Yuan devaluation and the ‘perfect’ EM storm

- **China joins currency wars, just as the Fed prepares to raise rates**
- **The ultimate impact on EMs depends on China’s motives**
- **But short-term pain is unavoidable; Asian economies are the most exposed**

Life has just got much tougher for emerging markets.

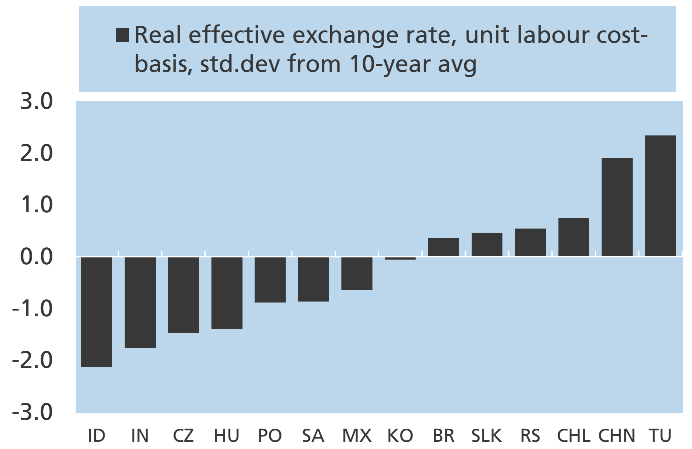
The yuan drop is the sharpest since 1994

The People’s Bank of China (PBOC) has pushed the yuan lower by 3.5% against the dollar over the past two days. This is the sharpest move in the currency since the steep devaluations of 1994. We have been arguing for a while now that China needs a weaker currency. The yuan is expensive and the real lending rate is exorbitant. The Chinese economy is unbalanced and its debt levels have surged at an alarming pace.

A re-run of 1990s-type EM crises?

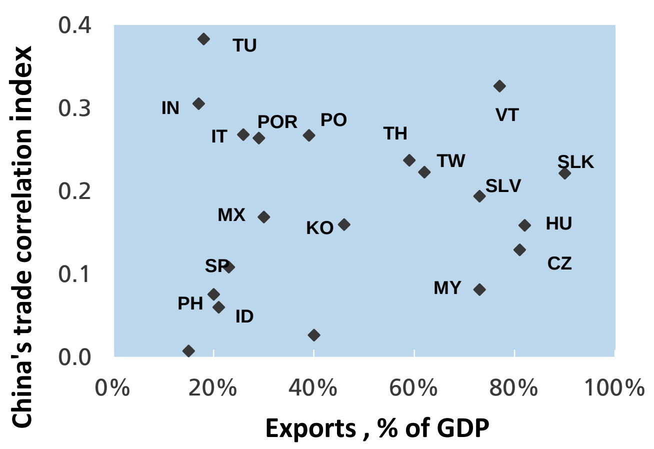
What does it bode for other emerging markets? After all, the 1994 devaluation is often cited as one of the first actions that ultimately led to a widespread EM financial crisis. The start of the Fed’s rate rise cycle during the same year was the straw that broke the camel’s back. No wonder that the repercussions for EMs of a similar change in the direction of Fed policy have been an issue of lively debate among investors, especially since the 2013 taper tantrum episode. But markets now have to factor into the equation an equally striking change of policy by the PBoC, which until this week

Countries with a poor starting point will hurt more



Source: OECD, LSR

Who is more exposed to yuan devaluation?



Source: UNCTAD, OECD, LSR

had refused to countenance a weaker currency.

Yuan devaluation is potentially a huge risk for EMs. We do not see China's policy shift leading to a re-run of 1990s-style crises. But we have been mindful of the potential fallout of such a move since 2013. What is particularly worrying is that China has acted just as the Fed is getting closer to reversing its ultra-easy policy stance. As it is, EMs are already grappling with deficient global demand, souring domestic fundamentals, a strong dollar and potentially higher US real rates.

Dollar strength is not without its benefits for EMs, which gain in relative cost competitiveness and enjoy the tailwind of higher US private consumption. Lower oil prices have also brought welcome relief for most EMs, not just through the direct channels of lower inflation, reduced current account deficits and a smaller bill for energy subsidies. Cheaper energy is an important reason why we expect US consumption to pick up, giving some breathing space to EM exports.

Short-term pain is unavoidable for EMs in any scenario

But the PBOC's move is likely to negate the modest advantages that EMs could have derived while exacerbating their debt burden. To understand the potential impact of the devaluation, we need to determine whether it is: (i) a step towards a crawling peg and hence an effort to spur genuine financial market reforms (ii) a one-off event or (iii) a prelude to a more aggressive, old-style devaluation. From the policy rhetoric and yuan moves so far, it appears that the first alternative is a more likely policy choice. The last outcome would probably be the most painful for EMs, depending on the extent of devaluation; the first would hurt the least in the medium term. Nonetheless, short-term pain is unavoidable.

If China reverts to a heavy-handed export-led growth model without market reforms, there may be a respite for commodity-exporting EMs and those linked to China's supply chain. But that would be just storing up significantly larger imbalances for later. Besides, having exhausted its cost advantage in low-end manufacturing exports, China's next step is to move up the value chain. Currently, the main beneficiaries of China-centric supply chains are the Asian Tigers, whose export basket is increasingly tilting towards higher-value- added products. For these economies, China may gradually become more of a competitor than a facilitator of their export growth.

Separately, a lower yuan may delay re-shoring of manufacturing to low-cost producers. But the worst-hit economies are likely to be those that are uncompetitive and whose export structure mirrors that of China. The pressure may be more intense if exports are a dominant growth driver (see right-hand chart above). A combination of a higher US$ and a cheaper yuan may be particularly painful if an economy is compelled to reduce its external funding needs.

Vietnam, Thailand, Taiwan, Korea and Malaysia are some of the Asian economies that are more vulnerable to yuan devaluation. The exposure to a lower renminbi extends beyond Asia and seems quite significant for some emerging European countries. While Hungary and Poland appear at risk, it is Turkey that may suffer the most. As for Latin America, a weaker yuan may undermine Mexico's relative cost advantage in exporting to the US, its largest market.

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