THE WALL STREET JOURNAL.

Do Not Fear the Yuan Devaluation

The critics are wrong. Beijing is taking the right steps toward achieving a currency valuation based not on manipulation but on market forces.

August 18, 2015

Fred Hu
Founder and Chairman of Primavera Capital Group

Global markets greeted China’s currency adjustment last week with alarm. Many investors and commentators regarded the latest move by the People’s Bank of China as a sign of desperation, revealing Beijing’s deep anxiety over sluggish economic growth and worsening financial fragility. Devaluation, they claim, is the last bullet in Beijing’s arsenal to revive sagging exports and to reboot its economy.

Critics add that further plunges in the Chinese currency could take other currencies, global equities, fixed income and commodities into a prolonged period of turmoil. Some observers even evoke the 1997 Asian financial crisis, predicting havoc for the world financial system.

Such reactions are grossly exaggerated. For more than two decades, the yuan has been a bastion of stability, enjoying steady and significant appreciation against almost every other major currency. The problem is not its value, but how that value is established.

After ending its de facto peg against the U.S. dollar in 2005, the yuan has been under a managed float. The PBOC fixed the central parity rate daily but permitted the exchange rate to move around within a very narrow band. And for much of the past decade the yuan appreciated.

But recently, as China began experiencing softening GDP growth, weakening exports and increasing capital outflows, the yuan stopped reflecting economic fundamentals. As the central parity rate mimicked too closely the resurgent dollar, the yuan became too strong relative to all other major currencies.

Just as the recent selloff in the Shanghai and Shenzhen stock markets was a necessary correction from overextended valuations, the PBOC’s latest currency move was a necessary adjustment to correct the misalignment. It’s not a drastic devaluation to reverse China’s export performance but a modest start to let market forces gradually guide the yuan to align with the new economic reality.

As China embraces a transition to a freer floating exchange rate, it’s likely to witness more currency fluctuations. In the short term, the yuan will further depreciate against the dollar and other major currencies. But it’s highly unlikely that it will go through a rapid free fall.

China still runs sizeable trade- and current-account surpluses, and the yuan continues to be supported by the largest foreign-exchange reserve in the world. It has the will and resources to stabilize the yuan if needed. A persistent and pronounced yuan depreciation is only an imaginary fear.

Another exaggerated risk preoccupying investors is the rising tension between Beijing and Washington over currency polices, particularly as President Xi Jinping's September visit to the U.S. approaches. For years the U.S. has prodded China to move to a market-determined exchange rate system. Now China has done just that.

Washington must accept that greater exchange-rate flexibility means two-way fluctuations for the yuan. The U.S. can no longer credibly charge that China is a major source of global imbalances. Whatever short-run movements might occur in the yuan-dollar exchange rate, they are predominantly an outcome of market forces, not a result of manipulation.

While China's economy continues to face significant downward pressures, the country has considerable scope to take monetary, fiscal and, most importantly, structural-reform measures to reflate the economy and achieve sustainable growth. China has a strong track record of managing tough economic times through sensible domestic measures, not beggar-thy-neighbor policies.

Even in the darkest of times, during 1997 and 2008, China never attempted to export its way out of economic trouble via currency devaluation. China's commitment to domestic, consumption-led growth is genuine and stronger than ever.

It is against this backdrop of China's transition to a new growth model that the PBOC has hastened the pace of monetary and financial reforms. It has accelerated liberalization of interest rates, the exchange rate and the capital account.

Meanwhile, China is making steady progress toward expanding the international role of the yuan. In all likelihood, the yuan will be a stable and strong currency consistent with China's rising global status.

In light of China's sheer size and the challenges of implementing complex structural reforms, there will be plenty of uncertainty and risks emanating from the country that will impact global markets. But China's currency is the last thing that should cause investors to lose sleep.