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China’s renminbi gambit: why it has devalued the yuan

Fears of slowing growth and a desire to have the renminbi recognised as an elite currency have prompted China to devalue the yuan

The yuan fell by close to 2pc against the US dollar

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China’s authorities have taken a shock decision to let the **yuan - also known as the renminbi - slide by close to 2pc against the US dollar** as they try to fend off slowing growth.

The resulting fall is the biggest one-day drop in the currency’s value since January 1994.

So why has China decided on this surprise move?

It wants to stimulate growth

China has had a torrid time of late: its stellar growth has slowed down and its stock market has been in turmoil for the last few months, with **stocks plunging by 32pc** after a high earlier this year.

According to data released over the weekend, **exports and factory gate prices both collapsed in July.** China watchers were expecting a prompt response from the authorities - but a currency devaluation was not anticipated.

The **official explanation provided by the People's Bank of China** (PBoC) on Tuesday stated that the move was a "one-off" adoption of a market-based approach to setting the yuan's value.

But to many, the decision looks an awful lot like an attempt to stimulate the economy.

Sean Yokota, head of Asia strategy at Nordic corporate bank SEB, said that growth fears were one of the main reasons for the intervention. The currency's strength was putting pressure on exporters, hampering output and most likely employment too, therefore it needed to fall.

The PBoC has lowered interest rates four times since November to support the Chinese economy, which is expected to grow at around 7pc this year - the slowest expansion since 1990. But with the yuan devaluation, it looks like China has reached for stronger measures to support its GDP.

Amy Yuan Zhang, an economist at Nordea, said: "Beijing has adopted a 'whatever it takes' approach to prevent growth falling too much below the 7pc target for this year."

In an interview with The Telegraph, Zhu Guangyao, China's vice finance minister, said that there were **"very big challenges" facing the global economy**, but added he was confident that the government would be able to steady the sell-off in stocks.

Tyler Cowen, of George Mason University, **said**: "Take this to be a signal of Chinese weakness. Overall this is a sign of surrender to the market."

Desire for elite currency status

The other reason for the PBoC's surprise move on the yuan is that China's authorities have long wanted the renminbi to gain a coveted status as a global reserve currency.

The devaluation could help the yuan gain inclusion in the International Monetary Fund's Special Drawing Rights (SDR) basket of currencies. This is "an elite reserve currency status", as Mr Yokota put it.

If included, the yuan would be among the currencies loaned to sovereign borrowers by the IMF in times of distress.

For now, the SDR basket contains just four currencies - sterling, the euro, the US dollar, and Japan's yen. The IMF has said that "significant work" is needed for the yuan to be added to the group.

Inclusion in the SDR basket is unlikely to help China financially. Rather, the status is one Beijing desires largely for reasons of vanity, marking it out as one of the world's most important countries.

Before Tuesday's move was announced, Jason Daw, of Societe Generale, said that there was a 70pc chance of the renminbi's inclusion in the IMF's basket, as a result of recent efforts to liberalise China and its currency.

After Tuesday's devaluation, the chances of the renminbi gaining inclusion are even stronger. The latest IMF review postponed a decision on the currency’s inclusion in the SDR basket until September 2016.

“This proposal indicates the IMF’s willingness to give China more time to make enough effort for the renminbi to qualify, and is thus a positive sign," Mr Daw said.

The PBoC opted to completely adjust the methodology by which it fixes its currency, rather than just increasing the band in which it is allowed to trade against this dollar. This decision “shows that the liberalisation and SDR inclusion is a high priority for China’s leaders”, Mr Yokota explained.

Tuesday's events show that Beijing has chosen to remain on the tightrope - refusing to give up on growth, while still wanting access to an elite club of market-based economies.

China and the rest of the world will be hoping that they don't fall off.