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We believe today's moves by the PBoC do not signal the start of a substantial devaluation in the yuan as financial and social stability remain the overriding concerns for policymakers.

The decision by the People's Bank of China (PBoC) to alter the way in which it fixes the yuan – now taking into account the previous day's closing spot rate – is a significant one. But contrary to many media headlines, we do not believe this is primarily a policy aimed at providing stimulus to exporters.

The resulting depreciation, less than 2%, means that in trade-weighted terms the yuan is back to the level it was at ten days ago. This is not the kind of change that will see a boom in Chinese exports. Far more important is the increased role of the market in determining the value of the currency. Consequently, we see this more as a reform aimed at Special Drawing Right^[1] (SDR) inclusion, rather than at boosting growth.

That said, the PBoC's chief economist has said that the central bank will stabilise market expectations to ensure an orderly transition to the new regime. This is not the end of intervention. Indeed, we think it would be unwise to allow a large depreciation at this time, given the sizeable capital outflows recorded in the first half of the year. Entrenching expectations of depreciation would serve only to exacerbate those outflows and potentially destabilise the financial system.

Will we see much more depreciation from here? Beyond the risk of capital outflows, which should discourage policy-led depreciation, there remain structural supports, particularly in the form of the current account surplus. But the reference to the closing spot rate, in current market conditions, will exert some depreciation pressure. PBoC intervention will be needed to alter market expectations if the authorities want to prevent depreciation.

One final change to note is that the fixing will also be determined by the exchange rate movements of major currencies. That possibly implies a move away from a pure dollar peg to a basket of currencies. If this is so, and the PBoC wants to peg the yuan in trade-weighted terms, depreciation versus the dollar becomes more likely, particularly if the wave of dollar strength continues. However, we believe financial and social stability remain the overriding concerns of policymakers, and so a large devaluation is not on the horizon.

[1] An international reserve asset, created by the International Monetary Fund, which member countries can use to supplement their official reserves.

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