The Devaluation of the Yuan*

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The Chinese central bank's decision last week to let the yuan depreciate in three stages by almost 4 percent against the U.S. dollar, was officially explained as a move towards greater market determination of its exchange rate. Though this explanation pacified stock markets around the world, China's devaluation of the currency portends a serious accentuation of the world capitalist crisis.

To see this devaluation in its proper context, we have to remember that the Trade Weighted Exchange Rate (TWER) of the yuan (i.e. its exchange rate against a basket of currencies whose composition is determined by the importance of that currency in China's trade), had appreciated by as much as 50 percent since 2005. Even compared to the year 2009 which had witnessed a major appreciation, China's TWER had appreciated by a further 20 percent until recently, which means that other countries' goods were becoming relatively cheaper compared to the Chinese goods, without the Chinese government doing anything about it. This had allowed other countries, including even the U.S., to experience higher growth than they would otherwise have done, while the Chinese economy itself had not experienced any marked slow-down in its growth rate, since its domestic demand had been rising owing to an asset market bubble. The appreciation of the yuan in other words had contributed towards imparting some degree of stimulus to the economies of the rest of the world.

China's economy is now beginning to slow down; the asset market bubble in China has collapsed; and China is now looking for an export thrust to boost its growth rate, which is why it has devalued its currency. All this means that the stimulus which the world economy was getting until now from an appreciating yuan will now no longer be forthcoming. And this augurs ill for the world economic crisis. True, the extent of the depreciation of the yuan that occurred last week is small as yet; but, coming after a gap of nearly 20 years during which there had been no depreciation in the yuan, it shows a new turn in Chinese economic policy. The current depreciation therefore is likely to be a precursor to other similar depreciations in the days to come.

But even more significant than what the Chinese action per se would mean for the world economy, are the reactions it is likely to generate among other countries. Already several currencies of the world, including the Indian rupee, have depreciated vis-à-vis the US dollar in the wake of the depreciation of the yuan. This is because when the yuan depreciates, speculators expect that other countries too would be forced to depreciate their currencies to protect their exports against Chinese competition and to defend their domestic production against Chinese imports. Hence they move out of those currencies in anticipation of such depreciation, and thereby precipitate an actual depreciation; and the governments of these countries do not intervene to defend the value of their currencies, because they too, in their desire to ward off Chinese competition, want such a depreciation. What this means is that the bulk of the world's currencies tend to depreciate vis-à-vis the US dollar when the Chinese currency depreciates, as indeed they are already doing.

Now, as far as the U.S. is concerned, if the value of its currency appreciates vis-à-vis other currencies, then that affects the net exports of the U.S. adversely, and hence its domestic activity and employment. Of late there had been much pressure on the U.S.

Federal Reserve Board to increase its interest rates which are currently as low as they could possibly be, at almost zero, since its domestic economy was supposed to have been "looking up"; and everybody was expecting the Fed to raise its interest rates in September. This, however, will now have to be postponed, since any such interest rate hike, by making the U.S. dollar more attractive to hold, would have the effect of further raising its value vis-à-vis the world's currencies, and hence further lowering the U.S. economy's level of activity even below what the current appreciation of the dollar (at near zero interest rates) would give rise to.

The problem with the U.S. however is that even though it can postpone an interest rate hike, it can do little else to prevent a dollar appreciation. It cannot lower its interest rates any further, since they are already at rock bottom. Short of imposing import controls in open or clandestine ways, it will find it difficult to prevent a lowering of its level of activity and employment.

This explains why the U.S. which had been pressurizing China all these years to allow greater market determination of its exchange rate is so peeved when China claims to have done precisely that. The U.S. calculation was that "greater market determination" of China's exchange rate would produce an appreciation of the Chinese currency vis-à-vis the U.S. dollar, and hence be of benefit to the United States in enlarging its market. As a matter of fact, since "greater market determination" has resulted in a depreciation of the Chinese currency, many U.S. lawmakers have now started lashing out at this denouement.

Looking at it differently, with China wanting a larger share of the world market as a means of stimulating its domestic growth, which has been hit by the collapse of its asset market bubble, the competition between countries for a larger share of a more or less stagnant world market is getting intensified. On the one hand there are no factors working towards an expansion of the world market, and the collapse of China's asset bubble has removed the last of such expansionary factors; on the other hand, every country, including China, is now joining in the race to get a larger chunk of this non-expanding world market. Not surprisingly, this can only compound the recession, since it constitutes a classic case of a "beggar-my-neighbour" policy, such as what had characterized the 1930s depression.

Two other factors are likely to work in the same direction. One is the collapse of the capitalists' already feeble "inducement to invest". Until now, for instance, being able to sell to China had acted as some sort of an investment stimulus for advanced country capitalists; this is now being removed. In addition, the currency price fluctuations, all of which do not move up or down synchronously, make profitability calculations much more difficult, and hence increase the risks of investment. For these reasons, again as in the 1930s, when "beggar-my-neighbour" policies were rampant, the capitalists' "inducement to invest" would get adversely affected, compounding the recession.

The second factor is that the appreciation in the value of the dollar makes it more attractive for speculators to hold dollars rather than primary commodities, which is why world primary commodity prices, already on a falling trend (which incidentally explains the "negative" inflation in India according to the Wholesale Price Index), have fallen even more sharply after the devaluation of the yuan. This is further aggravated by the fact that China's demand which had shored up primary commodity prices to an extent, would now be expected by speculators not to be doing so; this would also contribute to a collapse of primary commodity prices.

This fall in primary commodity prices has three effects: first, several countries like Australia, Brazil, Russia, and Chile, which are significant primary commodity exporters and whose fortunes therefore are tied up with primary commodity prices, will now experience a collapse of their growth rates. Secondly, debtor countries like Greece will now find that the real burden of their debt has gone up, which would push them further towards insolvency, and make creditor countries and creditor institutions impose even stiffer measures of "austerity" upon them. This, by reducing aggregate demand in those countries to an even greater extent, and hence, by implication, doing so all over the world, will aggravate the crisis even further.

The third effect is through what the American economist Irving Fisher, who had been a Professor at Yale and had himself lost his entire personal fortune in the 1930s Great Depression, had called "debt-deflation". It is not just countries, but all debtors who find that the real burden of the debt goes up when there is a fall in the price level. To be able to pay back their debt therefore they find themselves forced to sell some assets, which lowers the asset prices even further, raising the real burden of their debt even further, and so on cumulatively.

A "debt-deflation" in other words is a syndrome, which can result in acute crises and depressions. This is the reason why capitalists are always terrified of "negative inflation" or of "absolutely falling prices". Once an economy begins to face declining prices in absolute terms, it can slide rapidly downhill through the unleashing of the process of "debt-deflation", and its government and the central bank can do little to halt such a slide.

The world capitalist economy has been hovering close to such a scenario, of "deflation" or absolutely falling prices, for some time. (We know from our own experience that the Indian economy is facing a "deflation" in terms of the Wholesale Price Index largely because of international developments). With the depreciation in the Chinese yuan, and the expectations it generates regarding future Chinese growth and the future growth in primary commodity prices, there is a real likelihood of a "deflation" in the world economy setting in, and hence of the onset of a "debt-deflation" syndrome. In all these ways therefore the developments in China are likely to aggravate the capitalist crisis. We are in short on the threshold of a new phase in the world capitalist crisis which would witness its significant accentuation.

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