PERSPECTIVE

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CHINA'S CURRENCY DEPRECIATION IS NOT A RACE TO THE BOTTOM

On August 11th, the People's Bank of China (PBOC) implemented a change in the way it fixes the midpoint of the daily trading range of the Renminbi (RMB) against the greenback. The daily opening fixing rate will, more appropriately, refer to the previous day's closing spot price, instead of a more arbitrary setting by the PBOC. The timing of this surprise move to revalue the currency left many investors wondering about the underlying motivation and potential knock-on effects to the global economy. To answer this briefly, we believe that the primary motivation was to better align China's currency regime to IMF guidance and that the global impact will be minimal if authorities continue to maintain an orderly revaluation. Now for the deep dive on why we think this is the case.

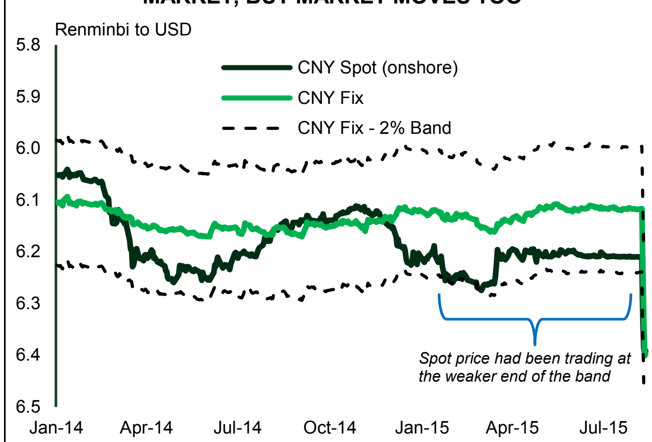
There are two schools of thought on this front. The cynics (or some may refer to them as, the realists) note that China's attempt to align its fixing rate to the lower-trading market rate is a deliberate attempt to orchestrate stronger export growth amidst a weakening economy. Simply put, they are reverting back to the old days of currency manipulation. The currency revaluation coincided with a string of soft data, not the least of which was an 8.3% year-over-year contraction in exports for July. And, as we noted in a recent report, China's growth prospects is being challenged by a number of domestic financial risks stemming from a credit-boom cycle.

The optimists (or some may also refer to them as, the realists) note that this is just another step among many that have already occurred towards the internationalization of its currency market. The timing coincides with a report issued by the IMF and a shortening runway for China to have its currency recognized as a reserve currency within the IMF's Special Drawing Rights (SDR) basket.

Admittedly, the timing on the revaluation is a "win" for China considering the weakness in exports, but we believe the goal of currency internationalization is the dominant motivation, and here's why.

First, a large and persistent gap between the fixing and market rates has been evident since the start of the year (Chart 1). With the RMB value as determined by market participants persistently lower than where the PBOC was setting its value the following day, revaluation seemed appropriate in order to align the two. In a press conference, the PBOC judged the currency misalignment to be roughly 3%, based on "market survey and analysts' general estimate". By this criterion, the RMB depreciation since August 11th has already removed the misalignment, suggesting that we are not on the cusp of a sharp down-leg in the RMB.

CHART 1. PBOC DEVALUES TO MOVE TO MARKET, BUT MARKET MOVES TOO

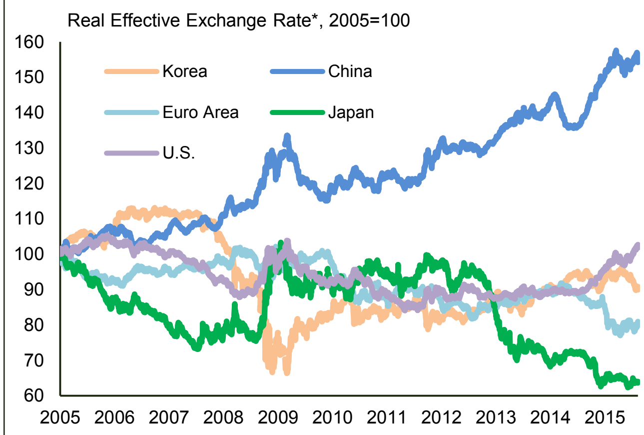


Source: Bloomberg

But, actions always speak louder than words. And, PBOC actions seem to support the currency "internationalization" viewpoint, with reports indicating that the central bank sold U.S. dollars mid-week to prop up the

RMB when fear-based downward pressure failed to subside over the uncertainty created by the policy shift. Although market intervention seems to run counter to a "market based" currency, ultimately the PBOC has no intention of stepping away from the managed float of the RMB, hence the trading band of +/- 2% remaining in place. This is, in part, to ensure that any currency adjustment remains gradual and orderly so as to avoid potential financial instability among domestic firms and its own balance sheet.

CHART 2. CHINESE EXCHANGE RATE HAD SEVERELY APPRECIATED IN REAL TERMS SINCE 2005



Source: JP Morgan. *Trade-weighted exchange rate, adjusted for inflation.

This leads us to a second point. A sharp and deliberately orchestrated fall in the value of the RMB would come with significant costs to China. Media reports and the market reaction have highlighted the concerns around firms operating in China with U.S. dollar exposure. But, the scope is wider than that, particularly on the political front.

