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China took step toward currency independence by devaluing yuan

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Instead of looking at China's recent devaluation of its currency as part of a currency war, or an indication of China's greater ambitions, what if people viewed it as a big step toward currency independence?

That's the view David Malpass, president of Encima Global, an economic consulting firm, poses in the Wall Street Journal.

A week ago, China stopped supporting the yuan's tight link to the US dollar. Since then, the yuan has weakened nearly 4% vs. the dollar. And while this decline is small by foreign-exchange standards, Japan's yen is down nearly 35% since 2012, it's unsettling to global markets worried about deflation and weak growth worldwide.

After this summer's stock market crash in China, the yuan's depreciation has led many to predict China's economy is about to hit a hard landing.

However, Malpass said that the devaluation is more of a reaction to the global economic slowdown and the strengthening of the dollar. Malpass said that "under current US policies, the dollar has no reliable value — it weakened massively in the 1970s, strengthened in the 1980s and 1990s, weakened in the 2000s, and has been soaring in recent years. This instability makes the dollar an unsuitable long-term link for Beijing and its aspirations for fast economic growth."

While the US lets markets determine the value of the dollar, "creating momentum-driven boom-bust cycles," this contrasts with China's commitment to a "strong and stable" yuan.

By remaining linked to the dollar, the yuan's value climbed too high to meet Beijing's goal of price stability, said Malpass. Delinking the yuan from the dollar helps China maintain the stability of its own currency. The International Monetary Fund approved the move. And that works in China's favor, which has made turning the yuan into a global reserve currency one of its top priorities.

Malpass said the bears asserting that China is acting out of panic or weakness has it all wrong.

"Beijing is methodically pursuing financial liberalization while responding to the external problems of slower global growth, excessive dollar strength, and the reverberations in China from the US Federal Reserve's inexplicable policy of setting interest rates near zero six years after the recession. China's move is another step in the gradual shift away from the dollar bloc and U.S. economic leadership that dominated Asia since World War II. China hopes to replace this with an anchor to the yuan, and China-based institutions like the AIIB," he said.

Whether the new currency policy help's stabilize China's slowing economy remains to be seen. "This won't suddenly stop the slide in its exports that is the result of the global slowdown. Nor can exchange-rate policy cause businesses to invest more effectively or consumers to open their pocket books," said Malpass.

However, Malpass said, and Asia Unhedged agrees, with "no plan to change the Fed's top-down, market-distorting misallocation of credit as the first interest-rate hike approaches … China's decision to create distance between the yuan and the dollar" gives China the freedom to weather whatever storm lies on the horizon.