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CHINA CURRENCY CONUNDRUM

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KEY TAKEAWAYS

The Chinese government is actively working to transition China to a more domestically focused, consumer-led economy.

We believe the recent 3% decline in the yuan is part of a series of Chinese government engineered policy moves to help revive China's "struggling" economy and ease it through this transition.

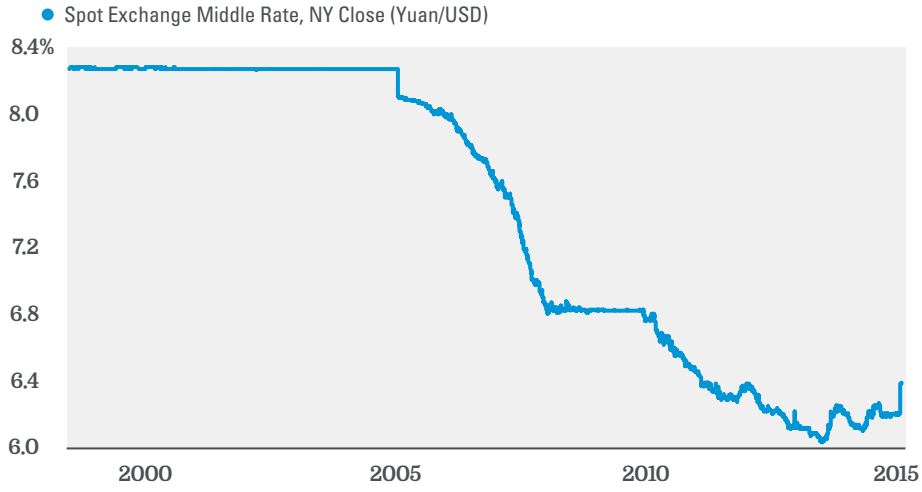
Last week provided another reminder that China's policy actions are still more like blunt instruments than precision tools.

Last week, China altered its currency management strategy, resulting in a 3% devaluation of its currency, the yuan, versus the U.S. dollar. Despite reports suggesting otherwise, this is not the first time China has used its currency's exchange rate as a policy tool. In fact, China has been manipulating the value of its currency for at least a decade, if not longer. The last major revaluation of the Chinese currency versus the dollar came in July 2005, when China uncoupled the value of the yuan from the dollar and tied it instead to a basket of currencies including the dollar, also known as a "managed float." As can be seen in Figure 1, China's currency has been mostly appreciating versus the U.S. dollar (fewer yuan needed to purchase a single dollar) since 2005. Chinese authorities also made major shifts to the currency policy in 2008 and 2010. In August 2008, China tied the yuan back to the dollar in an effort to halt the appreciation in the yuan and to help boost exports. In June 2010, China again moved to a "managed float" and since then, the yuan has appreciated by 11.4% versus the dollar (as of July 31, 2015).

ENGINEERED POLICY MOVES

Last week's policy change caused widespread uncertainty among financial market participants, who feared that the 3% move over a few days was a precursor to a larger devaluation ahead. The Chinese government's unexpected devaluation of the yuan also appears to be at odds with its goal of increasing acceptance of

1 SINCE 2005, CHINA'S CURRENCY HAS BEEN MOSTLY APPRECIATING VS. THE U.S. DOLLAR



Source: LPL Research, *Wall Street Journal*, Haver Analytics 08/17/15

the yuan as a global currency. In general, financial markets prefer free floating currencies (such as the dollar, yen, or euro) to currencies that are pegged to another currency (or basket of currencies) or currencies that use a "managed float" system, like the yuan. Although China has made noises about letting the yuan float freely, until it does, it cannot even be considered in the same league as the dollar, yen, and euro. In the meantime, investors must be prepared for these "one-off" moves by the Chinese government as part of its overall economic policy.

