Shift Afoot in China?

Just noise or a real signal? The hypothesis that the sudden drop in the Chinese currency in recent days is unlikely to have major repercussions and has been orchestrated by the authorities in the sole aim of curbing speculative flows on the currency, is not completely unfounded given the wide-scale efforts to eradicate the growing sources of shadow banking. Assuming the hypothesis is true, the move would be a sea change, and a worrisome development for a number of domestic sectors that are heavily-dependent on foreign financing, although one with no major direct consequences on other countries.

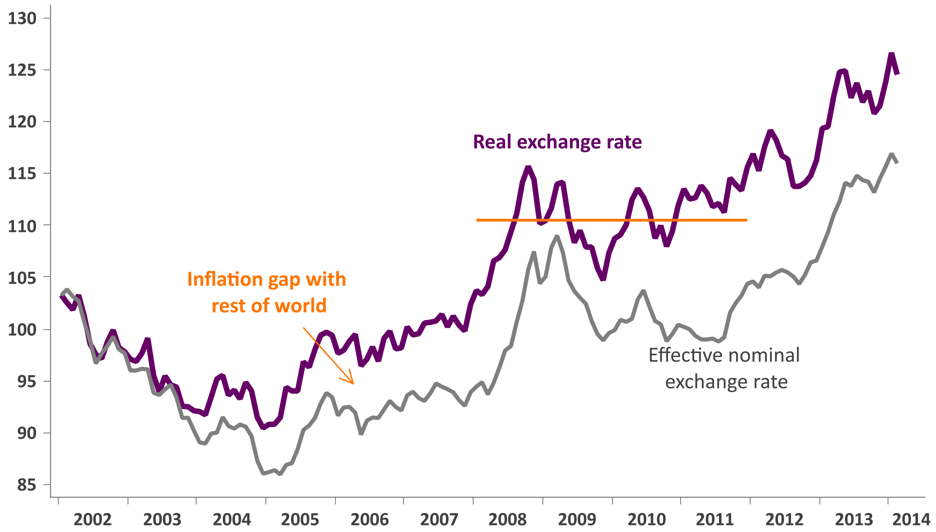
However, the reasons liable to underpin a strategic shift with a view to provoking the yuan's depreciation are more than sufficient to support the idea that a forex policy shift is afoot in Beijing - with much more potential damage occurring abroad. After two years of near-continuous increases, the appreciation of the Chinese currency is a major handicap for the country and cannot, by all accounts, continue indefinitely. Consequently, the time of the much-feared policy shift, which we have been fearing for several quarters now, may have finally come (for more on this subject "2013-2014 Scenario: The Financial Crisis, Act III… and Epilogue?").

Unsustainable Appreciation

Since peaking in mid-2011, the exchange rate of the yuan has appreciated 19% in nominal terms and 16% in real terms given China's inflation gap with the rest of the world throughout the period. Stage-managed, in part, by the Chinese authorities since 2010, the appreciation met several goals simultaneously:

- An effort to appease critics of Chinese forex policy, which is generally considered to be unfair, while its strategy of increasing openness called for a degree of economic diplomacy
- A commitment to reducing the growing cost of commodities that China is largely dependent on (one-third of its total imports)
- And, most likely, a desire to increase the currency's purchasing power in order to help Chinese firms go global.

