

China's Currency Devaluation

August 17, 2015 (IN10342)

-|

-|

James K. Jackson, Specialist in International Trade and Finance (jjackson@crs.loc.gov, 7-7751)

On Tuesday, August 11, 2015, the People's Bank of China (PBC), China's central bank, surprised global [financial markets](#) by lowering the reference rate of the renminbi, effectively depreciating the currency, and adopting a new method for determining the currency's value. Some observers view this action as part of China's recent efforts to move toward a more market-oriented exchange rate—a view that could be reinforced if China allows its [currency the same latitude to appreciate](#). Congress has had long-standing interest in how China manages its currency (see CRS In Focus IF10139, [China's Currency Policy](#), by Wayne M. Morrison).

The PBC's action on August 11 led to an immediate 1.9% depreciation of the renminbi, the largest one-day devaluation of the currency in more than two decades, and more than 4% since August 11. By August 12, 2015, the PBC also intervened in foreign exchange markets to blunt further depreciation of the renminbi by instructing Chinese banks to sell dollars, effectively attempting a "managed depreciation." The PBC's announcement negatively affected major stock markets and the stocks of firms that do a significant portion of their business in China. It also pushed up the value of bonds, particularly U.S. Treasury securities, which often are considered safe haven securities during times of financial or economic uncertainty. The move also negatively affected the currencies of other countries and prompted concerns over the prospects of a "[currency war](#)," or competitive devaluations of currency exchange rates. The move could increase pressure on the currencies of other nations that are deemed to be overvalued; for instance, Vietnam announced on August 11 that it was widening the band within which it would allow its currency to fluctuate.

According to various reports, the PBC moved to adjust the renminbi in response to a number of developments:

- China reportedly is attempting to move toward a market-determined exchange rate to enhance its prospects of being recognized as a reserve currency along with the dollar, the pound, the euro, and the yen by the [International Monetary Fund](#) (IMF).
- Over the weekend, China released data that showed its exports had fallen at an annual rate of more than 8.0%, reflecting the slow pace of global economic growth and the relative appreciation in the value of the renminbi as a result of its peg to the dollar.
- The pace of economic growth in China is slowing to an estimated annual rate of 7.0%. Unofficial estimates indicate that growth may be closer to 4% this year.

Prior to the move, the PBC had set the renminbi's exchange rate each morning within a band of plus or minus 2% around a target rate. Going forward, the PBC announced that it would set the exchange rate, with the 2% band, based on the market rate from the close of the previous trading session. The band serves to limit the extent of movements in the value of the currency, presumably to reduce the prospect of a currency run.

To date, the devaluation of the renminbi has been small with likely limited effects on the real economy. Financial market reactions, however, likely reflect the growing role of China in international financial markets and the prominent role that China plays in international trade. Financial market reaction also may reflect concerns about weaknesses in the Chinese economy that may pose additional challenges to the global economic recovery. Some market observers reportedly are concerned over the ability of the Chinese government, which has been criticized for its handling of a sharp drop in the value of its main stock markets in July 2015, to successfully manage its economy (see CRS Insight IN10325, [China's Recent Stock Market Volatility: What Are the Implications?](#), by Wayne M. Morrison and Gabriel M. Nelson). According to some reports, the Chinese government took extraordinary steps to stem the drop in the stock

market by encouraging financial institutions to increase their lending to investors; freezing initial public offerings; cutting interest rates; forcing state-owned companies and funds to buy shares; and threatening to prosecute short-sellers. These actions have raised questions about the government's resolve to liberalize financial markets and its ability to navigate the challenges of a slowing economy and potential continued market pressure on the renminbi. Taken together, these economic issues could pose a political challenge to China's leadership.

The devaluation of the renminbi will improve the price competitiveness of Chinese exports, which likely will put additional pressure on other economies in the region to follow suit. The lower renminbi also would be expected to increase China's exports—a tactic that some observers argue is the primary motive behind the devaluation. This devaluation, however, comes at a time when both the euro and the yen have depreciated against the dollar as a result of expansionary monetary policies, an action that normally would be expected to promote exports from those areas. These devaluations increase the risk of further depressing international prices for goods and raw materials, potentially adding to concerns over deflation. Market reactions may also reflect uncertainty over the actual market value of the renminbi and how aggressively traders will challenge the resolve of the PBC to allow the currency to adjust to market forces. In such circumstances, the Chinese economy could experience continued capital outflows and a prolonged period of gradual currency depreciation that could involve additional Chinese government intervention in foreign exchange markets. Under such a scenario, the renminbi could face either a "soft" landing (a gradual adjustment) or a "hard" landing (an abrupt adjustment) in its value.

For the United States, the devaluation of the renminbi has mixed effects. Lower prices for imports from China and lower commodity prices overall likely will constrain inflationary pressures in the United States and elsewhere and provide a boost to consumers' real incomes. In addition, foreign demand for U.S. Treasury securities (as a safe haven) should keep interest rates below the level they would reach otherwise and potentially reduce pressure on the [Federal Reserve](#) to raise interest rates. At the same time, the combined effect of lower values for the renminbi, yen, and euro relative to the dollar makes U.S. exports more expensive in global markets, which likely will reduce global demand for U.S. exports, place increased pressure on import-sensitive industries, and may intensify concerns in Congress over currency issues. (See CRS Report R43242, [Current Debates over Exchange Rates: Overview and Issues for Congress](#), by Rebecca M. Nelson.)