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# Currency Devaluation Is a Short Step in China's Long Advance

AUG. 22, 2015

Strategies

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When China's currency, the renminbi, fell against the dollar on Aug. 11, it set off a furor.

Stock and commodities markets have shuddered around the world, and many traders feared that China had begun a sharp and dangerous devaluation — a salvo in a “beggar thy neighbor” currency war, in which countries would seek competitive advantage by making their goods cheaper in global markets.

That could turn out to be true, of course. Countries like Kazakhstan and Vietnam have devalued their currencies as well, and many emerging-market currencies have been dropping. But there is another way to interpret what happened in China. And while it may seem counterintuitive, I think it's equally valid.

China did not devalue its currency sharply, and it has not embraced a currency war, at least not so far. What it has done is make very modest adjustments both in the value of its currency and in the manner in which it trades. Those moves continue an agonizingly slow process that has been underway for more than 35 years. They are a small but important part of China's transformation into a modern nation.

But there are specific reasons for the timing of this latest Chinese move. One

runs counter to a commonly held assumption in the United States: that China has been manipulating its currency by making it artificially cheap. The markets have been saying that the opposite is true — that the renminbi was, and still is, not cheap enough.

It has not fallen more sharply because Chinese authorities have prevented it from doing so. Over the last week they have stemmed the tide of the markets to keep the renminbi, also known as the yuan, from falling more steeply.

The numbers tell the story — and it is not one of precipitate decline in the renminbi, at least not yet. To the contrary, the renminbi has dropped less than 3 percent against the dollar since the close of trading on Aug. 10. The next day, China announced a technical change in its rules, saying market forces would begin to play a bigger role in renminbi price-setting. In addition, it set the renminbi less than 2 percent lower against the dollar. The currency's declines over the next two days were smaller.

By Aug. 14, the Chinese central bank's intention of stabilizing the renminbi became clearer, and the currency started to flat-line on the foreign-exchange charts. Since then, it has not been plummeting, as many people had feared. It has been one of the best performers among emerging-market currencies, rising slightly against the dollar. Even including the first days of decline, it has outperformed many currencies, including the Russian ruble, which is down 9 percent, and the Colombian peso, down more than 6 percent, according to Bloomberg data.

That said, the renminbi's fall on Aug. 11 was significant. Small as the currency's drop may have been, it startled the markets partly because it was the biggest one-day change in the currency in 20 years. China made some really big changes in its foreign-exchange system back then — changes that dwarf what has just occurred.

Consider that at the start of 1994, China effectively devalued the renminbi by 33 percent — yet that truly sharp decline had scarcely any effect on global markets. While trade frictions with the United States had already flared up by then, China was relatively unimportant in world finance, and the renminbi was not a major currency.

Until the 1994 overhaul, China had two official foreign-exchange systems with

confusingly different rates — an unfavorable one for foreigners and a better one for qualified Chinese enterprises. It also had a thriving black market and lots of corruption.

As part of the changes, China unified the two official foreign-exchange systems, setting the rate for foreigners at roughly the same level used internally by Chinese enterprises on swap markets. Those were critically important steps in China's evolution.

But they were just intermediate steps. So were the ones taken this month, disturbing though they may be for international markets. The recent brouhaha is an indication of how little China has done to free up its currency over the last 20 years, and how much still needs to be done.

The International Monetary Fund has responded to China's latest measures cautiously, indicating that they are not yet enough to give the renminbi the enhanced stature that China desires: an elite currency, ranked along with the dollar, the euro and the yen. The I.M.F. last week deferred that particular seal of approval, deciding not to include the renminbi in its so-called Special Drawing Rights basket, which would add to the renminbi's international luster, until at least next year.

Aside from its long-term goal of achieving greater global status, China had domestic reasons for taking action on Aug 11. Its stock market has fallen, its exports have flagged, and its economy is undergoing restructuring. China's cabinet last month asked that the renminbi be included in the mix of solutions.

That brings us to the timing of the central bank, which continues to exert a great deal of control over China's exchange rate. It chose a very interesting moment to act. This is why: Over the last year, the numbers show, the renminbi has been a sidekick of the dollar, rising in strength as the dollar has moved higher.

The central bank's own rigid foreign-exchange rules helped make this happen. The bank stabilized the renminbi by restricting its movement: It enforced a tight trading range against the dollar, and so the renminbi essentially did what the dollar did. One result is that even including the recent devaluation, the renminbi has fared better against the dollar than every major currency that is freely traded.

That has made Chinese goods more expensive on world markets, and it helps explain why there was such alarm when China devalued its currency. At this stage, though, the decline in the renminbi's value seems to have been carefully calibrated. It is too small to have helped China much with its exports, and not large enough to set off much additional capital flight by people afraid that their renminbi assets will depreciate in a currency decline.

Still, the central bank's move might help stave off domestic political pressure and improve China's standing with bodies like the I.M.F. And because the markets have clearly been pushing the renminbi downward, the timing is useful in diplomacy with the United States, which will have difficulty arguing now that the renminbi's price has been set too low. Under current conditions, if China's central bank stops intervening, the renminbi might well fall sharply.

"What China has done is very astute," said Eswar S. Prasad, the former head of the I.M.F.'s China division, and now an economist at Cornell and the Brookings Institution. "The People's Bank of China has managed to pull off a reform that is important to them and to do it in a way that allows them to mollify domestic critics and stave off criticism from international investors."

In short, China has made a little progress and bought a little time to make further changes in its economic and financial systems. It has come far but it still has a very long way to go.

A version of this article appears in print on August 23, 2015, on page BU6 of the New York edition with the headline: A Short Step in China's Long Advance.