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How does the devaluation of the renminbi impact global trade?

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POLICY INSIGHTS

HOW DOES THE DEVALUATION OF THE RENMINBI IMPACT GLOBAL TRADE?

- The depreciation of the *renminbi* below seven to the US dollar last week marks a significant development in the US-China trade war.
- In addition to increased production costs, companies may see a slight rise in the rate of inflation.
- Signals from Beijing indicate that after the initial drop, the *renminbi* is unlikely to devalue too dramatically, unless further developments in the trade war push Beijing towards a more aggressive monetary policy.

On 5th July, both the onshore and offshore *renminbi* ‘smashed seven’ (*poqi*) for the first time since 2008, with its value dropping by 1.5% to 7.05 *renminbi* to the dollar. This has rattled global markets, with many indexes reaching record lows: Japan's Nikkei dropped by 1.7%, the S&P 500 index falling 3.0% and the FTSE 2.5% in one day alone.[1]

This development reduces the likelihood of a swift resolution to the trade war. There is still some level of debate as to whether the drop should be considered the result of simple market forces or is part of a coordinated policy strategy out, in any case, China seems reluctant to spend its foreign exchange reserves to continue bolstering its currency.

As a result, tensions between Beijing and Washington have been on the rise. After designating China as a currency manipulator in response, Washington has been putting out mixed signals on the next move for the US dollar.

President Trump in particular seems undecided, declaring that he won't push the Fed for a weakened dollar one day and then tweeting about the benefits of a weak dollar the next.[2]

Devaluation of the US dollar seem unlikely, however. It is less easy to manipulate, due to the relatively high demand for it as a 'safe haven' currency, fewer levers with which the Fed can use to dilute the dollar and the implications of dollar depreciation for key US allies. Furthermore, the Fed has already cut interest rates in response to the wider pressures of the trade war and is unlikely to cut rates further. The norms that ensure the Fed remains fully independent are also still likely to stay in place for the long term, limiting the ability of the Executive to exert too much influence on the currency. Therefore, the most likely outcome is a relatively strong dollar and a *renminbi* that stabilises at just past seven to the dollar. At the same time, Beijing is likely to see these signals as evidence that it needs to be prepared for an increasingly combative trade war.

What does the *renminbi*'s new normal mean for business? The drop in the value is too small to produce the dramatic market response to the *renminbi*'s devaluation in 2015, and regular communication from policymakers should help markets to adjust. In fact, there have been warnings against attaching too much importance on the upper limit of the *renminbi* at above seven to the dollar coming from political insiders since the end of May when former Governor of the People's Bank of China, Zhou Xiaochuan, stated that it was an "overreaction" to believe that seven to the dollar was a red line for the *renminbi*. This signalling indicates that the devaluation has been anticipated, if not planned, by Beijing for some time, and so markets need not be too concerned about uncontrolled downward movements in the currency.

The most visible shift will be a rebalancing of imports and exports. Exporters to China will see an immediate increase in their retail prices in-market, encouraging consumers to favour domestic products. Many Foreign-Invested Enterprises (FIEs) may also find that their supply chains are more globalised than the average Chinese corporation, making production costs and profit margins more sensitive to currency fluctuations. Recent claims have emerged that Tesla will be raising their prices due to the currency devaluation, for example, and other companies are likely to quietly follow.[3] While hedging may limit the impact of these shocks, companies that don't have the resources to maintain sufficient reserve funds - such as SMEs - may be disproportionately affected.

Business will also have to navigate the long-term implications of devaluation on the Chinese economy. As domestic companies face less pressure to compete with imports, the prices of their products and services will increase, potentially causing inflation to rise. China has been attempting to encourage consumption as a key driver of the economy, but the impact of tariffs on prices may couple with falling consumption rates to further erode the general public's spending power. In the event of a protracted trade war, therefore, companies must be prepared for the possibility of a drop in demand.[4]

At the same time, currency devaluation presents a mixed picture for future investment. On the one hand, a cheaper *renminbi* encourages foreign investors to channel money into China in the short term with the promise of favourable exchange rates. On the other, those looking to invest for the long term may be pessimistic in the face of a slower rate of return and uncertainty as to where the new ‘ceiling’ for the *renminbi*’s value may stand. While this may not have an immediate impact on the investment plans of FIEs, uncertainty in capital markets can lead to further depression of the wider market and reduce prospects for growth. For now, companies should expect the *renminbi* to continue hovering at just over seven to the dollar, but shore up reserves just in case the trade war takes another unexpected turn.

[1] 'Stocks have their worst day of 2019 as U.S.-China trade war escalates’. Los Angles Times, Aug 2019

[2] 'Trump presses Fed to respond to Chinese 'currency manipulation’. The Hill. Aug 2019.

[3] ‘Tesla considers raising prices in China from September: sources’. Reuters. Aug 2019.

[4] ‘Dow closes 390 points lower, loses grip on 26,000 as 10-year Treasury hits 1.64%’. Market Watch, Aug 2019.

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