CURRENCY WARS IN ASIA?

Jesper Koll — Senior Advisor
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The devaluation of the Chinese yuan is unlikely to mark the start of competitive currency devaluations coming to Asia. Yes, the move was clearly forced by real economic forces, but I do not believe, this is the start of an imminent series of future devaluations from China. Why? I am convinced that one of the overriding goals of China's authorities is to elevate the yuan to the status of trusted reserve currency of choice for Asia. To get there requires a credible track-record of defending your currency against the temptations of "beggar thy neighbor" devaluations. **Will Markets Believe the Authorities?** While this sounds sensible for the medium- to long-run, surely global capital markets will want to test the authorities' resolve in the short-run. For over a year now, China has experienced persistent capital outflows and the steady loss of currency reserves has pointed to significant US dollar selling by the Chinese Central Bank to keep the USDCNY stable. The devaluation should narrow the gap between the market and the daily fixings; but if in coming weeks, spot continues to trade on the weak side of the fixed currency band surely the risks of more downside adjustment to the fixing will be significant. The key question is whether the devaluation will actually trigger a reduction in capital outflows. Unfortunately, it could also become a catalyst for exactly the opposite: capital flight could accelerate if domestic households and institutions interpret the move as further evidence of rising economic policy uncertainty. The same goes for global investors' cutting back on investment into China (which works indirectly against the authorities by cutting global demand for the yuan). Added pressure comes from the increasing likelihood of a full-blown desynchronization of U.S.–China monetary policy. The move highlights how just as the Federal Reserve (Fed) begins to tighten, Chinese monetary authorities are searching for added tools of monetary ease and accommodation. Clear speak: tension between Chinese authorities and global capital market players is poised to stay high, in our view. Risk premiums in Asia, including Japan, are thus set to rise - until the authorities' assert control and re-establish the confidence of capital markets. Currency market intervention - buying yuan and selling US dollars - would be an immediate tool that can smooth the process. More fundamentally, to really get there, we would want to see either a credible pick-up in Chinese economic growth or a re-energized commitment to sizable fiscal reflation (which would entice domestic savings to invest at home rather than abroad). **China as Asia's Germany, not France** I see one very strong force in favor of believing that the Chinese authorities will not bring currency wars to Asia. It is political more so than economic. It is the de-facto stated objective that Chinese authorities have the medium- to long-term goal of wanting to see the yuan become Asia's reserve currency of choice. If this is true, the yuan must be defended as a strong and stable currency, similar to what Germany did during the 1970s and 1980s. Starting a series of currency devaluations would be extremely counterproductive for China's standing and credibility in Asia and the world, in our view. This political ambition will, of course, be tested by domestic realities. If the economy slows to the point of Chinese unemployment beginning to rise, the pressures for quick-fix stimulus measures are poised to rise. So far, the Chinese unemployment rate has been remarkably stable at around 4%, and as far as the data can be trusted, there is little conclusive evidence that China's job creation machine is running below the Communist Party's comfort level. Any signs of this changing would put us very much on the alert—as an increase in Chinese unemployment would significantly raise the odds of competitive devaluations coming to Asia. **Cyclical Adjustments versus Structural Goals** All said, this week's move clearly underscores China's desire to allow her currency greater flexibility and move more in line with the cyclical realities of the Chinese economy. However, it does not mark the start of a fundamental change in policy priorities - the goal of engineering a stable and strong Asian currency that deserves to attract a reserve currency premium is still very much in place, in my view. *All sources are Bloomberg as of 8/13/15, unless otherwise stated*

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DEFINITIONS

Devaluation : deliberate downward adjustment to the value of a country's currency, relative to another currenc.

Yuan : the currency of the People's Republic of Chin.

Outflows : a large amount of money that moves or is transferred out of a place.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Fiscal Reflation : designed to expand a country's output while controlling the effects of deflatio.

Reserve currency : A foreign currency held by a central bank or monetary authority as a long-term store of value.