PRUDENTIAL FIXED INCOME

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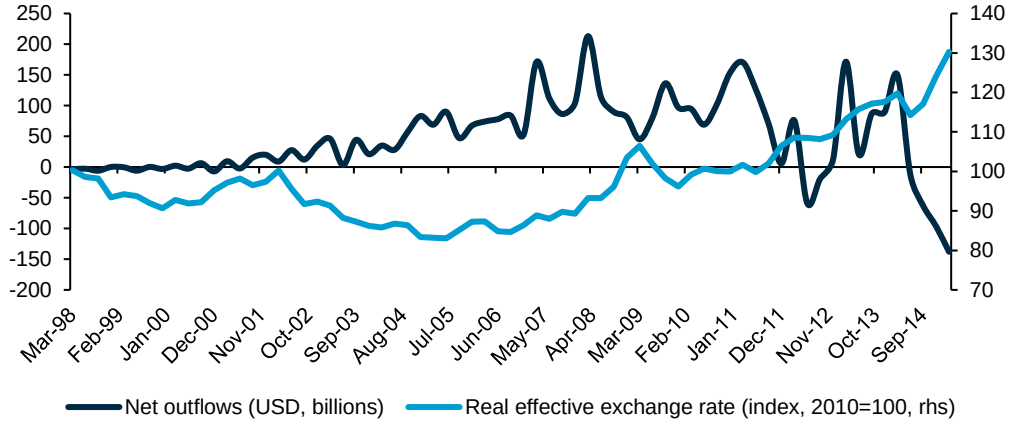
China's Constructive Devaluation Step

The recent devaluation of the Chinese yuan (CNY) has triggered considerable volatility in a broad swath of markets and has also left many observers puzzled both about the intentions of Chinese policy makers as well as the general implications for the global economy. While initial market commentary and reactions have appeared to be on the bearish side, we take a more constructive view. In our assessment, China's move to change its FX fixing arrangement and the attendant depreciation is an overdue and positive development for the Chinese economy—with a potential beneficial impact globally—if properly managed by China's trading partners.

Against the background of the 14% real-effective appreciation of the CNY over the last year alone (and 30% since 2010), this week's depreciation is only a small step; while we expect more to come, we do not think that this will be an uncontained and aggressive bid by the Chinese authorities to gain competitiveness at any cost. Developments over the next couple of weeks will be critical in determining whether the Chinese authorities are now using their reconstituted macro-policy arsenal in order to push the crucial structural reforms that have been wanting thus far.

Most importantly in our view, the depreciation offers China the realistic prospect that monetary policy can again become an effective policy tool. Significant steps in capital account liberalization over the recent quarters combined with maintenance of a stable U.S. dollar/CNY exchange rate have blunted efforts to ease monetary conditions. Instead, this policy mix resulted in large-scale capital outflows, which served to actually tighten monetary conditions (including through another large real currency appreciation). Allowing the CNY to weaken to a level consistent with easing monetary conditions could, at least at the margin, remove incentives for further outflows and thereby boost domestic liquidity, especially if the authorities were to cut the reserve requirement ratio (RRR) going forward, as we expect.

China's Net Outflows Amid Currency Appreciation



Source: Haver Analytics and Prudential Fixed Income as of August 2015.

Contrary to some initial market commentary, we think that a weaker CNY also has a constructive role to play in China's future deleveraging efforts. Chinese exporters have been able to maintain market share in the face of significant real CNY appreciation only by aggressively cutting prices—and hurting their margins—as recently evidenced by once again accelerating PPI deflation coupled with poor and deteriorating profitability. The need to finance the implied losses has been a driver for higher credit growth (with ever smaller impact on GDP growth) and worsening credit quality. A weaker CNY will, in contrast, allow producers to preserve margins while maintaining competitiveness, over time reducing the need for leverage and improving credit quality. In turn, higher margins, improved profitability, and reallocation of credit to more productive causes could play a part in reversing negative investor sentiment and, along with a more realistically valued currency, curtail incentives for further capital flight.

