HEALTH WEALTH CAREER

WHAT'S BEHIND THE CHINESE CURRENCY DEVALUATION

AUGUST 2015

WHAT HAS HAPPENED?

On 11 August, the Peoples' Bank of China (PBC) announced changes to the daily fixing arrangements for the yuan. In practical terms, the new policy represents further liberalization of the FX regime, which is in line with the Chinese government's desire for internationalization of their currency.

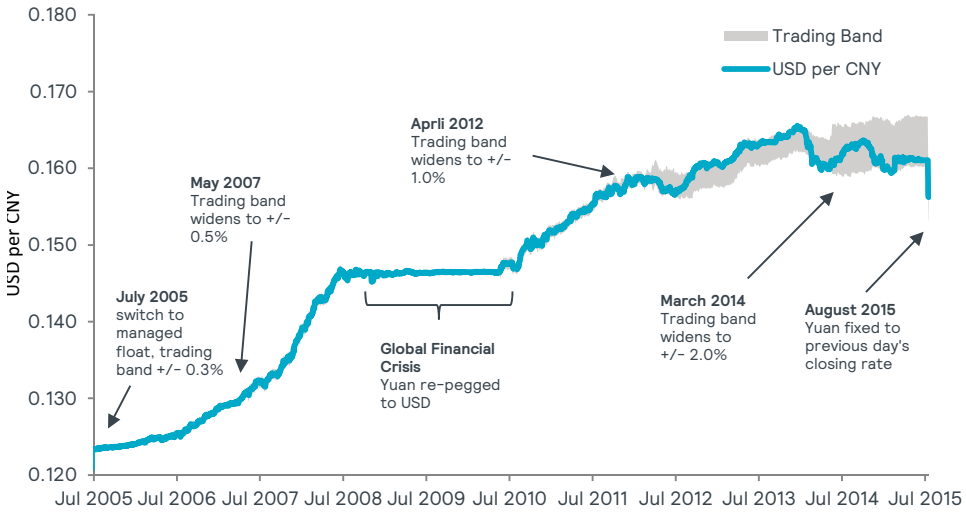
Under the previous policy regime, the yuan was more tightly controlled, rendering it one of the least volatile major currencies globally. This latest step towards a fully floating regime naturally brought about more volatility and the likelihood of greater intraday moves, in line with the yuan's global counterparts.

However, against the backdrop of diverging monetary policies, the ongoing commodity price slump, and broad weakness in emerging market assets, this latest shift in China's foreign exchange policy has triggered an extension of the ongoing sell-off in risk assets globally. "Currency wars" have hit the headlines once again.

TECHNICAL DETAILS

The yuan used to be pegged to the US dollar, until July 2005 when a managed float was introduced. In subsequent years, the trading band was gradually widened; from +/- 0.3% in the second half of 2005 to +/- 2% in March 2014 onwards (only interrupted by a temporary re-pegging during the great financial crisis). Under the most recent framework, the PBC would set the daily reference rate each morning, and the yuan was permitted to trade each day within a +/- 2% band. The reference rate was determined by the PBC, but more recently the market spot rate often varied significantly from the official fixing.

HISTORY OF CHINA'S FX POLICY



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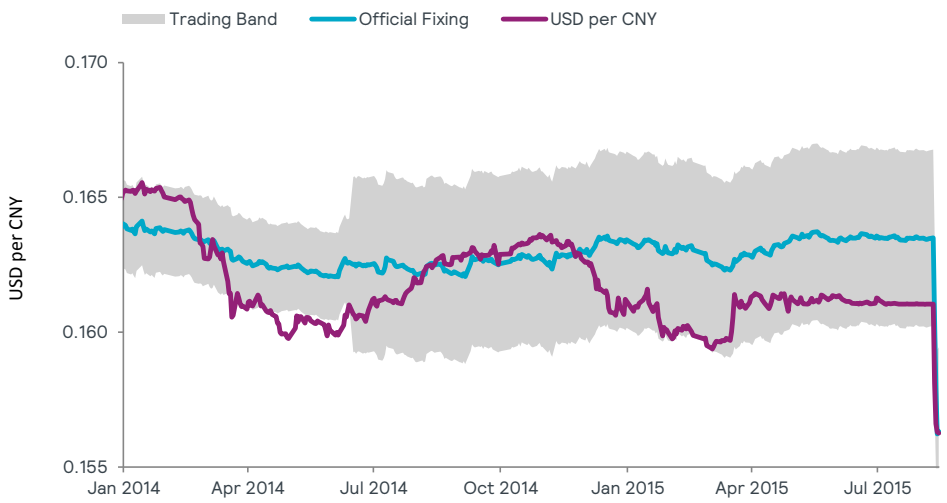
Under the new arrangements that were put in place this week, the reference rate is now set at the previous day's closing price, while the trading band remains unchanged at +/- 2%. The new arrangements led initially to a 1.9% fall in the yuan (the largest daily decline since the adoption of the previous arrangements in 2005), as the yuan had closed the previous day close to the bottom of the permissible range. Although the decision was described by the PBC as a 'one-off' move to establish parity between the reference and spot rates, the Bank was forced to set the reference rate on 12 August again at the lower end (of a new lower range), resulting in a further 1.6% depreciation. The reference rate was set a further 1.1% lower on 13 August.

