ACRI OPINION
UTS UNIVERSITY OF TECHNOLOGY, SYDNEY
AUSTRALIA-CHINA RELATIONS INSTITUTE 澳大利亚-中国关系研究院 AUGUST 2015

China's devaluation critics are missing the point

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August 14 2015

Note – this article appeared on *Business Spectator*, August 14 2015

With all the attention being given to China's cheaper currency, a key point is being missed: it's the market that has driven the renminbi lower.

Since the surprise move by China's central bank on Tuesday, the rate at which the renminbi has traded in the offshore market has been even lower than in Shanghai.

And over the past year China has been experiencing net capital outflows precisely for the reason that investors viewed the currency as overvalued.

A market-determined exchange rate is, of course, what for years everyone has been telling China it needs.

True, switching now also serves the purpose of giving its exports an extra boost. But that doesn't render the recent changes in its value artificial.

Despite what some US lawmakers had been claiming, in May the International Monetary Fund said that the renminbi could no longer be considered undervalued.

And according to the Bank of International Settlements, China's effective exchange rate has appreciated by more than 13 percent in the past year alone. The falls this week don't come close to offsetting that.

Let's be clear: what was artificial was the situation where China tightly pegged the value of its currency to the US dollar.

In fact, this wasn't just artificial: economic theory and practice says that it was downright dangerous for both China and the global economy.

A decade ago it might have made some sense. China's economy was less than half the size that it is now, growth was driven by exports, particularly to the US, and its borders were far more closed to international investment flows.

But in 2015 it is the world's largest economy in purchasing power terms, growth has been entirely dependent upon domestic consumption and investment since 2010, and capital controls have been rapidly removed with an eye on the RMB being accepted as a reserve currency by the IMF in a review scheduled for later this year.

In that environment it's a flexible currency that delivers economic stability. China has been the odd one out amongst major economies in having an exchange rate that doesn't respond to changes in economic conditions at home and abroad.

Australia has spent the past decade marvelling over a flexible exchange rate in action.

During the mining boom it was a sharp appreciation in the Australian dollar that spared the economy from rampant inflation. Now a falling dollar is providing demand with much needed support.

An increasingly popular narrative about China is that market reforms have stalled. But as far as the economy at large is concerned, this week's events show that the two most important prices have been let off the leash.

The other is interest rates. Lending rates were fully liberalised in 2013 and in May this year banks were given flexibility to charge up to 1.5 times the official rate on deposits. There's growing confidence that full interest rate liberalisation will be achieved by the end of this year.

And now we've had China's central bank come out and say that at the beginning of each day the value of the renminbi will be set with reference to the direction the currency moved the day before. This means that we should expect to see greater changes in the exchange rate over time.

The global economy doesn't need to fear that China has fired a salvo in the currency wars. The bigger worry is that China's authorities will get spooked by the flexibility they've just given their currency and retreat to old habits.