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Chi on China

Will China Join the Currency War?

Victory at all costs, victory in spite of all terror, victory however long and hard the road may be; for without victory, there is no survival.

Winston Churchill

SUMMARY

- If global growth remains lacklustre, the currency war is likely to continue as many countries have lost monetary and fiscal policy flexibility. Some market players predict that the renminbi might soon be dragged into the currency war and be devalued by 10%.
- Indeed, strategic analysis, using Game Theory, shows that even rational governments have strong incentives to engage in a currency war, even though such a war is a negative sum game with a lose-lose outcome when everyone is involved.
- China's weak growth momentum and intensifying deflationary pressures together with a weak euro and yen are increasing the tail risk of renminbi devaluation, although this is not our base case. If China were to devalue, it could send global interest rates and Asian and commodity currencies lower.

Some analysts are predicting a 10% devaluation of the renminbi in the coming year, which is an important tail risk when weakness in the euro and yen may prompt Beijing to recalibrate its FX policy stance[1]. We

[1] This is because Europe and Japan are two of China's largest export markets, and the euro and yen are the second and third largest component in the renminbi currency basket that have sharply driven up the renminbi's real effective exchange rate for more than a decade.

have warned about the renminbi devaluation risk[2], but have also argued that devaluation would not be the best option for China[3]. On balance, Beijing's rational policy response would still be for it to resist joining currency war. The change (on 11 August) in the renminbi's daily fixing regime, which weakened the RMB-USD exchange rate by 1.86% overnight, is not a harbinger for renminbi devaluation.

If the global economy fails to regain healthier growth, a currency war will likely prevail because in a world of feeble growth and insufficient policy levers to boost aggregate demand, currency devaluation can be a useful tool to stimulate growth. But in competitive devaluation, one country gains at the expense of the other. The resultant increase in FX volatility will raise the cost of international trade and investment, leading to contraction in capital flows and global growth and, thus, a lose-lose outcome.

So countries should avoid such an outcome, right? Not necessarily. To maintain their strategic positioning, even rational governments would have a strong incentive to devalue, and the only stable equilibrium would be one in which everyone devalues.

The cost

A currency war leads to higher FX volatility, thus increasing FX risk and the cost of cross-border transactions. Higher hedging costs, plus the negative impact of a strong currency, will squeeze the profit margins of exporters in the non-devaluing countries, prompting companies to focus on their home markets at the expense of international markets, thus dampening global trade. It will also discourage foreign direct investment (FDI) flows and strengthen the home bias for capital flows, increasing the cost of capital in countries that run current account deficits.

In the end, a currency war only leads to heightened FX volatility exacting a toll on international trade and capital flows. The more intense the competitive devaluation, the higher is the cost in terms of hedging and trade contraction and slower economic growth. It is a negative sum game.

The currency war game

So why do governments still engage in currency wars? Will China be dragged into the battlefield? The "prisoner's dilemma" framework of Game Theory helps us analyse FX policy decisions and sheds some light on China's strategic position in the currency war. Here is the game:

Assume two countries, Europe and Japan, do not communicate with each other on their FX policy moves. Each has the option to either devalue its currency or stay put. Let us further assume the game delivers the pay-offs depicted in Table 1.

- If Europe devalues but Japan stays put, Europe gets 1% growth and Japan contracts by 2%, as Europe will be better off by attracting FDI and boosting GDP growth at the expense of Japan.
- On the contrary, if Europe stays put and Japan devalues, its growth shrinks by 2% while Japan gains 1%.
- If both devalue together, each country's growth shrinks by 1% because any gains in competitiveness will be offset by higher FX risk, which will reduce FDI, trade and economic growth for both countries. For Europe, this is still a better outcome than staying out and getting -2% growth alone.
- If both stay put, there is 0% growth impact for both.

[2] See "*Chi on China: Currency War, a New Episode - Yen versus Renminbi*", 26 March 2014.

[3] See "*Chi Time: Renminbi Devaluation Not China's Best Option*", 7 May 2014.

Table 1: The prisoner's dilemma of currency war

	Europe devalues	Europe stays put
Japan devalues	-1 for Europe -1 for Japan	1 for Japan -2 for Europe
Japan stays put	1 for Europe -2 for Japan	0 for Europe 0 for Japan

It is clear that no matter what the other decides, each country gets a higher pay-off by devaluing its currency. The reasoning involves a dilemma that neither country knows what the other will do. Strategically, devaluation is the best choice for both Europe and Japan. So both countries have a strong incentive to devalue, even though that would make them both suffer 1% growth contraction, and even though staying put would yield a better outcome of 0% growth for each. When more than two countries are playing this game, the increase in FX volatility, risk and hence cost on capital flows and economic growth are much higher.

The renminbi tail risk

The latest episode of the currency war has been fought at the expense of the US dollar and the renminbi, whose trade-weighted exchange rates have risen sharply. In China's case, both its nominal and real effective exchange rates have risen for more than a decade, but the rate of appreciation has sped up since the currency war started in 2010[4].

China's weak growth and intensifying deflationary pressures are creating concerns among some Chinese officials about the strong renminbi further damaging the local economy. Hence, some market players are predicting that China might join the currency war by devaluing the renminbi to find an escape route.

The PBoC's recent move on changing the renminbi daily fixing's calculation, which caused the renminbi to fall against the US dollar by 1.86% on the first day of change should not be seen as a policy shift towards devaluation. It is a reform step towards increasing market forces in renminbi trading[5].