Our estimate suggests that a 1% decline in the real effective exchange rate would boost Chinese exports by roughly 0.75% with a lag of one quarter. But, this is only one side of the equation. A Bloomberg Analytics estimate indicates the benefit would be partially offset by an outflow of capital of roughly $40 bn (USD). This amount is small relative to the export benefit, but needs to be taken alongside a risk that capital outflows inject and reflect another layer of financial and economic uncertainty – a much bigger concern for Chinese authorities. In fact, creating an international perception of ad-hoc currency manipulation is completely at odds with past moves by China to liberalize their capital account by permitting greater foreign investment inflows and domestic outflows via programs like the Qualified Foreign Institutional Investor (QFII) and the Renminbi Qualified Foreign Institutional Investor (RQFII). Details on these programs and others are in a report we released this week.

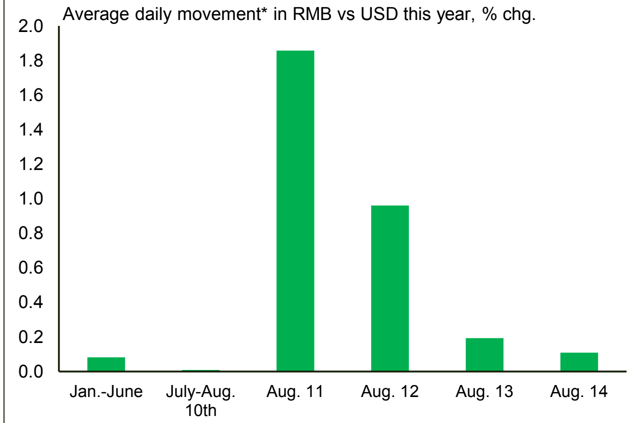
These programs are a testament to the political motivation to not orchestrate a massive, rapid or even continual depreciation. China wants the RMB to be recognized as a reserve currency. This week's move actually aligns to guidance that was provided by the IMF on August 3rd in a document that reviewed the method of valuation of the SDR. That report reiterated that the criteria for inclusion boils down to an evaluation of whether a currency is an export gateway and is freely usable. China met the first criterion back in 2010 given the sheer size of its exports in the global economy, but it did not meet the freely usable criteria. The review occurs every five years, and later this year a decision is due on whether China's past financial market reforms have succeeded in aligning to this requirement. A "yes" on the free usability criterion would see the RMB break into an elite club, qualifying as the fifth reserve currency in the SDR basket (the others being the U.S. dollar, pound, yen, euro).

One of the required building blocks discussed in the IMF report was that "a market-based representative" RMB rate was needed and that the onshore fixing rate did not meet that measure. Here's the kicker. "Based on staff's preliminary assessment, it appears that one of the benchmark exchange rates already calculated daily by the China Foreign Exchange Trading System (CFETS) would be suitable for this purpose." The rate they are referring to is the benchmark exchange rate calculation done by CFETS near the close of the Chinese market, when the market is deemed most liquid and is closest to the market opening in London. Against this backdrop, the PBOC move towards better alignment to the market closing rate seems less mysterious.

Looking forward, what are the implications?

Unfortunately, like many financial liberalization policies implemented in China, the execution was far from flawless. The policy change was not well telegraphed or immediately accompanied with sufficient detail to market participants, with a press conference called well after markets convulsed. To quell the market cynics, even the IMF issued a press release endorsing China's policy as a welcome step in allowing market forces to have a greater role in determining the exchange rate.

CHART 3. AFTER DEPRECIATING SHARPLY ON TUESDAY, PACE OF RENMINBI MOVEMENT DECELERATED



Source: Bloomberg. *In absolute terms.

It's still early days, but we expect financial markets to settle down now that there is greater transparency on China's motivation and implementation tactic. This appears to be already occurring, with the speed of depreciation in the spot price subsiding substantially (Chart 3). The recalibration of market expectations to the new policy will likely keep downward pressure on the RMB, which we think has the potential to depreciate a further 3-5% by year end. But, considering the heights from which it is adjusting from, this is not cause for concern. It's also possible that China will consider widening the trading band to reflect more market influence along this continuum towards financial liberalization, but it would likely do so only once a period of stability is established.

Concerns over a currency war are not materializing. Asian currencies appreciated broadly against the RMB this week, but the RMB remains extremely elevated on a longer term basis. Although Vietnam's central bank responded a day after the PBOC move by doubling the dong's trading band, others have taken a more pragmatic approach of doing nothing for now, and giving China the benefit of the doubt.

Concerns that China's revaluation will export deflation globally, and specifically to the U.S., also seem to be overdone. First of all, this is not new news. Chinese producer prices have been falling for some time due to domestic overcapacity, weak commodity prices and soft global demand, rather than RMB strength per se. A 3-5% devaluation is immaterial and will not influence that outcome. A back-of-the-envelope estimate suggests the hit to U.S. CPI would be -0.1%, at most. And, if the sceptics are correct on the motivation of the currency revaluation, China's growth prospects could actually improve from the export boost, lifting commodity prices and easing disinflationary forces globally.

Upon learning about China's foreign exchange shift, market expectations for a rate hike in September by the Federal Reserve were significantly reduced, although one hike is still expected by year-end. This reaction seems premature, particularly if China credibly sticks to only a modest revaluation. Early indications suggest the Fed is of the same view. New York Fed's President Dudley suggested on Wednesday that these are "very early days to judge" global impacts and that so far there was "no evidence" that global uncertainty is setting the Fed off its current course to raise rates soon. If a Fed condition for raising rates is to wait for global uncertainty to dissipate, it will be waiting in perpetuity.

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