

YUAN IS TOO FLEXIBLE FOR SOME

The big story this week was the devaluation of the yuan (Renminbi). This newsletter has a focus on chart and technical analysis, but Guppytraders also provides political and economic analysis to Government, corporates and financial media.

The 3.5% fall in the Renminbi is nothing compared to the three week fall of 7.98% in the Australian dollar in September 2014. It's miniscule compared to the 28% fall in the Australian dollar in the past 16 months. It's similar to the 7% fall in the US Dollar Index in April. It's time to ignore the hysterical commentary from America.

Those seeking proof of the importance of the Renminbi need look no further than the reaction when the Peoples Bank of China (PBOC) set a lower peg for the calculation of the trading band for the Renminbi. Taken at face value this looks to be another round fired in the currency wars that have been simmering ever since the US embarked on the multi year program of quantitative easing.

After years on the receiving end of a worsening global currency war the POBC has taken action. Some believe the real culprits are the large developed economies who slashed interest rates to near zero and embarked on unprecedented money printing that pushed down their exchange rates. The POBC move triggered widespread falls in currencies against the US dollar which can be seen as a global readjustment.

The Renminbi has risen nearly 15% in trade weighted terms over the past year. This added to increasing evidence that the Renminbi was actually over-valued as noted by the International Monetary Fund in July. This, combined with much softer than expected export trade data, has prompted the POBC move. Some would argue it's long overdue.

As with every significant policy decision made by China is often useful to look behind the bluster and outrage to examine the detail. This is a classic strategy of a Secret Escape Through Chen Cang where the opponent is distracted from the real motives.

The change announced by the PBOC means the central bank's daily fixing of the trade band will now reference the previous day's market closing rate. The fixing will now take the midpoint from market makers quotes and the previous day's closing price. This is a particularly significant change because the calculation point for the trading band is now decided directly by the market and not by the PBOC.



The OANDA chart shows the recalibration and the way this settles into new trend behaviour with lower volatility.

Currently the Renminbi can trade 2% either side of the calculation peg, but the position of each days peg is now dependent upon the previous days trading activity. In time we would expect to see the trade band widened to increase Renminbi flexibility.

The International Monetary Fund and others have suggested that this type of situation was necessary for the Renminbi to become an international reserve currency. After more than a decade of US accusations that China was keeping its currency artificially low, the IMF said in July the Renminbi was no longer undervalued although it needed to be more flexible. The POBC has moved to deliver increased flexibility, albeit from a revised starting point.

Most believed subjecting the Renminbi to market forces would lead to a rise in the Renminbi but now there is a strong possibility that this new flexibility will allow the market to push the Renminbi lower in coming weeks. Those who argued for a more flexible Renminbi in the belief it would lead to a rising Renminbi may be disappointed.

China is seeking to gain admission for the Renminbi to the IMF's basket of currencies making up its special drawing rights (SDR). Including the Chinese currency in the SDR basket of elite currencies would be an endorsement of its efforts to open up its financial system and a boost to the country's prestige.

IMF President Lagarde said that recent Chinese intervention to avoid a disorderly functioning of equity markets was the duty of central authorities. The intervention in the currency market can be seen in the same context because the lasting result is increasing flexibility for the Renminbi. It's this flexibility that is an important factor in determining admission to the SDR basket of currencies. Despite US protests, this is a step towards a flexible exchange rate for the Renminbi and it is causing some discomfort.