Economist Insights

Fixation

China announced last week a change to its currency regime, allowing the market a greater determination in the exchange rate. Financial conditions have been too tight, and the CNY had become overvalued. The increase in flexibility not only helps with monetary policy, but also helps China in its arguments to have the CNY included in the IMF's SDR basket.

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When is a peg not a peg? When it is no longer convenient. Chinese economic policy has a reputation for being a mix of pragmatism and long-term thinking. Unfortunately, long-term thinking has landed China in some short-term difficulties. The long-standing peg of the renminbi, or Chinese Yuan (CNY), to the USD has left the currency overvalued, causing economic difficulties. Now it is time for pragmatism. Last week the People's Bank of China (PBOC) announced a one-off revaluation of the currency and is letting the market have a greater determination in the daily fix of the exchange rate.

Why? Quite simply, Chinese financial conditions are too tight. To stop the currency falling against the USD, the PBOC must fight market forces by selling US assets and buying CNY. This means that they are shrinking the monetary base, a tightening of monetary policy that lower interest rates and cuts in reserve requirements at banks are meant to counter. But this means the loosening has not been as great as it appears (see *Economist Insights*, 25 May 2015).

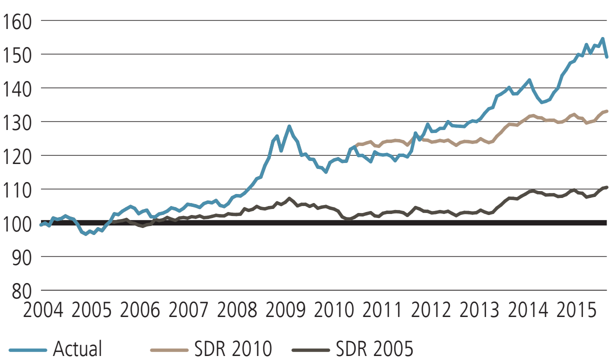
China has got itself into difficulties in part by maintaining the peg to the USD. As the USD has appreciated against the rest of the world, so has the CNY. The nominal effective exchange rate (NEER), which takes into account all a country's exchange rates based on relative trade importance, for China rose by about 11% in the twelve months to July. This recent move reversed about a third of that increase.

The last two times that China made big changes to its currency regime, back in 2005 and 2010, various commentators proposed that if China wanted to keep the currency steady it could switch to pegging to a basket of currencies. The idea is that this would prevent big moves in the USD from shifting the CNY too much against the EUR and JPY, for example.

The most well-known currency basket is the IMF's Special Drawing Rights, or SDR, a basket of USD, EUR, GBP and JPY. If China had shifted to this basket it would have been at least partly insulated from movements amongst those four currencies. So even though the USD would have been pushing the CNY peg up, the EUR would have been pulling it back down. Since 2004, the trade-weighted CNY has risen by 50% (chart 1). If China had shifted to an SDR peg in 2010, that increase would have been just 30%. But if they had changed back in 2005 they would have been up just 10%, and would also have been remarkably stable right through the crisis. Of course trade patterns might have been a bit different which changes the result, but for stability a peg to a basket is the clear winner.

Chart 1: Basket case

Chinese nominal effective exchange rate, actual value and hypothetical values if China had switched to an SDR peg at various dates (2004=100)



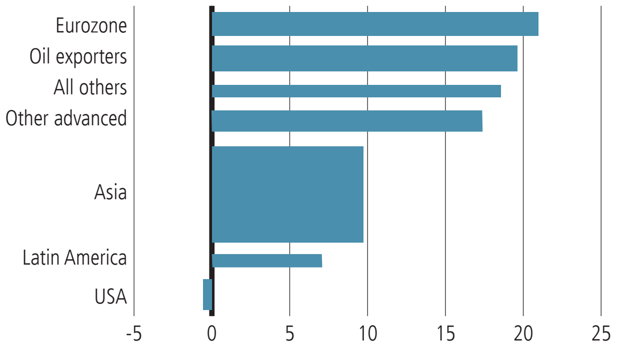
Source: UBS Global Asset Management

There would have been some drawbacks. Not least of which is that the PBOC may have had to buy lots of European sovereign bonds to prevent CNY depreciating too much against the EUR. That would have tested their patience in 2010 and 2011 when the sovereign crisis blew up.

The NEER is a useful summary, but it can gloss over some important regional differences. If we construct regional NEERs, that only look at specific regions and countries, then we can get some interesting results. Since the CNY is pegged to the USD, there is very little change against the US, but that means that the divergence against the other advanced economies, especially the Eurozone, is even more stark (chart 2). Appreciation against other Asian economies is not as sharp, but that is largely because many of them also have some sort of peg or link to the USD.

Chart 2: Appreciation of geography

Appreciation of regional nominal effective exchange rates year to end July 2015, % (width of bars reflects relative trade importance)



Source: UBS Global Asset Management

Make markets, not war

Market commentary is fixated on the idea that this is part of a currency war. The story goes that China is intervening in the currency market to give itself a competitive edge, triggered no doubt by the recent terrible export data. This is, quite frankly, rather ludicrous. A currency war is when a country intervenes in the currency market in order to push its currency below the market level. The PBOC is reducing the amount of intervention in order to let the market determine more (but not all) of the level. In terms of intervention, this is less a currency war than a currency peace offering.

Of course, it is no doubt convenient and not at all coincidental that China is doing this at a time when the CNY looks overvalued. It knows the market will push the currency lower. But it is still limiting the moves to small increments. If China wanted to gain a competitive advantage compared to where it is now, it would let the currency float and watch it drop by 10% or more. But even if China did that, no self-respecting economist would call it a currency war if the markets were determining the price.

This increase in flexibility not only helps with monetary policy, but also helps China in its arguments to have the CNY included in the SDR basket. To China, this would be an important mark of international recognition. To the party leaders, the objective of joining the SDR can be used to override the domestic objections to the reforms that the IMF requires.

A more market-determined exchange rate is a clear minimum requirement. If the CNY was to be added to the SDR basket while it was still closely pegged to the USD, one would have to ask why bother? All that it would effectively be doing is increasing the weight of the USD in the SDR basket, making it track the USD more closely and making it rather useless as a basket.

Other countries in Asia may respond to the PBOC move by loosening their currencies against the USD. Vietnam has already done so. But many of these currencies are also overvalued against the USD, so like China they will just be moving closer to where the market thinks they should be. Markets have been so fixated on the fixed exchange rates that they have forgotten that it is the market's job to determine the exchange rate.