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CHINA GAMBLES WITH THE YUAN

BY JAMES SUROWIECKI

Chinese investors look at prices of shares this week in Shanghai.

PHOTOGRAPH: AP

If you're confused by what's been happening to China's currency (http://www.newyorker.com/news/john-cassidy/chinas-long-minsky-moment) over the past few days, don't feel bad. The wild ride that the yuan has taken has left plenty of people perplexed, including, perhaps, China's very own policymakers. The turmoil started on Tuesday, when China's central bank announced that it was effectively devaluing the yuan. China has historically kept very tight control over the value of its currency. It's done so by announcing a daily target value for the yuan, one that is designed to keep the exchange rate between the yuan and the dollar stable. (In theory, the yuan is pegged to a larger basket of currencies, but in practice, it's been pegged to the dollar.) And it's backed up that commitment by being willing to buy or sell as much currency as necessary to maintain the peg. Typically, the value of the yuan has moved only a tiny bit from day to day. On Tuesday, though, the central bank announced a value that was roughly two per cent lower than the day before, and the yuan quickly traded down to that level.

On its own, this would not have been all that big a deal. It could plausibly have been seen as China just trying to moderate the value of its currency, which has been rising steadily this year (because it's followed the value of the dollar, which has soared). But the story didn't end there. The central bank also announced that henceforth it would let the yuan's value be determined, in part, by where it had ended trading the day before, rather than by government decree. This suggested that China was loosening the peg and would tolerate wider swings in the yuan than it once did. Investors took the cue—the currency's value against the dollar tumbled another 2.6 per cent over the next couple days, bringing its over-all decline to 4.4 per cent. Now people are wondering how much further, if at all, China's government will allow the currency to fall.

The confusion stems, in part, from the mixed messages that the Chinese government has been sending. On the one hand, many observers believe China is trying to drive the value of the yuan down, which would help its flagging export sector by making Chinese-made goods cheaper to buy. On the other hand, if a serious devaluation is the government's goal, it's going about it in a strangely bumpy and haphazard way. In late trading on Wednesday, for instance, the value of the yuan actually spiked higher, which sparked stories that the government had intervened in the market to drive the yuan *up*. And on Thursday evening, after the currency had fallen once again, the central bank said that it had "withdrawn from the normal mode of intervention," but also said that there was no reason for the yuan to fall further. What that means, in policy terms, is anyone's guess.

If there's a coherent story to be told here, it may be this: because China's economy has been struggling, and its exports in particular have been weak (they fell eight per cent in July), policymakers wanted to devalue the yuan in order to make the nation's products more competitive in the global marketplace. They also wanted to give the market more say over the value of the yuan, because ultimately that's the only way that China's currency can become a global one like the dollar or the euro. So Chinese officials announced a small devaluation, and have then allowed the market to send the yuan lower. Exports will get a boost, and the government, which has been criticized in the past for manipulating the currency to give China an unfair trade advantage, can say that it is investors who are determining how much the yuan is worth.

The problem with this strategy is twofold. First, ceding at least some control over the value of your currency to the market means ceding more control over your economy as well. Just about every country in the world already does this, but it's very different from the path that China has followed in the past—and it requires accepting more uncertainty than Chinese policymakers have been used to. It's not surprising, in that sense, that China's actions over the past few days have seemed erratic, appearing to oscillate between a hands-off and a hands-on approach. (A similar dynamic, arguably, has been at work in the way China has tried to manage its stock market (http://www.newyorker.com/news/daily-comment/the-real-risk-behind-chinas-stock-market-drama) in recent months.)

The other problem for China is practical: devaluation is not a silver bullet for the country's economy. It will raise inflation. It will create problems for many Chinese companies, which have piles of dollar-denominated debt that becomes harder to pay off as the value of the yuan sinks. And it's also politically toxic—U.S. lawmakers are already blasting China for starting a currency war. So even if the Chinese wanted the yuan to fall, that doesn't mean they want it to keep tumbling, especially not at a rapid pace. And that means they may need to intervene to prop the yuan's value up, even as they're allowing the market to drive it down.

These problems are hardly unmanageable. But the real question that the turmoil over the yuan raises, especially when coupled with what's been happening to the Chinese stock market, is whether policymakers actually have a real plan for the economy, or whether they're just winging it. For many years, the abiding assumption about China has been that the people in charge of the country can be counted on to keep its economy on an even keel, and that they're up to meeting whatever new challenges that the country faces as its economy matures and slows. And certainly anyone betting against that assumption in the past has been proven wrong. But as we watch China's leadership struggle to deal with myriad problems (some of which are self-inflicted), it might be worth keeping a fundamental rule of investing in mind: past performance is no guarantee of future results.

James Surowiecki is the author of "The Wisdom of Crowds" and writes about economics, business, and finance for the magazine.