Economic Insight

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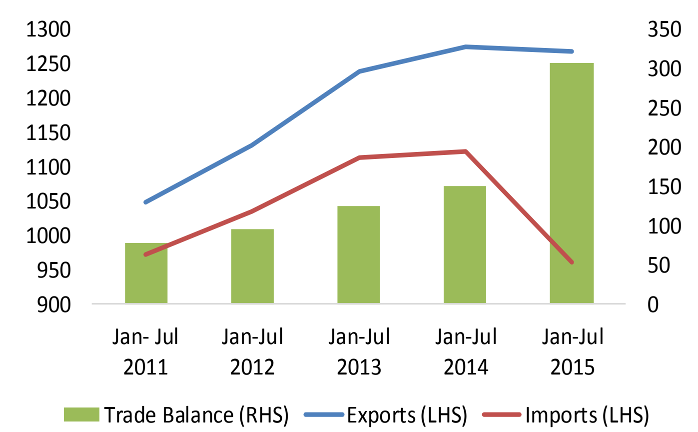
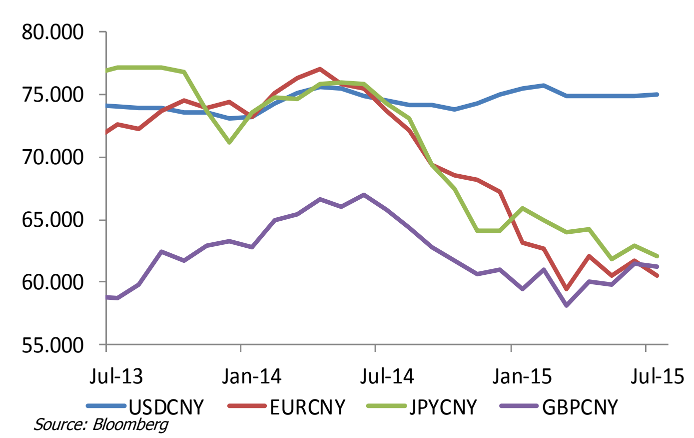
China: The Redback Sinks, Currency War Looming?

CHART 1: CHINA'S TRADE ACTIVITIES ($ BILLION)



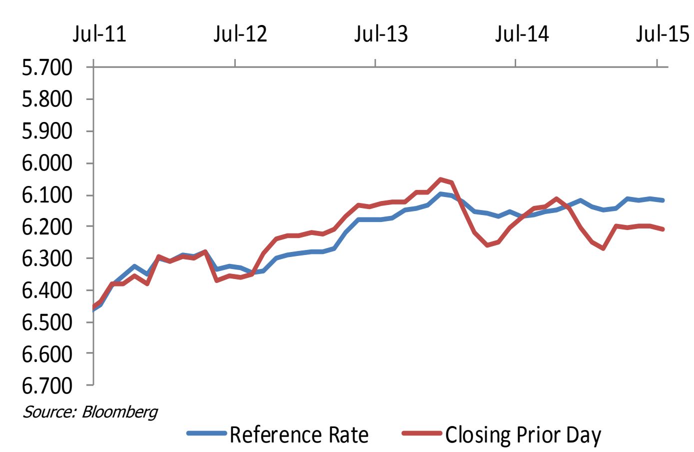
Source: Bloomberg

CHART 2: RENMINBI VS MAJOR CURRENCIES (JAN 2010=100)



Source: Bloomberg

CHART 3: USD/CNY EXCHANGE RATE (INVERTED)



Source: Bloomberg

- A tremendous shock reverberated through the global financial markets yesterday as China devalued its currency by 1.9%, the biggest one day drop since 1994. But why did the People's Bank of China (PBOC) do it? Was it because to arrest the decline in exports? Or was it something else entirely?

- Truly, July was a devastating month for China's exporters. Exports in July fell by 8.3% yoy while imports contracted by 8.1% yoy. Shipments to Japan tanked by 13% yoy, while those to Europe by 12.3% yoy. Exports to South Korea also dropped by 7.4% yoy, while Malaysia fell by 1.3% yoy.

- Nonetheless, merely looking at two data points (July 2015 and July 2014) might bring about an inaccurate picture of the whole situation. As depicted in chart 1, YTD exports (Jan-Jul 2015) remained steady as compared to the same period last year. On the other hand, imports sank by 14.4%, from $1.123 trillion to $961 billion. As such, trade surplus had more than doubled from $152 billion in Jan-Jul 2014 to $307 billion in Jan-Jul 2015.

- Therefore, when the (PBOC) devalued renminbi by 1.9% yesterday, it was unlikely because of the worry over the trade performance. But rather, this is another step to gradually liberalise its exchange rate regime. Following the removal of the peg to USD in 2005, the PBOC sets the daily reference rate, and lets the currency trade within a certain band. Currently the band is at 2% and had been widened from 1% in 2014, 0.5% in 2012 and 0.3% in 2007.

- Previously, the daily reference rate was set according to an undisclosed formula, but it was probably a loose peg to the USD, as could be deduced from historical data. This is in contrast to the exchange rate regime in Singapore which manage-floats its currency against an undisclosed basket of currencies of major trading partners.

- The cost of such a peg is apparent from chart 2. Since July 2014, the renminbi has drastically appreciated against all other major currencies, with the exception of USD. Whilst the impact of yuan appreciation has not been noticeable in the trade numbers yet, there might be some negative impact a few months down the road. As such, we laud the fact that the authorities are already pre-empting the possible negative repercussions on trade activities.

- From now own, the PBOC would set its reference rate based on the closing exchange rate from the prior day. In fact, in late July, the State Council had announced that it would allow the renminbi trading band to be widened further, without giving a timing or scope for the potential adjustment. As the government is looking to include yuan into Special Drawing Reserve (SDR) of the IMF, it is paramount that yuan is accorded more flexibility to move up or down.

- The government seems intent on continuing its gradual opening up of its capital account and financial markets. Flexibility in exchange rate will of course comes with greater volatility, but that is the price that China has to pay to reform its economy, in line with other developed nations.