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China's three devaluations in a row

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China shocked the world this week.

It devalued its currency, the renminbi on Tuesday, 11 August by 1.9%, Wednesday by 1.6% and again Thursday by 1.1%, totaling in all 4.6%.

That would remind readers of two similar devaluations in 1987. Of course, there are differences. Fiji's two devaluations were spaced ones and the total size was large: 33%.

The rate on Monday was 6.20 renminbi per US$; on Tuesday, it was changed to 6.33; Wednesday it became 6.44. With one more another change downwards, the shock was greater.

The size of Chinese devaluation is negligible.

The second one on Wednesday, within 24 hours raised fears of further devaluation in doses. Third one confirmed the fears. The Tuesday official website said the value of renminbi would be determined by market forces and the devaluation was just one-off adjustment. The second one was followed by the official announcement that there was no intention of any "sustained devaluation."

The third one clearly indicates China is in distress.

The Chinese have their own way of doing things.

The world has accepted China is the world's second largest economy, beating Japan to third place. During the global economic downturn, China was the engine of growth by providing markets for raw materials, thereby softening the impact of the Great Recession. In turn, China's exports of cheap consumer goods helped to grow faster than any country. Its foreign exchange reserves stand at US$ 3.7 trillion.

The US claimed China had been manipulating its exchange rate regime. By deliberately keeping its currency undervalued for several years, it exported consumer goods and accumulated export surplus. Under a flexible exchange rate regime, where value of domestic currency is determined by market forces of supply and demand for the currency, the situation will be different.

The Chinese ambition

With huge reserves, the renminbi should have risen all these years. The US criticized China never allowed its renminbi to rise in value in terms of other currencies. Having succeeded, China wants to be counted as one among equal giants of the world economy. China is keen that its renminbi be included in the basket of currencies linked to IMF's Special Drawing Rights- together with US dollar, pound, yen and euro. Many African and some Southeast Asian nations are settling their trade payments in renminbi without any recourse to US dollars.

The IMF is sympathetic, with a caveat.

China should make renminbi flexible and determined by market forces, not fixed by decrees; and domestic financial market be liberalized.

China is aware of the requirement. Only recently, China reduced its control over the offshore market rate. Thus it had two rates: domestic rate under control and offshore freely trading rate.

Why three cuts in a row?

It is widely known that China has not been doing well compared to its superlative growth rates of 10% and above until last year. The growth rate has slowed down to 7% year-to- year growth in the first quarter. Exports have fallen 8 percent in the first quarter. For boosting growth and exports, China has to devalue. Secondly, this is an opportunity to impress the world as well.

For making it look like an effort towards fulfilling the obligation of moving towards a flexible currency, the central bank simultaneously announced that unlike the earlier practice of government setting the rate, every day the previous day's closing rate under market forces would be the day's rate and it will be allowed to fluctuate within 2% of the rate. China feels that this will satisfy IMF and the US.

Does China want to show that it has a flexible rate regime? Does it get out of crisis by allowing the currency to depreciate and promote exports for reviving the economy?

The Chinese President, who is visiting US shortly, wants to impress with its new policy. He needs the support of the US at the October IMF meeting on adding the renminbi to SDR's list of currencies.

It is the best opportunity to achieve the twin objectives: boosting the economy and improve the international image.

Impact on the rest of the world

The immediate impact will be on global tourism.

Chinese tourists spent US$129 billion last year. That will decline.

Holders of renminbi, fearing further fall in currency are moving their funds overseas. The foreign owned manufacturing units located in China will experience decreases in their earnings when converted into dollars. Mineral exporting countries will be hit harder than others, as their exports earnings will fall. The currencies of Southeast and South Asian economies, which are depending on Chinese markets, have already depreciated. The Indian rupee fell to the lowest in two years at Rupees 65 per US$.

The US Federal Reserve will have to reconsider any interest rate hike, which will only worsen the country's trade deficit with China.

Cheaper goods from China will flood the Walmart chains one again!