Our base case remains that Beijing will continue to resist the devaluation temptation because it:

- Would not significantly help Chinese exports and economic growth[6]
- Could lead to destabilising capital outflows due to expectations of further devaluation
- Could exacerbate the financial burden of those Chinese companies with large and unhedged foreign currency (mainly USD-denominated) debt

[4] See "*Chi on China: Up or Down? The Knowns and Unknowns of the RMB New Normal*", 28 January 2015.

[5] Starting 11 August, the daily fixing will be based on the previous day's average market closing rate as quoted from the China Foreign Exchange Trading System, the onshore foreign exchange market made up by 35 large banks designated by the monetary authorities. Before the change, the daily fixing rate was calculated as the moving average of the closing rates in the past ten trading days. Nevertheless, the PBoC has retained discretion to adjust the ultimate fixing rate according to market demand and supply conditions.

[6] See footnote 3.

Given the prevailing short-term negative sentiment towards the renminbi, the move to reform the daily fixing regime does signal a minor policy shift from the previous "stable renminbi with a strong bias" to now "stable renminbi with a weak bias", with the bias being determined by market sentiment.

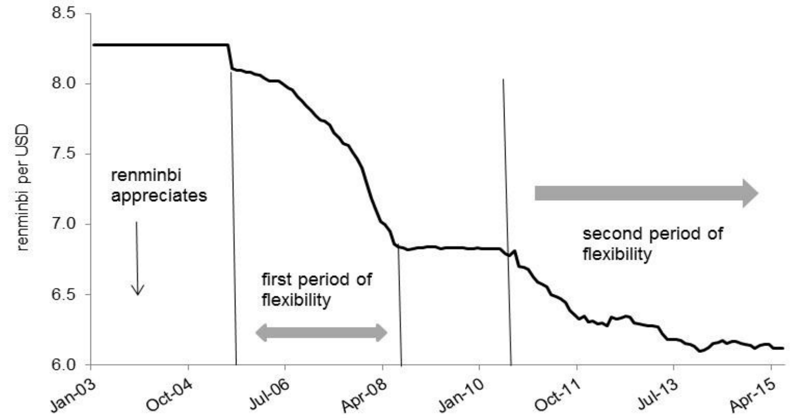
However, if we consider Beijing's FX policy in the context of the prison's dilemma that it is facing in the currency war environment, especially if the euro and yen continue to weaken, a policy shift to devalue the renminbi could become a crucial tail risk in the short-term.

Tail risk implications

If China were to join the currency war, it could trigger competitive devaluation in Asia due to the increasing number of Asian currencies that have been closely tracking the movement of the renminbi in recent years. Technically, this is equivalent to the emergence of a renminbi bloc in Asia.

China has had two periods of renminbi flexibility against the US dollar: the first ran from June 2005 to June 2008, the second started in June 2010 and is still extant (Chart1). Since June 2010 when Beijing allowed the renminbi to "float" within a wider trading band against the US dollar, the number of Asian currencies tracking the renminbi's movement has increased compared to the first period of flexibility. Meanwhile, the number of Asian currencies tracking the movement of the US dollar and the euro has fallen since mid-2010.

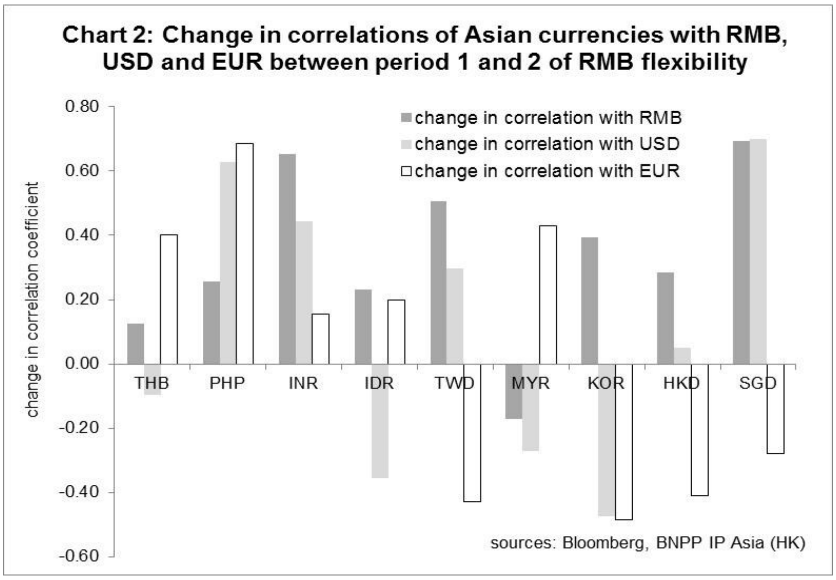
Chart 1: RMB-USD exchange rate



sources: CEIC, BNPP IP Asia (HK)

The correlations between the renminbi and the major Asian currencies have also increased since mid-2010 compared with the first period of flexibility, with eight out of the nine Asian currencies in our sample seeing increased correlation (Chart 2). This implies that the Asian majors have been tracking the renminbi's movement more closely than before.

The rise of a renminbi bloc in Asia is a natural result of China's increasing economic ties with the region. Countries that trade with China or are part of the supply chains centred on China have a strong incentive to minimise exchange rate volatility against the renminbi than against the US dollar or the euro.



A corollary of China joining the currency war is that it could exacerbate the Asian currency battles and send global rates lower. It would also be bearish for commodity currencies, which track Chinese demand. Finally, the resultant market volatility would be bullish for US Treasuries, as capital flows head for a safe haven. This would reinforce the downward pressure on global interest rates.

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