The Economist

China's exchange-rate policy

Currency peace

Devaluing the yuan would do China more harm than good

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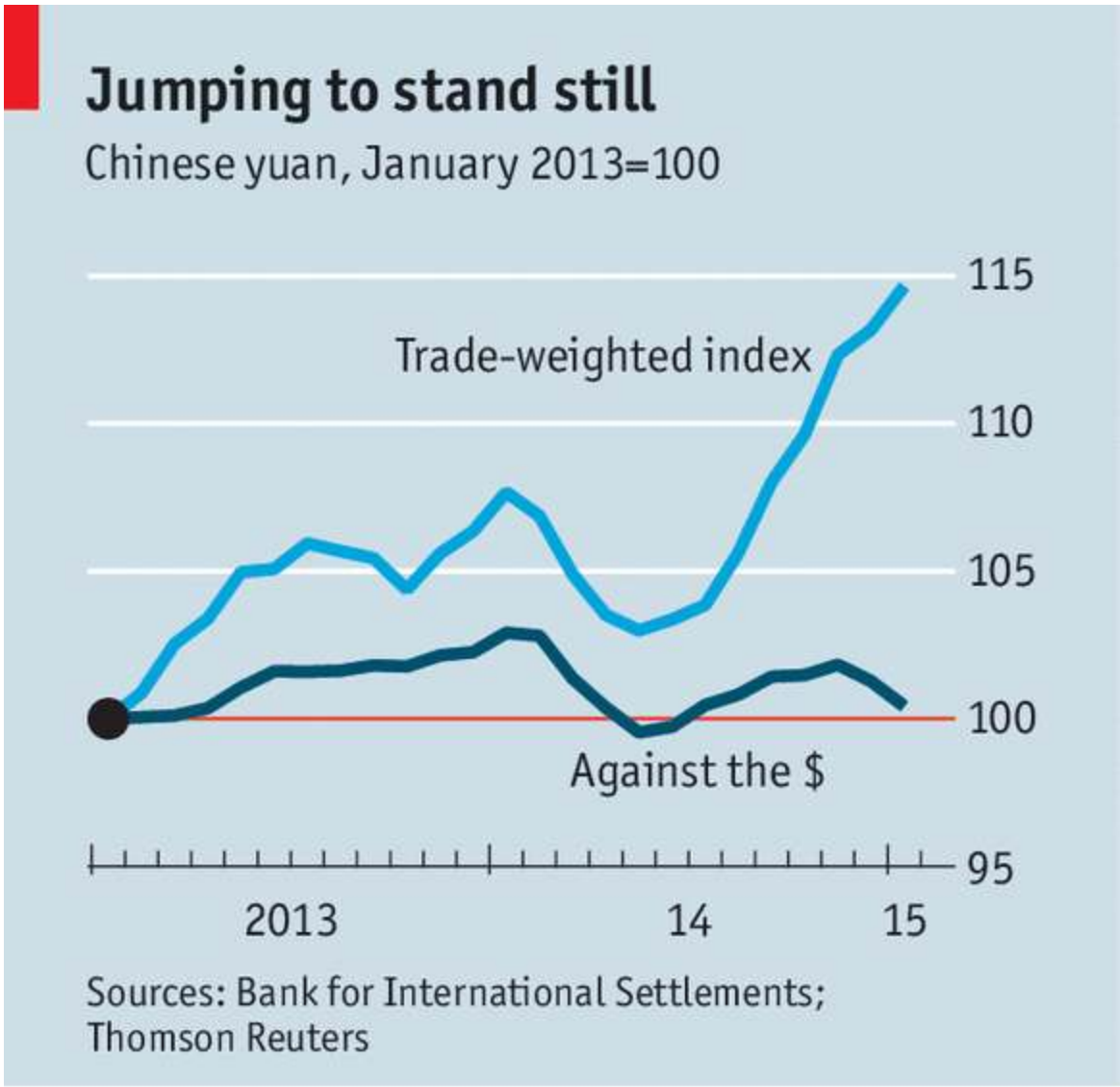
CHINESE officials tired of defending their



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exchange-rate policy can at least appreciate the irony in the latest charges levelled against them. For years foreigners accused them of keeping the yuan artificially weak to boost exports. Now, domestic critics say, they are doing just the opposite: keeping the currency artificially strong and, in the

process, wounding the economy. Some predict China will soon change course and engineer a devaluation. But just as the Chinese authorities did not resort to a big one-off appreciation when the yuan seemed too weak, they are unlikely to embark on a dramatic devaluation now that it is looking strong.

The yuan has been one of the world's top-performing currencies this year. The reason is simple. Although China claims to be trying to manage the yuan's value against a basket of currencies, in practice it is still loosely pegged to the dollar. As the dollar has risen against most currencies over the past seven months, the yuan has hitched a ride. The dollar is up by 18% since July against the world's seven most traded currencies, but by only 0.6% against the yuan (see chart). As a result, the Chinese currency is at an all-time high in trade-weighted terms.

Those forecasting devaluation believe the state of the economy does not justify such strength. More than $90 billion (nearly 3% of quarterly GDP) flowed out of China via its capital account in the fourth quarter, a record deficit. The central bank sold a small slice of its nearly $4 trillion foreign-exchange reserves at the same time, implying that it intervened to prop up the yuan.

Devaluation would, all else being equal, let Chinese exporters regain some lost competitiveness. By raising the cost of imports, it would also help China stave off deflation. With monetary easing from Japan to Europe setting up several currencies for bigger declines, it is fair to ask whether China can afford to sit on the sidelines.

Yet the costs of devaluation outweigh the benefits for China, for two reasons. First, it is doubtful that it would deliver the desired economic outcome. Despite talk of currency wars, Asian countries have so far avoided full-scale hostilities over their exchange rates. If the region's biggest economy launches an offensive, others would surely follow, wiping out any advantage it hoped to gain. In fact, a devaluation might hurt the economy. A falling yuan might spur the outflow of capital. It would certainly endanger China's companies, which have amassed $1 trillion in foreign debt, which would become more expensive to service if the yuan lost ground.

Second, the politics of devaluation would harm China. In the short term, there would be renewed complaints in America about Chinese currency manipulation, raising the possibility of countermeasures. In the longer term, it would hamper China's efforts to make the yuan a rival to the dollar. The strongest reserve currencies serve as safe havens when others are in turmoil. During the Asian financial crisis of 1997-98 and the global meltdown of 2008, China maintained a steady exchange rate against the dollar, despite having ample cause to allow depreciation. Such actions have bolstered the yuan's credibility. A rush to devalue now would undermine it.

That said, some weakening of the yuan is likely in the coming months. The central bank has long vowed to give the market greater sway over the exchange rate. With the current-account surplus narrowing and capital flowing out, the market is pointing to at least mild depreciation.

The central bank has also vowed to make the exchange rate more volatile, to wrong-foot speculators and force companies to do a better job of hedging their exposure to different currencies. Guan Tao, an official with the foreign-exchange regulator, sounded such a warning this month, citing an ancient proverb: "A wise man should not stand next to a dangerous wall." The dollar's relentless rise may dislodge a brick or two, but China is not about to let the yuan collapse.

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