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# On the RMB Devaluation

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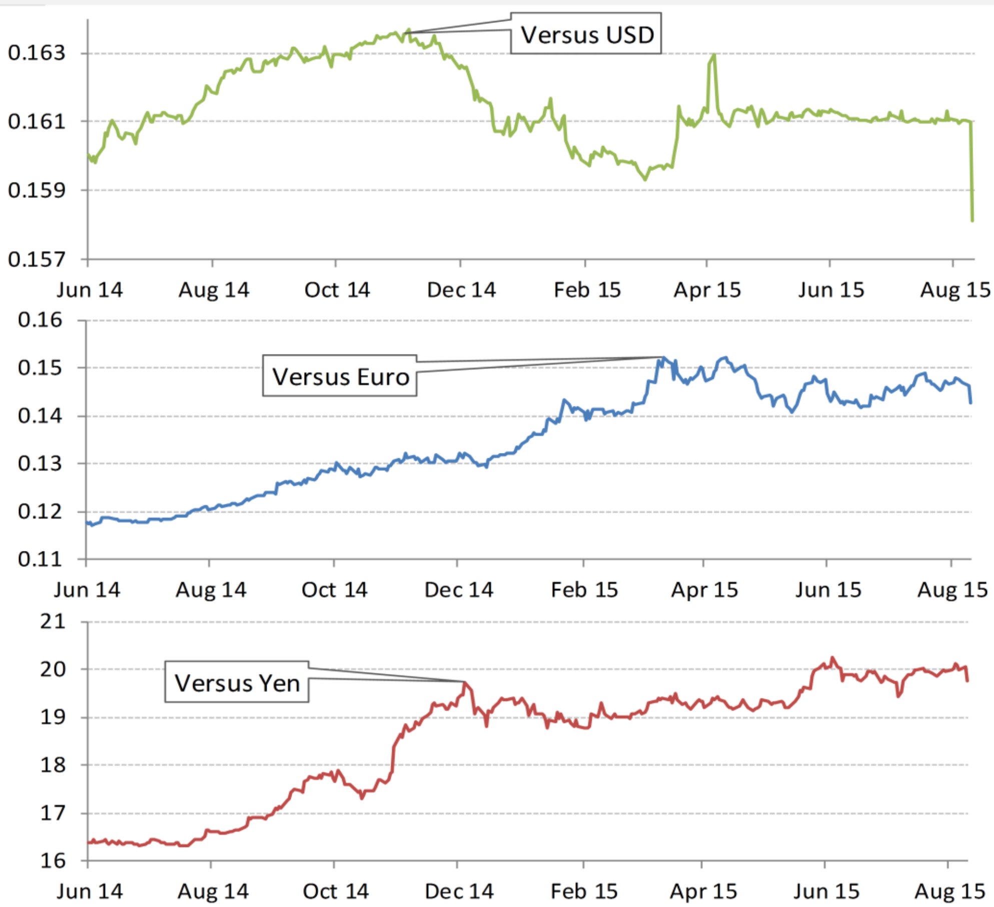
**Donald Luskin**

**It's not that China needs to weaken the RMB. It's that the dollar is just too strong.**

The 1.9% weakening of the Chinese remnimbi versus the US dollar is being played in the press as a "devaluation," and evidence of China panicking in the face of a potential hard landing. For what it's worth, the People's Bank of China is characterizing it as, on the one hand, a technical adjustment to "improve quotation of the central parity of RMB against US dollar" and, at the same time, as "the reform of RMB exchange rate formation mechanism" toward "market orientation."

**China RMB versus major currencies**




Source: Bloomberg, TrendMacro calculations

**Update to strategic view**

**EMERGING MARKETS MACRO, FX:** China's move to weaken the RMB should not be seen as a devaluation against the dollar, as though the dollar were an objective benchmark. Rather, it is a liberation from the too-strong dollar, a salutary adjustment toward the valuations of the yen, the euro and the currencies of China's other trading partners. Through the currency peg, China passively imports US monetary policy. The growth trajectories of the US and China are too divergent now for that peg to go unadjusted. Say what you will about China's potential for a hard landing -- this move was the right thing to do.

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- This move looks very dramatic -- very scary -- on the chart of the RMB/USD exchange rate (please see the top chart on the previous page).
- But China's reason for making this move is revealed in how minimal the move looks on the charts of the RMB versus the yen and the euro (please see the bottom two charts on the previous page).
- *We think China wisely weakened the RMB against the dollar because the dollar itself has become too strong* (see "Dollar Strength: A Crude Connection" April 23, 2015 and "On the April FOMC and Q1-15 GDP" April 29, 2015) *-- and by being passively linked to it, the RMB was become too strong for China's export-driven economy to tolerate.*
- We mustn't think of the dollar as being an objective standard, against which it is correct to adhere and incorrect to deviate. The dollar itself deviates considerably. *By passively pegging itself to those deviations, China effectively imports US monetary policy.*
- *That's precisely the wrong thing for China to do now. The US economy has been gradually accelerating over the last four years, while the Chinese economy has been gradually slowing. Why would these two very different nations want to share the same monetary policy at this moment?*

The Chinese authorities have embarrassed themselves with their ham-handed interventions in the stock market (see "China: Toil and Trouble, but No Bubble" July 10, 2015). And they were embarrassed again last week by an International Monetary Fund staff report questioning the "freely usable" status of the RMB ahead of its year-end consideration of including it in the Special Drawing Rights basket. Markets are predisposed to see anything they do now as dumb and dumber. But this move today was the right thing to do. We don't know how much trouble the Chinese economy is really in -- we tend to be naturally skeptical of the bearish consensus. Either way, this was a move in the direction of goodness.

## Bottom line

China's move to weaken the RMB should not be seen as a devaluation against the dollar, as though the dollar were an objective benchmark. Rather, it is a liberation from the too-strong dollar, a salutary adjustment toward the valuations of the yen, the euro and the currencies of China's other trading partners. Through the currency peg, China passively imports US monetary policy. The growth trajectories of the US and China are too divergent now for that peg to go unadjusted. Say what you will about China's potential for a hard landing -- this move was the right thing to do.

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