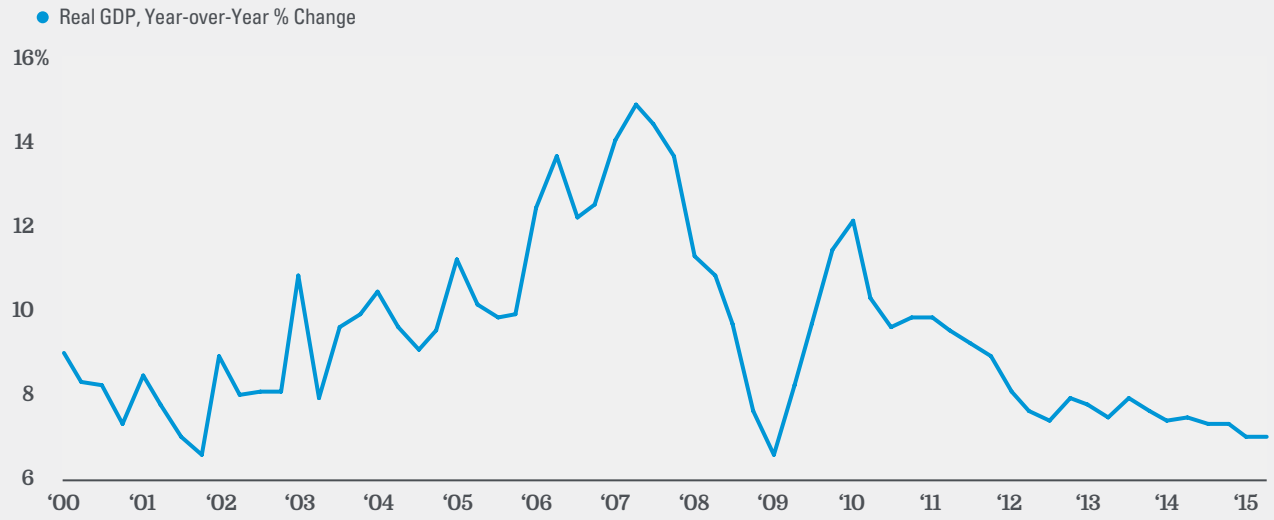
In our view, the 3% decline in the yuan is just another in a series of the Chinese government's engineered policy moves to smooth China's transition from the manufacturing and export-led economy it has been since the late 1990s to a more domestically focused, consumer-led economy. In addition to devaluing its currency to make its exports more attractive to global markets, over the past year or so, the Chinese government has:

- Cut interest rates four times by a total of 115 basis points (1.15%)
- Cut its reserve requirement twice by a total of 150 basis points (1.5%)
- Announced numerous infrastructure spending initiatives
- Loosened rules on home ownership and equity ownership

MIXED RESULTS

The results to date have been mixed, at best. As we noted in our recent *Weekly Economic Commentaries*, "Gauging Global Growth: An Update for 2015 & 2016" and "Global GDP Tracker: Summer 2015 Edition," China's official economic growth—as measured by inflation-adjusted gross domestic product (GDP)—is expected to be near 7% this year and between 6.5% and 7% in 2016, nearly three times as fast as expected U.S. GDP growth and more than twice as fast as global growth. As we noted in our *Midyear Outlook 2015: Some Assembly Required*, China's expected 6.5–7% GDP growth for this year and next represents a significant downshift from the unsustainable 10–12% GDP growth posted by China in the first decade of the 2000s [Figure 2]. We acknowledge that the risk of Chinese economic growth slowing even further in the coming quarters

2 CHINA'S PACE OF GDP GROWTH HAS DECELERATED SINCE THE EARLY 2000S TO NEAR 7% IN 2015



Source: LPL Research, China National Bureau of Statistics, Haver Analytics 08/17/15

remains, as the downturn in some Chinese equity prices, coupled with the deflation of China's property bubble, act as drags on growth.

However, with massive currency and fiscal reserves and restrained inflation, the Chinese government still has resources to help smooth the once-in-a-generation shift from a manufacturing-based export economy to a middle class–driven, consumer-oriented economy. But actions taken by Chinese authorities last week were another reminder that China's policy actions are still more like blunt instruments than precision tools. As the Chinese economy transitions and economies closely tied to China adjust, global economic volatility may increase.

IMPACT OF THE DEVALUATION ON U.S. IMPORTS FROM, AND EXPORTS TO, CHINA

At 13% of global GDP, there's no question that the Chinese economy matters to global growth, especially for growth in commodity-producing emerging markets (Brazil, Russia, South Africa, etc.) and developed economies (Canada, Australia), as we noted in the "Global GDP Tracker" update last week. Although China is the United States' fourth-largest export partner (behind Canada, Mexico, and the Eurozone), just 7% of U.S. exports head to China, versus nearly 30% for the European Union and Japan. Economic growth in both the Eurozone and Japan (which together account for nearly a third of global GDP) is exceeding expectations and accelerating here in 2015 versus 2014, and is expected to continue to accelerate in 2016, which should help U.S. exports withstand the impact of the 3% devaluation of the yuan versus the dollar.

China's devaluation of the yuan last week was a surprise for many market participants; however, it remains consistent with recent policy moves designed to help China's economy transition to a still robust but more mature stage of economic development. While even this small change will produce winners and losers, we do not believe it signals meaningful deterioration in China's expected growth trajectory and we continue to expect improved overall global growth in 2015 and 2016. ■