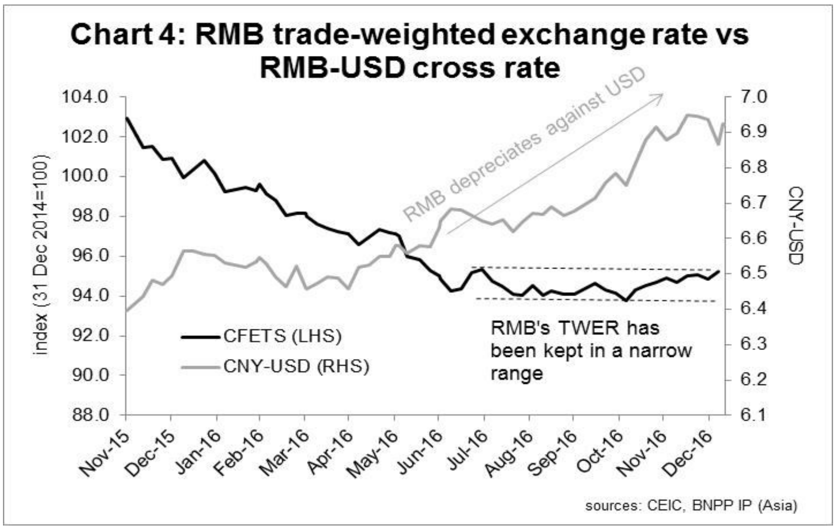
Evidence also does not support the devaluation view. The most important driver for the recent decline in the renminbi exchange rate has been capital outflows from China, as we warned earlier[4].

There are not a lot of foreign portfolio outflows from China, but domestic outflows have been large. These are driven by several factors: 1) Chinese households and companies starting to diversify their assets offshore, especially amid concerns about a domestic asset bubble and diminishing marginal returns on investment; 2) Beijing pushing for renminbi internationalisation and "going out" investment strategy, but also prompting unwanted (illegal) capital outflows; 3) Chinese companies repaying foreign liabilities since mid-2016; and 4) players expecting further renminbi depreciation.

PBoC's FX policy

The PBoC has shifted its FX policy since late 2015 from targeting the USD to targeting the renminbi's trade-weighted exchange rate (TWER), as represented by the CFETS basket[5]. The recent expansion of the CFETS basket to include 11 other (mostly EM) currencies will make the TWER more volatile because of the addition of the volatile EM currencies. Since the PBoC aims at keeping a stable TWER by using the CNY-USD cross-rate as the adjustment factor, this implies a more volatile CNY-USD cross-rate.

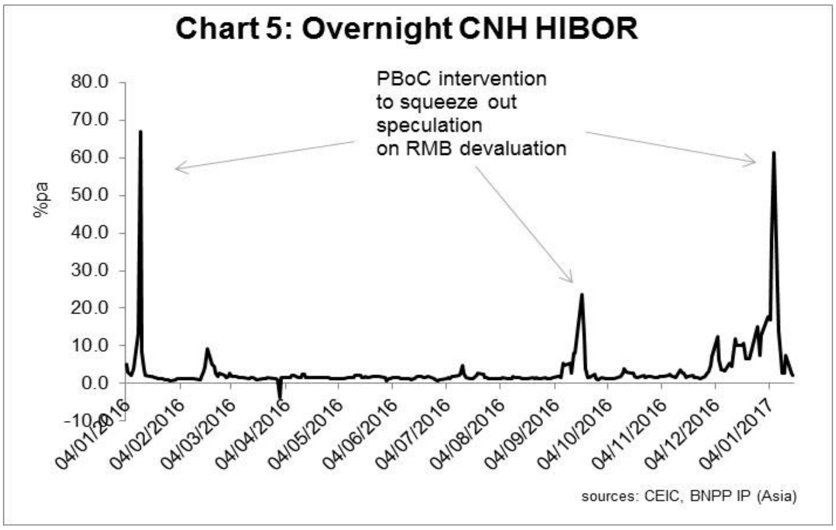
From this perspective, the fall of the renminbi against the USD is not a devaluation policy, but a tool for keeping the TWER stable (Chart 4). The PBoC also notices that it is the CNY-USD cross-rate that matters to onshore renminbi sentiment, not the TWER. Hence, it will continue to employ a tactical policy shift between targeting the CNY-USD cross-rate and targeting the TWER. At times of volatile and poor renminbi sentiment, FX policy will shift towards stabilising the cross-rate, allowing the TWER to adjust. When sentiment is stable, a stable TWER policy will prevail, allowing the CNY-USD cross-rate to adjust.

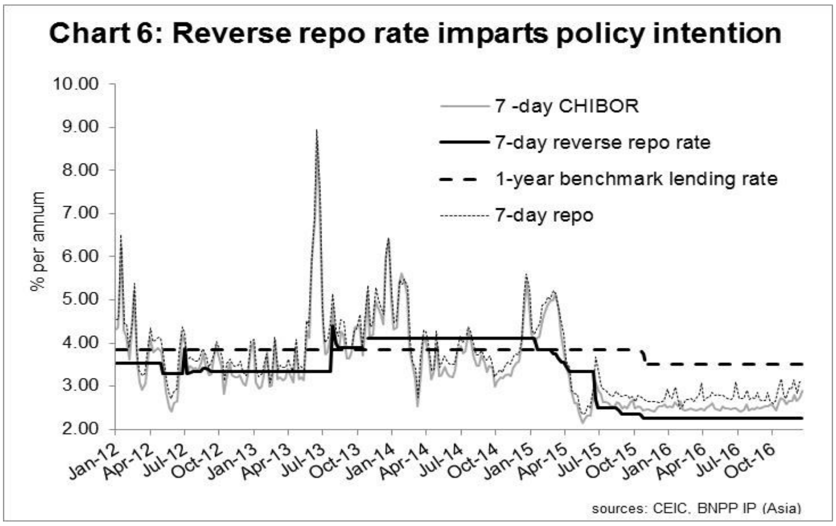


To show its support for the renminbi, the PBoC intervened in the CNH market in January 2017 to squash the one-way bet on renminbi devaluation. The intervention, though not admitted by the PBoC, was clear from the liquidity squeeze (Chart 5) that pushed up CNH HIBOR to more than 60% and the administrative directive issued to SOEs to sell FX both in the off- and on-shore markets.

[4] See "*Chi Time: The Changing Tide of the Renminbi*", Chi Time, 27 July 2016.

[5] See "*Chi Flash: What's Behind the PBoC's Announcement of a Renminbi Currency-Basket?*" 15 December 2015.





However, the intervention comes at a cost of reversing renminbi internationalisation in the short-term as it shrinks the offshore renminbi pool. This, in turn, confirms our view that Beijing wants stability at all cost even at the expense of reversing capital account liberalisation temporarily[6]. Despite a slight tightening bias due to the passive liquidity squeeze from FX intervention to keep the renminbi from falling too fast, there is no policy intention to tighten up, as seen in stable and low reverse repo rate and the flat benchmark rate which impart policy signals, despite volatility in the money market rates (Chart 6). We can expect more capital controls, not sharp RMB devaluation and not interest rate hikes, to augment FX intervention to manage the renminbi's depreciation.

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[6] See "*Chi on China: RMB Internationalisation (part 1 of 2): Short-term Tactics May have Changed*", 24 February 2016.

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