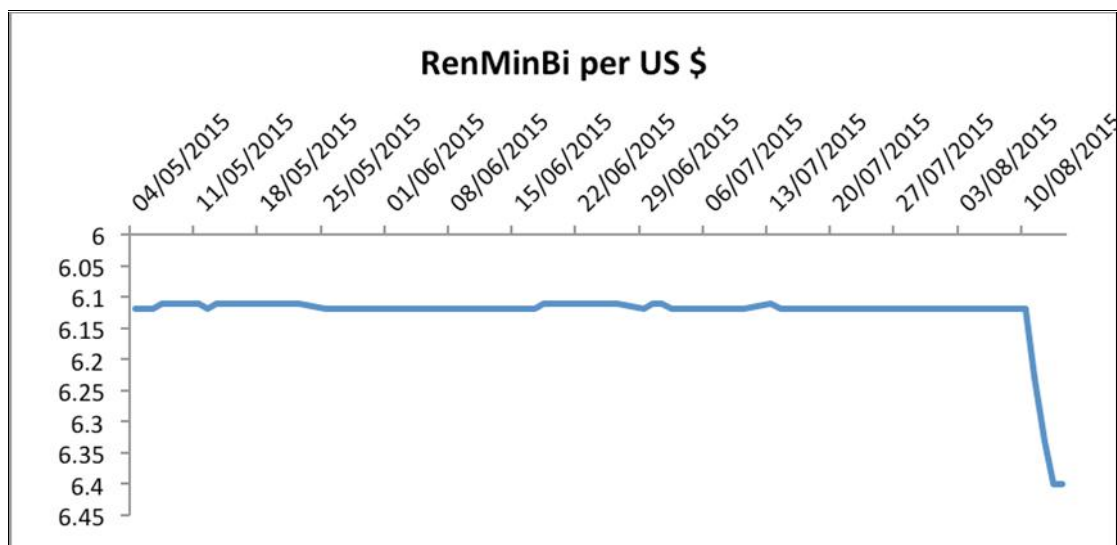


China's RenMinBi Strategy*

C.P. Chandrasekhar and Jayati Ghosh

When the value of the Chinese currency – the RenMinBi – started [falling](#) on 11 August, there was more than just surprise among international observers. The surprise came from the fact that hitherto, ever since the RMB was officially taken off the US dollar peg in 2005, the Chinese government had managed the value of the RMB so that it would change in relatively gentle and barely noticeable movements – as evident even from Chart 1 that covers movements over the past three months only. Yet the 1.8 per cent decline on 11 August was followed by two further days of decline, such that over these three days the currency fell against the US dollar by nearly 4.6 per cent.

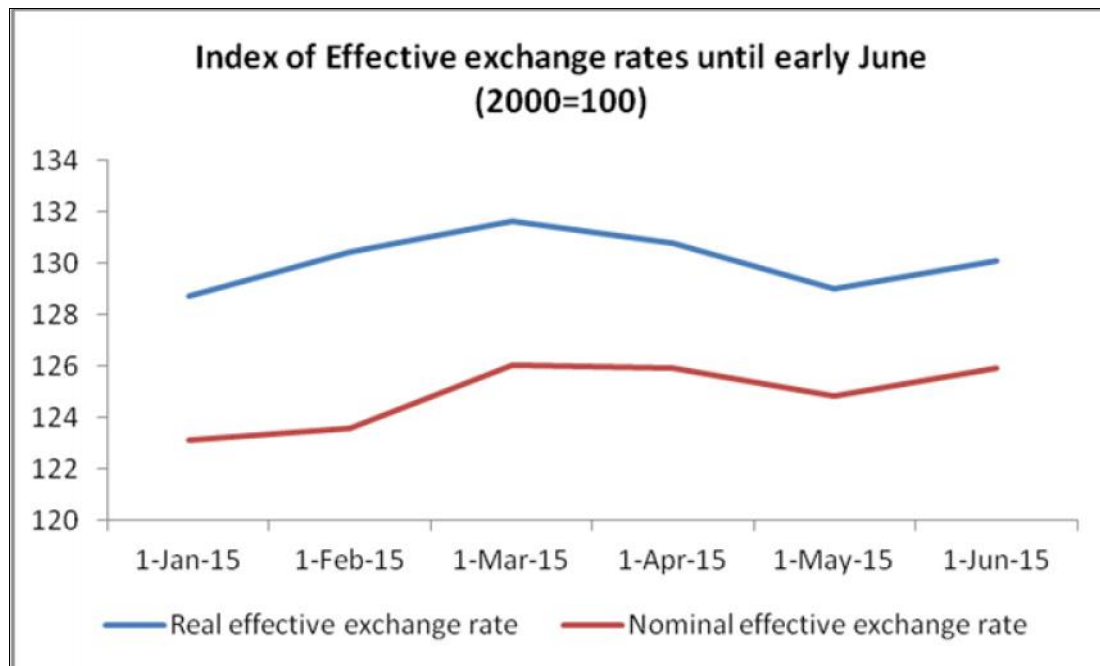
Chart 1



Only on Friday 14 August did the RMB appear to stabilize against the US dollar, after the People's Bank of China (the central bank) raised the value slightly through its open market operations, to close the day at 6.3975 per dollar, compared to the low of 6.4010 per dollar of the previous day. An official of the bank has announced that "there is no basis for the exchange rate to continue to depreciate", but this story is not over, and most analysts expect that there will be some further depreciation of the RMB in the medium term.

