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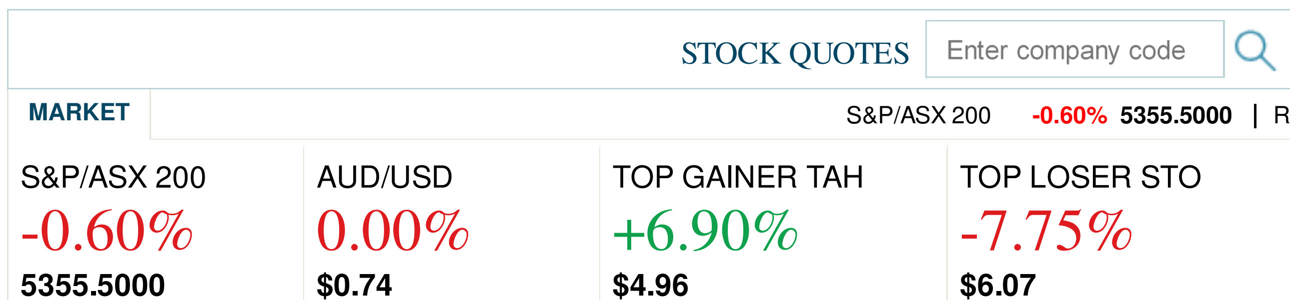

How China’s devaluation could affect Australia

STIRLING LARKIN THE AUSTRALIAN AUGUST 15, 2015 12:00AM

The Bund, Shanghai’s historic financial centre. China’s devaluations of the yuan this week were warranted amendments. Picture: Rory Daniel. Source: Supplied

When it comes to the return of China to the front ranks of our global economic mix, it is imperative that we sit on what will be the winning side of history.

Importantly, that means respecting that even though the currency fluctuations seen in China this week were material, they were not abject steps taken to attain the “impossible trinity” in which a country shoots for stability across exchange rates, capital movements and independent monetary policy at the same time.

China is changing, and doing so for the better, and these changes bring with them direct implications for the Australian dollar.

The events of this week — in which the People’s Bank of China amended its exchange rate mechanism and subsequently devalued its onshore legal tender thrice in short measure — were warranted amendments to what is still a fixed exchange rate mechanism.

Before we scoff and roll our eyes, it should be remembered it was not long ago that Australia also struggled with “pegged” exchange rates — up to 1983.

Pairing currencies — such as the US dollar against China’s yuan — is never a predictable or

circumscribable affair and those who profess to be able to foretell any currency's trajectory with certainty are simply deluding themselves.

Currencies do not move via predictable models and of all the respective asset classes — such as equities, credit, debt and commodities — foreign exchange remains truly "native".

Taking a step back, however, there are larger forces at work that can now be considered when determining the probabilities of currencies appreciating or depreciating heading into 2016.

One such example was found last week following a Japanese cabinet meeting, when Finance Minister Taro Aso — in reply to a question about China's possible inclusion in the highly desirable International Monetary Fund Special Drawing Rights basket — said, "I think it would be desirable (for the yuan) to become such a currency but whether it is qualified should be decided by objective facts."

(The SDR basket is an IMF asset created to supplement its member countries' official reserves.)

More than mere semantics, this statement was not only a watershed moment for Sino-Nippon relations but also particularly important for the existing tiered global reserve currency system.

This system was galvanised following the "Nixon shock" of 1971, when the US dollar was unpegged from the gold standard.

It has continued to this day and sees the US greenback remain the prime global reserve currency, the euro, Swiss and yen secondary, and the Canadian loonie and the Aussie tertiary.

This also partially explains the Australian dollar's reputation as a "hot currency", referring to its tertiary reserve and relatively liquid status.

Aso's comment, as well as being politically astute, is also a tacit acknowledgment the yuan's inclusion within the SDR basket is a likely fait accompli.

By publicly supporting this change, the Japanese are informally assisting the Chinese positioning of the yuan as a soon-to-be secondary reserve currency.

When this inclusion does occur next year or in 2017, the ripples thereafter are relatively foreseeable and pre-empting these allows us to better understand the Australian dollar's likely repositioning. Clearer understanding surrounding this future is particularly important for Australian domestic stockmarket investors. This is because many ASX 200 constituents' forward multiples are "baked" on the assumption of a declining Australian dollar during this period — a very dangerous presumption to maintain and, if incorrect, leaves Australian stockmarket investors in a most precarious and undesirable position.

This position is further complicated by the fact our reserve currency peer, Canada, recently fell into recession while we miraculously found another way to avoid such a fate.

It could reasonably be argued that if and when the yuan achieves SDR status, there will likely be an uplifting influence on the value of the AUD-USD pairing.

In other words, there's more likelihood that the Aussie dollar will go up in the next year, presuming this scenario plays out.

Evidence to support this argument can be found when the AUD in late 2012 achieved inclusion in the IMF COFER — Composition of Official Foreign Exchange Reserves — grouping.

The AUD had identifiable and immediate uplift, sharply rising from US98c in June 2012 up to

$US1.05 following the IMF’s November announcement.

This was due in large part to global central banks rebalancing their currency baskets to reflect this amendment and saw a quantum shift in the “range-bound” price bracketing of our currency.

This bracketing is often referred to as “top and tail”.

Similar to when a constituent stock enters or leaves an index (for example, the ASX 200 or S&P 500), the same principle applies to a currency in these circumstances.

So when the yuan achieves SDR status, which will be most significant, sizeable rebalancing of central bank reserves, alongside those also made by global sovereign wealth funds, will have a derivative effect on AUD holdings, given our linkages to the existing tiered global reserve system.

These are also forces well outside the control of the Reserve Bank of Australia.

Circling back to the immediate implications of this week’s devaluation, remember that as the graph illustrates, the yuan on a trade-weighted-basis has sharply appreciated alongside the greenback’s strength and is still about 15 per cent higher than a year ago.

The PBOC’s position that these amendments were executed to front-run the US Fed September “lift-off”, which is expected to cause further strengthening in the USD and capital flow volatility, should be accepted and respected at face value.

The graph also emphasises the widening trade imbalance, particularly since China’s inclusion in the World Trade Organisation in 2001, and this should also matter to Australian businesses.

As no one can predict currency movements, it is important to remain objective, mindful and aware that the return of China affects us in more ways than one.

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