CHINA

Of Devaluation, Currency War, and Growth Conundrum!

China's Renminbi bombshell devaluation by nearly 4 per cent in two consecutive days has aroused across the globe a flurry of speculation and panic of doom and gloom. Some $300 billion has moved out of China since the end of 2014. Is China coming off her wheels? What is the endgame?

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The Renminbi (RMB) has appreciated by some 30 per cent against the dollar since 2005 and against a trade-weighted basket of currencies by the same percentage since 2008. As the RMB unofficially tracks the dollar, the latter's growing strength has made the RMB the second most over-valued currency in the world. Even after the devaluation, the RMB is still up around 20 per cent against the Euro, 15 per cent against the Yen and 10 per cent against the South Korean Won, compared to 18 months ago. This has been causing a perilous drop in China's exports and continues to erode the country's competitiveness. China is struggling to maintain a growth target of 7 per cent as the nation transits to a more balanced and sustainable economy. So the RMB's massive over-valuation must be corrected if the economic foundation for the "China Dream" is not to be shattered.

China has made known her desire for the RMB to be included by the International Monetary Fund (IMF) as one of the world's reserve currencies, alongside with the dollar, the euro, the British Pound and the Japanese yen. One of the pre-conditions for this recognition is the market's role in determining the RMB's exchange rate. In recent years, China has been relaxing the currency's guidance daily trading band, doubling to 2 per cent of the band's mid-point in March 2014. The bold devaluation is touted to be part of a strategy of "stress tests" of dramatic movement in the rigid trading band. At the same time, China's central bank, the People's Bank of China (PBoC), has decided to link the guidance rate to the previous day's spot close. This market-oriented posture augurs well for greater currency flexibility and was welcomed by the IMF.

Ever since China widened the RMB's daily trading band, there has been a great deal of hot money flowing into China (in various disguised forms), speculating on RMB appreciation. But, of late, following slower growth and perceived problems of the Chinese economy, there has been a growing money outflow. These two-way flows are to be expected should the RMB become fully convertible as an international reserve currency. Now, after two consecutive days of devaluations, the RMB was deliberately strengthened by 0.05 per cent. This symbolic move was a shot across the bow that the RMB is not a one-way bet on its road to full convertibility. On its part, the PBoC has emphasized that there is no basis for continued devaluation and that the central bank has the power and resources to maintain RMB's stability. As the RMB still remains grossly over-valued in relation to other currencies, many observers take PBoC's assurance with a pinch of salt. However, it must be remembered that as China is expanding her consumer economy, a stronger RMB would be a key driver to put more purchasing power in the hands of the nation's burgeoning middle-class.

Impact on the global economy

So, what are the implications for the world economy?

The bad news is that such massive devaluation by China is likely to set off a global "currency war" of competitive devaluations. More currencies now move in tandem with the RMB than with the dollar (Subramanian, 2011). This in turn would translate into greater resort to the money-printing press, creating more bubbles in investment assets across the globe, especially stock markets and properties.

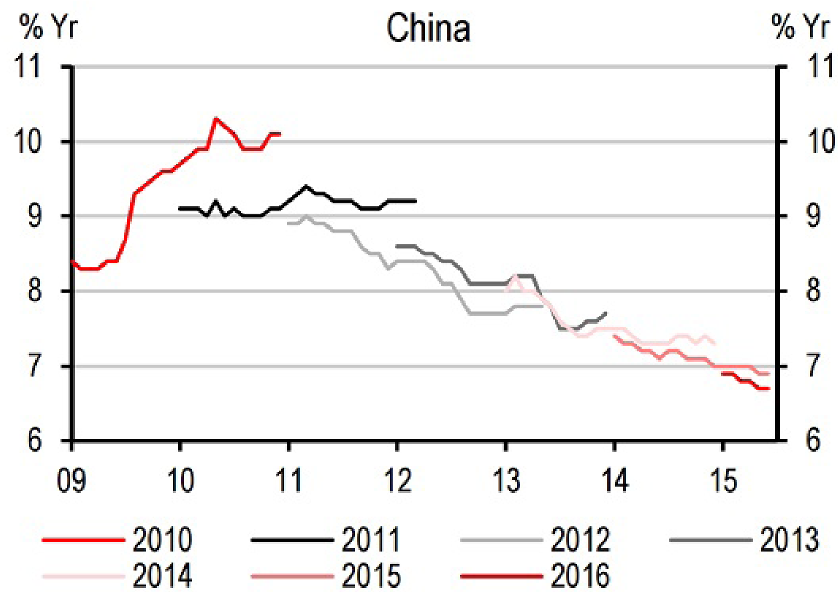
If this happens, China cannot escape unscathed as the world's largest trader at the central hub of a global supply and production chain. In addition, as China is the world's largest commodities customer, a continuing weakening of the RMB may dampen global aggregate demand for commodities, risking further price drops in already-depressed commodities markets.This is likely to send tremors to the financial world.

In the case of India, a cheaper RMB is likely to make Chinese imports even more competitive, worsening India's bilateral trade deficit. However, such deficit is less important than India' overall trade deficit, of which 70 per cent is due to oil and gas rather than Chinese imports.

The good news is that lower commodity prices driven by weaker Chinese demand will benefit commodity-dependent sectors of the rest of the world, including India.

Can it be a game changer?

Chinese growth forecasts have been systematically downgraded



Source: Consensus Economics

At the end of the day, China is unlikely to allow her currency depreciate by any sizeable amount, let alone rapidly, as this would retard or even reverse her strategy of re-balancing the economy towards consumption, industrial upgrading and innovation. All these changes require a stronger rather than a weaker RMB.

Nirvana would be reached if, and, that is a big if, armed with a stronger and internationally convertible RMB, China succeeds in transforming her economy and in synergizing other partnering economies to grow by capitalizing on her global economic connectivity. If that becomes reality, the world would see a phenomenal trajectory of China's consumer market into possibly history's largest. This outcome may well be achieved through quantum leaps in two-way trade and investment supported by trans-regional transport links. If so, unprecedented business opportunities would be opened up for many countries, India included, lifting the world economy up from doldrums to new heights.

All these may sound like pipedream. However, China is doubling down her bets. Her epic, pan-continental initiative of the One Belt, One Road infrastructure-cum-investment strategy, backed by a new Asia Infrastructure Investment Bank (AIIB) and a $40 billion Silk Road Fund, speaks volumes. To realize her ambitions, however, China needs, amongst other things, the RMB to become fully convertible sooner rather than later, possibly by 2020. For that to happen, China will have to reform, open up and strengthen her financial sector through exposing the RMB to rigors of global market forces while hammering out a more sophisticated regulatory system.

When all is said and done, China's abrupt and massive devaluations seem both an urgent attempt to nip a looming economic crisis in the bud as well as a step forward to opening one of the last bottlenecks of the world's second largest economy.

phone maker company, besides toppling compatriot Lenovo and Korean rival LG to become the world's third top selling phone manufacturer. The company reached a major milestone in its India sojourn when it announced that it sold one million handsets in less than six months of entering the country by the end of 2014. The company stunned rivals when

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