In addition to surprise, there was also concern, and even fear, that this move would have significant and potentially negative effects on both developed and developing countries. The Chinese authorities may point out that this recent nominal depreciation follows a period in which both nominal and real effective exchange rates (which show the movement of the RMB vis-à-vis a weighted basket of currencies of trade partners) have appreciated since the start of 2015. However, since early March there has been some effective depreciation, as shown in Chart 2.

Chart 2



Given China's huge significance in global trade (it is now the main trading partner for a majority of countries) this will obviously have major implications. Developing countries will feel the pinch immediately, because Chinese imports will become even more competitive and could threaten their domestic production, and because their exports to China may get hit. Indeed, the impact would definitely be felt by commodity exporters, who are already experiencing one of their worst years in a decade, with absolutely falling world trade prices of many commodities.

And these possibilities in turn also affect investor perceptions and capital flows. Indeed, many developing countries (including India) experienced both currency market and stock market volatility and downturn in the immediate aftermath of this move. Such countries are caught in a double bind, with their currencies depreciating vis-à-vis the US dollar but not necessarily vis-à-vis the Chinese RMB.

But developed countries are not likely to escape unscathed either. On the one hand, this depreciation further reduces the prices of China's exports, which amounts to another effective income transfer from Chinese workers and producers to consumers and investors in the North. But it also adds to the deflationary tendencies that have been lurking behind the scenes for some time now, and could significantly worsen them. In several developed countries inflation is at or close to zero and in some countries prices are already falling. This state of affairs has proved stubbornly resistant to the successive round of liquidity expansion that have been the only form of expansionary macroeconomic policy in advanced capitalism in recent years. And a further negative price stimulus coming from China could even push such economies into a more serious deflationary spiral, putting paid to all the talk of recovery even in countries like the US.

So what explains this recent move on the part of the Chinese authorities? Some argue that this is a sign that they are moving towards greater liberalization and a more market-determined exchange rate, in the effort to have the RMB recognized by the IMF as a reserve currency. But it is more likely to be a reflection of the increasingly desperate efforts at domestic economic management, of somehow trying to deal with the fallout of the successive collapses in various asset markets, first housing and real estate and now the stock market.

Indeed, the close relationship between the stock market and the exchange rate is important to recognise in the current economic situation in China. The recent roiling in the stock market was one of the first signs of the state actually losing grip given the financial liberalization of the past few years and the mistaken attempt to hold up stock market performance as an indicator of overall national economic success.

Having talked up and actively promoted the incredible – and inevitably unsustainable – rise of the stock market especially in the period since March 2015, the Chinese government found itself ill equipped to deal with the bursting of that bubble. Instead of recognizing that the market had driven stock valuations to clearly excessive levels (with price equity ratios in many companies of 200 and more) the authorities chose to be in denial that this was a bubble. They instituted a series of ham-handed measures that were initially less successful but ultimately succeeded in stabilizing the market: from banning some brokers from trading, to suspending stock market activity of around 800 listed companies, to throwing an estimated RMB 1.2 trillion into the market through a public sector financial corporation entrusted with buying stocks to shore up their values.

As Chart 3 shows, this has succeeded in stabilizing the market – for now. But by most indicators, stock market valuations are still too high and must eventually come down. This has implications for the recent China growth story that go beyond the bruising of some governmental and financial sector egos.

Chart 3



The point is that the various asset bubbles that sustained recent growth have now collapsed, and this will add to the negative stimulus to the economy that is already coming from slowing growth in the real economy and a stagnant global trade context. Although official figures suggest that GDP is growing at around 7 per cent, other indicators like electricity production (flat) and rail freight volumes (lower by 11 per cent) suggest much slower growth. Provincial governments that had spent heavily on borrowed funds are now in the process of deleveraging. July exports were more than 8 per cent lower than the level of the previous year – and imports are falling even more, suggesting that this is not the kind of positive rebalancing that was hoped for.

So the currency depreciation may be an attempt by the Chinese authorities to revive export growth and thereby provide some stimulus to growth in an economy that is flagging. The

irony is that this may release other economic demons – both in China and in the rest of the world – that make a recovery even less likely.

* [This article was originally published in the Business Line on 17 August 2015.](#)