Of course, an important caveat is that a weaker foreign exchange rate in itself will not solve China's fundamental rebalancing problem and aid the transition to a lower structural growth path. This transition will require the hard reforms that have so far been delayed, but a weaker CNY will provide important flanking support and buffer the adverse near-term outcome from such reforms (e.g., closure of excess capacity plants). However, the ball is now firmly in the court of Chinese policy makers to capitalize on their reconstituted monetary policy tool and fiscal stimulus already in place and initiate significant structural reform, before the political window of opportunity closes.

As with any significant change in policy frameworks, China's new FX approach will need to be carefully implemented in order to avoid creating excess volatility. Given the adaptive, T-1 nature of the new fixing—basing it on the prior day's spot closing—it is essential that the Chinese authorities avoid creating another one-way bet on the currency. In this context, interventions to support the CNY will need to take place from time to time, and they already appear to have been taken. Of course, given China's still large extent of state control, especially in the banking system, the authorities also retain significant scope to use moral suasion to steer the CNY market.

In a similar vein, recent events—especially the sharp gyrations of the stock market and large capital outflows—underscore the dangers of premature financial liberalization and capital account opening (at least until significant fiscal and real sector structural reforms have been implemented), and we would expect the authorities to pursue a more prudent capital account opening approach going forward—perhaps even rolling back some earlier initiatives, as they have done with respect to the stock market—which will also help them control the currency and stem volatility.

For the rest of the world, the outcome of the CNY depreciation is arguably more ambiguous, even though we have a broadly constructive view if other countries manage their response adequately.

- The adverse implications for China's export competitors will probably be less than many observers fear. All other things being equal, China's export competitiveness will improve. However, not all things will remain equal, and in line with the preceding argument, we don't expect a weaker CNY to result in much larger gains in China's global market share. Rather, the currency adjustment could boost the margins of Chinese exporters (and lower their loan demand). Still, we expect competitor currencies like Taiwan and Singapore to weaken along with the CNY. While Korea may want to follow a similar route, its very large current account surpluses and the resulting international attention may lower the authorities' scope to affect a much weaker won. Conversely, Vietnam will be impacted by improved Chinese competitiveness, but the authorities will likely try to resist depreciation as long as their reserves permit.

- **Moreover, to the extent that a weaker CNY bolsters China's economic performance, it will imply a boost to countries relying on Chinese demand, especially to the extent that their competitiveness has not substantially eroded.** In line with the preceding, we don't think that the new FX policy will aim at, or imply, a massive boost to China's growth outlook. Still, the depreciation will play a role, together with already announced large fiscal stimulus, in turning around China's moribund first half 2015 growth performance, and suppliers to China should see increased demand over the next couple of months. This group includes some Asian commodity-heavy exporters, such as Indonesia and Malaysia. Other commodity exporters could also benefit depending on the extent to which China's commodity demand would rise. For manufacturing exporters, the outlook is more mixed, given that a weaker CNY will allow Chinese producers greater scope to substitute imports. This could have negative implications for emerging markets integrated into global manufacturing chains, such as Mexico or Eastern European countries.

- **Globally, a weaker CNY could add another disinflationary element, at least to the extent that Chinese exporters are not using the weaker CNY to boost their margins.** However, it would be wrong to view this as an aggressive posture "currency war" as China has allowed its real exchange rate to appreciate by 30% since 2010. Aggressive international countermeasures would thus be a mistake; instead, international policy makers would be well advised to remind China about its need to move ahead with structural reforms and market opening. If this approach is pursued, global growth economic activity could receive a welcome and fundamental boost.

Of course, there are downside risks to our fundamentally constructive assessment, and a mismanaged devaluation could imply considerable global fallout. There are more risks emanating from the international front, since we consider that the Chinese authorities have an interest in avoiding instability and also have the means to achieve that objective. The residual risk, therefore, is not primarily one of a hard landing and financial instability, but more one of complacency, as the expected economic rebound may blunt incentives to finally initiate hard structural reforms. Internationally, things could be even more difficult, especially if fears about currency wars were to lead to rounds of competitive devaluations in various countries. Given China's size, leadership is especially important from advanced economies. In this context, the timing of the International Monetary Fund's Special Drawing Rights (SDR) review is propitious, as it will provide the major global economies an excellent forum to air these issues in a constructive manner.

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Source(s) of data (unless otherwise noted): Prudential Fixed Income as of August 2015.

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