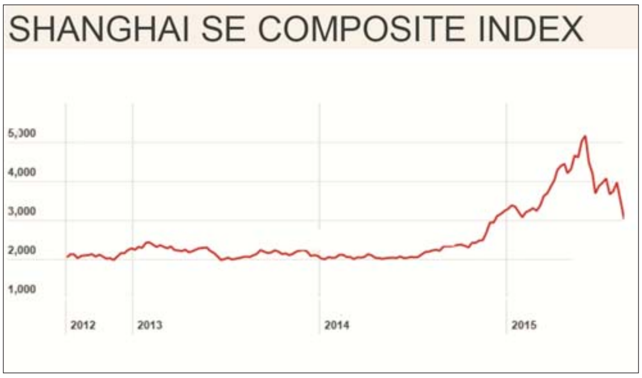
Dragon spits fire and the world feels the heat



■ ***Rajesh Agarwal***

The Chinese authorities devalued the country's currency, the renminbi, as it struggled with an economic slowdown and a stock market crash. The central bank set the official value of the renminbi weaker against the dollar. The devaluation is the largest since China's modern exchange-rate system was introduced in 1994. The Chinese benchmark Shanghai Composite Index lost almost 40% from its peak. The surprise cut in the daily reference rate, along with a change in methodology, announced by the Chinese central bank is seen as an attempt to deal with weakness in the economy and regain competitiveness in a world that has seen other currencies depreciate in recent months. China's sudden devaluation is a clear signal of trouble brewing in Beijing regarding the country's economic growth. Growth is wavering despite heavy pressure on state owned banks to lend money readily to companies willing to incur capex, and despite the strong government spending on high speed rail lines and other infrastructure projects. Growth in China, the world's second largest economy, has slowed this year and is set to hit a 25-year low even if it meets its official 7% target.

The faltering of the Chinese economy is clearly visible from the Chinese trade report, which showed that July exports fell off by 8.3% compared to the same month last year, an unexpectedly high figure. Not only exports, even domestic consumption have shown signs of slowdown. Automakers have announced declines in monthly sales. Ford China, for example announced that its sales had fallen 6% last month compared with July, 2015. China's decision to devalue the yuan caused ripples across the world, with markets adjusting to a weaker Chinese currency and policymakers and corporate executives fearing a surge in cheap imports from China. Following the announcement, global currencies ranging from the South Korean won to the Australian dollar weakened against the US dollar. The Indian rupee was no exception, and weakened to 66.74, it's lowest since September 2013. The devaluation of yuan sent shivers across equity markets. More than $5 trillion has been erased from the value of stocks worldwide since the devaluation of the yuan on August 11.

For Indian policymakers, the yuan devaluation is a major worry as exports have declined for seven months in a row. Although there is some assurance as the domestic economy is still growing. "India is relatively stronger than other countries and the RBI will not have any hesitation in using foreign exchange reserves to reduce currency volatility", said the RBI Governor, Raghuram Rajan. India has $355 billion reserves and an additional $25 billion of forward sales (due for repayment in future), so effectively $380 billion reserves, added Rajan. The impact of the yuan's devaluation will depend on the extent to which it falls. The People's Bank of China (PBOC) has spun the devaluation as aligning the currency more closely with market forces. Everything, therefore, depends on the level of the yuan with which PBOC is comfortable. The good thing is that Chinese companies too have a lot of overseas borrowing, the repayment of which becomes more difficult the more the yuan rises. While China has maintained that the current yuan devaluation is a one-off move, but there aren't many takers for this promise. What does this mean for Indian economy – though the exact amount of effects it would have is difficult to gauge, it's for sure that export competitiveness will take a hit, especially in segments like metals, steel, tyre and other manufactured products. Many of these sectors have been under pressure due to a surge in imports, which could spike further as a weaker Chinese currency would widen the price differential between imports and domestically manufactured goods. A lot of noise has been made on the after-effects of the yuan's devaluation on Indian exports, but the fact remains that Indian exports have anyway contracted for seven straight months mostly due to demand slowing down globally. The bigger concern, perhaps, for the RBI would be the potential impact of a depreciating yuan on the domestic financial markets and inflation. Although the Finance Minister Arun Jaitley and the RBI governor Raghuram Rajan has been quick to assure the investors about the situation, one needs to watch closely how central banks and governments in other countries react to ensure that their currencies remain competitive amid renewed fears of a global currency war. ■