Currency wars

Renminbi's worst month ever sparks US-China currency war fears

Economists say any attempt to 'weaponise' China's currency carries big risks

The renminbi weakened by 3.3% against the dollar in June, the worst single-month decline since China established its foreign exchange market in 1994 © Reuters

Gabriel Wildau in Shanghai and James Kynge in London JULY 1, 2018

China's currency suffered its largest ever monthly fall against the US dollar in June, sparking concern that Beijing is prepared to use currency devaluation as a weapon in an escalating trade war with the US.

From 2005 to mid-2014, China systematically intervened in its currency markets to weaken the value of the renminbi, leading to accusations that Beijing was seeking an unfair competitive advantage for its exporters.

US president Donald Trump revived those accusations during his 2016 campaign, despite the fact that China had already switched to a policy of supporting the renminbi to prevent capital flight.

But the renminbi weakened by 3.3 per cent against the dollar in June, the worst single-month decline since China established its foreign exchange market in 1994. Analysts say that so far the move looks more like market forces than an act of currency war. Still, they warn that continued weakness could further inflame trade tensions.

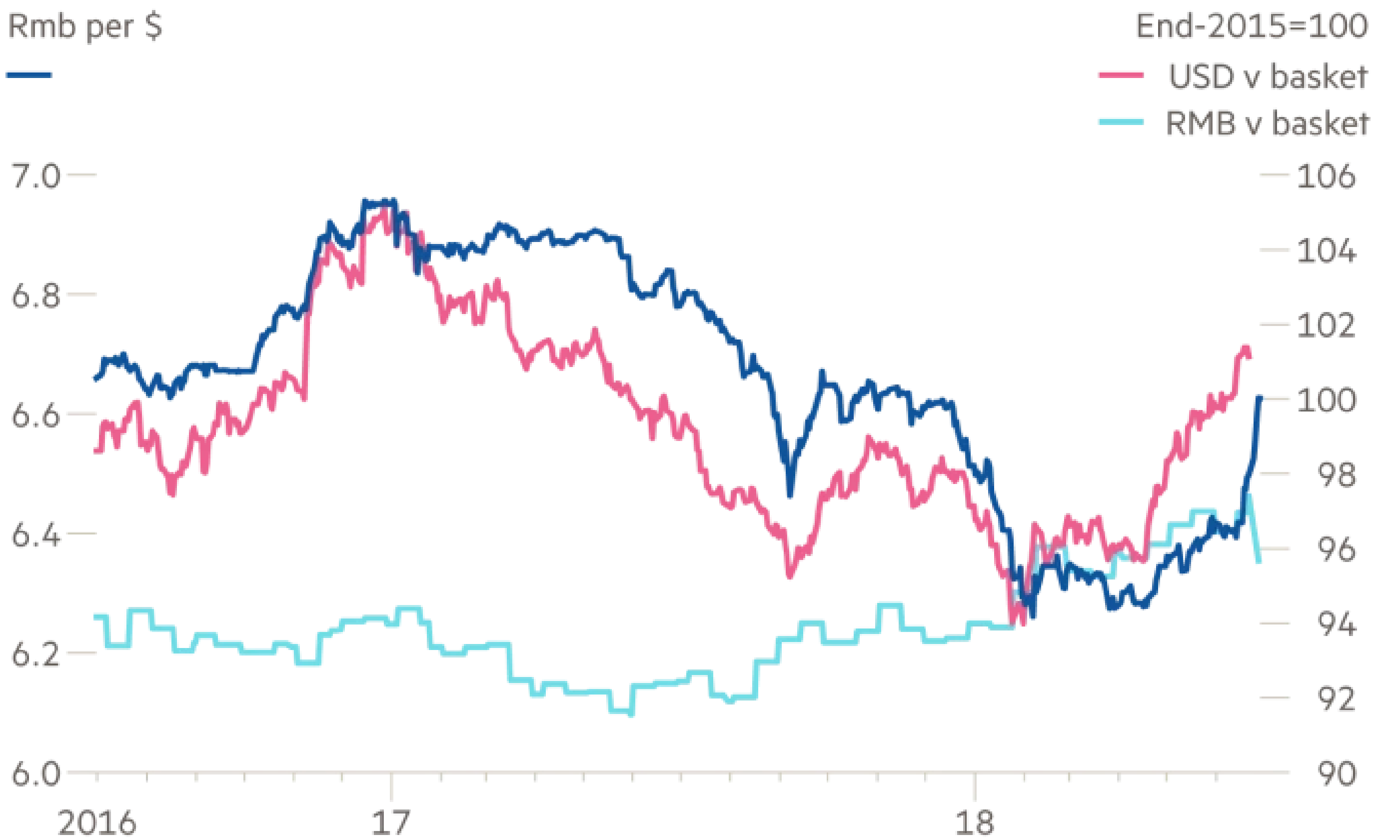
"In the context of rising trade and economic frictions between the two countries, exchange-rate movements take on greater symbolic significance than in normal times," said Eswar Prasad, economics professor at Cornell University and former head of the International Monetary Fund's China division.

"The renminbi's depreciation relative to the dollar could serve as a Rorschach test. It could either be seen as a sign of a more market-determined exchange rate or as an attempt by Beijing to send a message to Washington about another tool in its trade war arsenal."

The renminbi had been an island of strength earlier this year, even as the dollar strengthened against the euro and many emerging market currencies. The recent declines are partly a catch-up effect, analysts say.

In late 2015, China's central bank announced it would begin targeting renminbi stability against a broad basket of global currencies, shifting away from a narrow peg to the dollar. That policy implies the renminbi should weaken alongside other currencies in periods of broad dollar strength.

China targets renminbi stability against currency basket



Sources: China Foreign Exchange Trading Center; Federal Reserve Board; CEIC; Thomson Reuters
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"For now, it's relatively easy to explain the renminbi's move in the context of China's efforts to manage its currency against a basket," said Brad Setser, former deputy assistant US treasury secretary for international economics and senior fellow at the Council on Foreign Relations.

"But if it starts to look like a conscious effort to depreciate significantly to offset the impact of tariffs, there's a much greater chance it will attract attention."

The renminbi's 1.9 per cent fall last week was its second-biggest weekly decline, trailing only mid-August 2015, when the People's Bank of China shocked global markets by announcing a sudden policy change that unleased a 2.8 per cent depreciation in a single week.

But market reaction to recent renminbi weakness has been more subdued, even though — as in 2015 — renminbi declines have coincided with a sell-off in the mainland stock market. The Shanghai Composite Index fell 8 per cent in June amid signs of an economic slowdown in China.

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Bo Zhuang, chief China economist at TS Lombard, a research group, said that Beijing was probably allowing a tactical depreciation to send a signal to Washington but that a deep devaluation would be counterproductive for China.

"Many market participants speculate . . . that China may have weaponised the renminbi, opting for a devaluation to offset the impact of US tariffs. We disagree, though policymakers are now considering devaluation as an option," said Mr Bo.

The PBoC burnt through roughly $1tn in foreign exchange reserves in 2015-16 in order to fight market expectations of depreciation. Reviving those expectations now would carry big risks, Mr Bo cautioned.

"Any benefit from a major renminbi devaluation would be far outweighed by the negative consequences: accelerated capital flight, domestic liquidity tightening and the possibility of increased credit stress," he said.

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