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THE VIEW
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Rebalancing act

Yuan devaluation does not signal the start of a currency war. It is just economics, making exports cheaper and attracting foreign exchange

"The shot heard around the world" triggered the start of the first world war after a Serbian assassin shot the Archduke Franz Ferdinand of Austria in 1914. Analysts are asking whether the shot from the People's Bank of China in devaluing the currency this week will start a global currency war.

China's economic problems appeared to be largely domestic and in control because of the limited way that capital can be transferred in and out of the country. The government has already prevented a property market meltdown, stimulated and then rescued the stock market, and recapitalised highly indebted local governments.

No one expected that, after so many protestations to the contrary, China would mess with its currency.

The exchange rate has been, up to Tuesday, virtually pegged on average this year at around 6.19 yuan to the dollar, even though the economy has continued to weaken. The euro meanwhile has weakened 9.4 per cent, the yen by 4.6 per cent and the aussie by 13 per cent. In the BRIC countries, the real is down 31 per cent, the rouble by 11 per cent, and the rupee by 2.5 per cent against the dollar this year.

The clarion calls for a stronger renminbi just three years ago are now silent. Low domestic demand, no inflationary pressures, static industrial production, and weakening export figures have done little to dent the impression that the currency was a little too strong for its own good.

Yet China desired to strut its geopolitical stuff on the world stage and that meant a strong renminbi regardless of economic performance at home. It wanted to become part of the International Monetary Fund's special drawing rights, a form of reserve currency. It wanted a strong currency for Chinese companies to buy foreign assets. It wanted to feel that in the eyes of many, mistakenly, a strong currency equals a strong country.

> **Strong currency hinders exports – pretty crucial to an export-led economy**

Devaluation will cure some problems and create others. Photo: AFP

The fact that the Chinese currency was pegged to the US dollar through capital controls gave the impression that despite a little local difficulty, everything was fine.

But economics is like "whack-a-mole"; you solve one problem then another one crops up.

A strong currency hinders exports – pretty crucial to an export-led economy. A strong currency policy means that you cannot reduce interest rates to help the domestic economy and ease the debt burden for fear of weakening the currency. And all of this was happening amid the noise of a US interest rate rise that pressured the yuan to keep pace.

Devaluation cures a lot of economic ills as it makes exports cheaper and brings in foreign exchange. However, trading countries who feel that their economy is in better shape may feel that the devaluer now has an "unfair" advantage.

But it is not a case of starting a currency war, it is pure economics and the beauty of economics is that it rights the balances in free markets or foul.

Serial devaluation is not the answer; it can be a curse or a drug as Britain found in the 1960s and '70s. Sustained currency weakening worked at first, but in the long term led to stubbornly high inflation, low growth – and a booming stock market, for sterling investors alone.

China doesn't care if other countries are hurt by the yuan, just as the US doesn't care if domestic economic policy affects the dollar. The mantra of US treasury secretary John Connally in 1971 still rings true, "it is our currency and your problem".

Devaluation has sideswiped the Malaysian ringgit and the Indonesian rupiah, which have touched lows last seen in the 1997 financial crisis. Traders fear for the won, the loony (Canada), the kiwi, and the aussie – all big exporters to China – should the PBOC continue to capitulate.

It is not a currency war but just plain old economics of balance and rebalance. China's devaluation means lower cost exports that will facilitate lower prices in the US; more buying of China's goods will stimulate both economies. If it were a war, China would not have changed policy; revealing its weaknesses, and seeking the market's help to rebalance the economy.

However, if the Fed delays increasing US interest rates because of a misplaced notion that it wants to see inflation, the wounds could be serious. For while money costs next to nothing, there is an insidious, silent and creeping increase of debt. If a weak yuan becomes the prelude to the next debt-fuelled crash, it really will be the shot that is heard around the world.

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