Yuan Exchange Rate, 2002=100

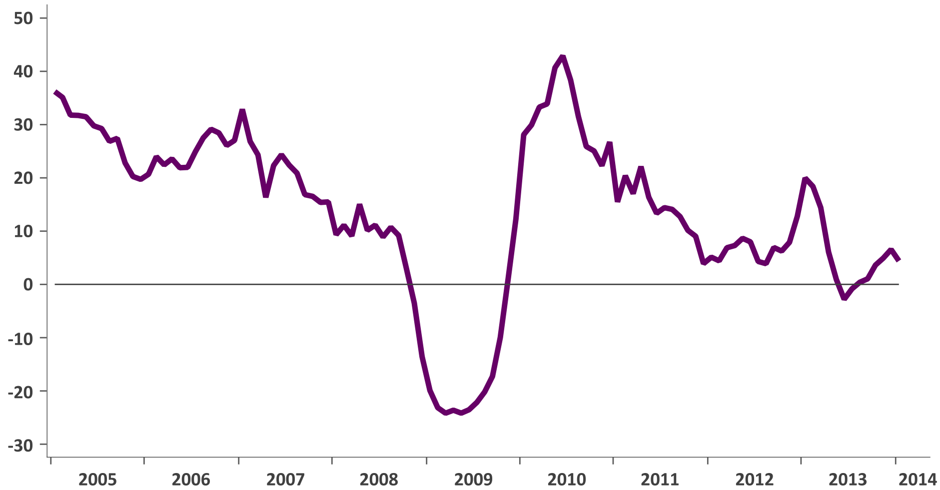


Sources : RichesFlores Research, Macrobond

This strategy was not very onerous, and even provided significant benefits when the economy was on the verge of overheating in 2010-2011, but has become a bigger liability in recent years as Chinese companies have been hit by spiraling export losses and heightened instability on the domestic front.

Export Growth of Manufactured Products

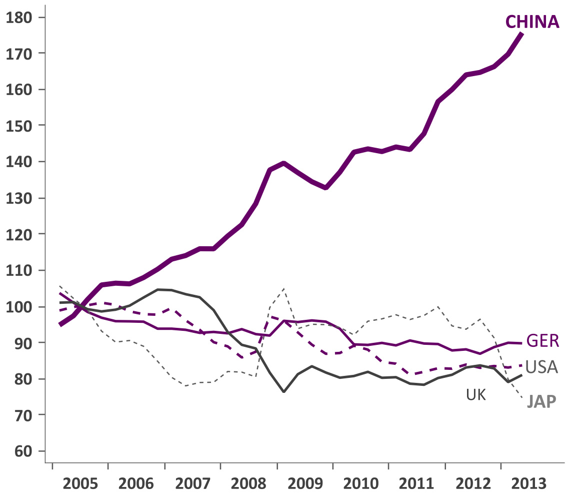
YoY in %, 3MMA, CNY



Sources: RichesFlores Research, Macrobond

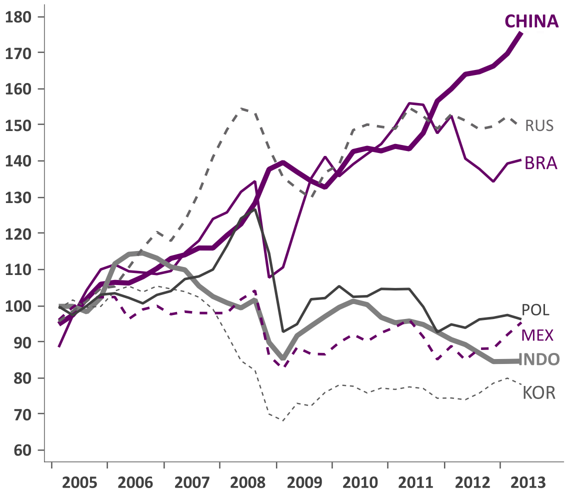
While it has been proven that domestic consumption growth would not be enough to ensure the longevity of Chinese industry, allowing the country's competitive position to deteriorate further would not make much sense either. In fact, productivity gains, which are in a structural decline, and the appreciating exchange rate have already significantly eroded the competitiveness of Chinese companies in the last several years. According to OECD estimates, China's unit labor costs relative to the main industrialized countries as well as most major emerging markets (with the exception of Brazil and Russia) have surged by over 100% since 2005.

Relative Unit Labor Costs, 2005 = 100



Sources: RichesFlores Research, OECD, Macrobond

Relative Unit Labor Costs, 2005 = 100



Sources: RichesFlores Research, OECD, Macrobond

Currency War

Against this backdrop, the depreciation of the yen from December 2012 and the fall of most emerging currencies since the summer of 2013 have undoubtedly increased pressure, which could compel the Chinese authorities to break with their past strategy.

The signal from the past few days could mark a very worrying crossroads that could be equated with an escalation of the economic war being waged by a growing number of the world's economic powers. After the United State and Japan, a policy that would depreciate the Chinese currency would most certainly have terrible consequences both in terms of international trade and the global economy. Liable to worsen the crisis in a number of emerging markets, such a shift by China would not spare the developed world, particularly the countries of the euro area…

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