YUAN'S "DEVALUATION"



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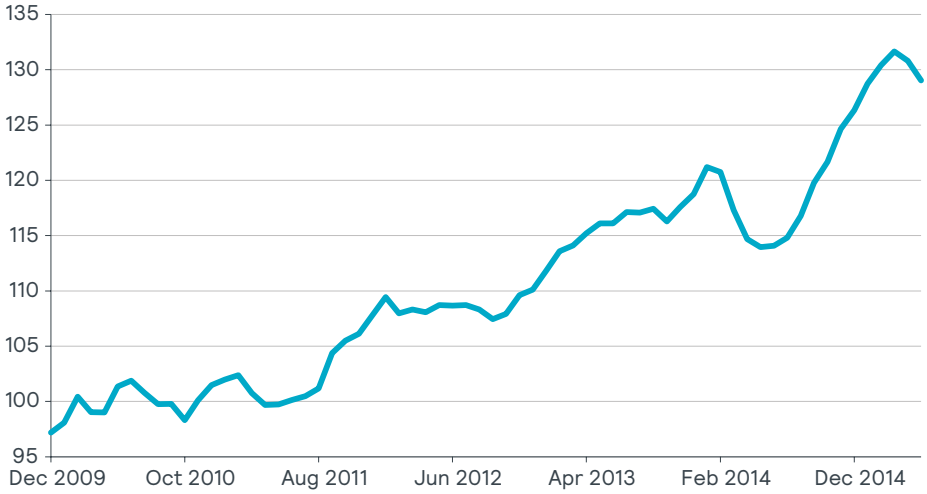
The new arrangements accompany ongoing negotiations between China and the IMF to include the yuan as one of five currencies in the Special Drawing Right (SDR), and to further enhance the yuan's role as a global reserve currency. Recently, the IMF extended the review period to September 2016, essentially requesting China to undertake further measures to liberalise trade in the yuan.

In our view, the new fixing arrangements and the ensuing depreciation of the yuan should be viewed firstly as a direct response to the extension of the review process. Indeed, the move further towards the floating regime has been cautiously welcomed since by both the IMF and the US Treasury. In broader terms, moreover, a more flexible exchange rate and relaxation of other capital account controls are clearly stated objectives of China's financial liberalisation process. The move also follows other measures in 2015 to liberalise China's equities and local government bond markets.

Arguably, judged against the ensuing market reaction and previous market liberalisation measures, the boldness of the move sits somewhat uncomfortably with China's history of policy 'gradualism'. While the government's broader plan to transition from an export-led to a consumption-driven economic model remains in place, the move was never intended to be swift, with the "new China" very gradually expanding and replacing the "old China". In real effective terms, the yuan appreciated by around 30% over the last five years, a significant drag on China's competitiveness. Underlying economic growth has moderated sharply in 2015, most likely to below the comfort levels of the authorities, and partly reflecting a 15% trade-weighted appreciation of the yuan since mid-2014 due to its USD "peg". The degree of the apparent "devaluation" looks quite insignificant when observed in the context of these moves.

CHINESE YUAN - REAL EFFECTIVE EXCHANGE RATE



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Given also the disparities between the spot and reference rates, and recent declines in China's foreign exchange reserves (partly to keep the exchange rate within the band), markets have become fearful these initial declines may become the first in a larger series of competitive exchange rate devaluations.

Indeed, the move and the accompanying depreciation has precipitated a new risk-off episode across global markets, amid fears China is increasingly prepared to export deep domestic disinflationary pressures abroad. Commodity prices and emerging market and commodity currencies have all depreciated significantly since the announcement, building on deep declines already in 2015 in the face of slowing Chinese growth and a rising USD. In contrast, the trade-weighted USD index has appreciated, contributing to a further tightening in US financial conditions. US Treasuries have rallied moderately amid expectations the downward pressure on US inflation will force the Fed to defer 'lift-off' in the funds rate to the December FOMC meeting or even later.

MERCER VIEW

At this early stage of the new arrangements, it is unclear to what extent China's authorities are prepared to tolerate a significantly weaker yuan. Although supportive of China's GDP growth at the margin, expectations of further depreciation could lead to intensified capital outflows, and further downward pressure on China's foreign exchange reserves.

In the absence of FX interventions, the yuan is now technically allowed to depreciate as much as 10% in any given week. As demonstrated recently following the collapse in China's equities markets, it may be more palatable for the authorities to intervene directly and ensure a more orderly drawdown on reserves. Although running contrary to the longer-term reform agenda, China's authorities frequently have been prepared to backtrack in order to ensure shorter-term stability.

Indeed, China has yet to exhaust other potential sources of stimulus before even considering competitive currency devaluations. The tools at disposal include further fiscal expansion, additional cuts to interest rates and required reserve ratios, and additional central bank liquidity to the various policy banks. Importantly, there is no evidence of a significant deterioration in employment, the paramount concern of China's policymakers.

As they turned out, Mercer believes these developments largely reflect two major economic themes in 2015 we have previously identified: the potential for further USD appreciation as global monetary policy continues to diverge and the likely difficulties confronting China's policymakers as they seek to both liberalise and rebalance the economy. At this point, we see neither development seriously jeopardising the outlook for global growth, particularly if they are accompanied by further monetary easing in China and delayed tightening in the US.

Nevertheless, the accompanying potential for increased market volatility, together with rich valuations, suggests investors increasingly need to become more selective across both asset classes and across regions. While it may remain a challenging period for many emerging markets and those developed economies with strong trade linkages to China, heightened volatility will inevitably deliver new investment opportunities in due course.

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