THE CARLYLE GROUP
GLOBAL ALTERNATIVE ASSET MANAGEMENT

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Sometimes a Cigar is Just a Cigar: The RMB Devaluation One Year Later

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One year ago, the People's Bank of China (PBoC) stunned financial markets with a surprise devaluation of the renminbi (RMB). Over the course of five trading days, the PBoC cut the RMB's daily reference rate by 3% relative to the U.S. dollar. Panic selling ensued, with global stock indexes plummeting by over 10% the next several days.

The magnitude of the sell-off seemed disproportionate. With markets nonplussed by much larger downward adjustments in major currencies like the yen, euro, and Australian and Canadian dollars, the stock market correction only made sense if devaluation were interpreted as a sign that conditions in the Chinese economy were much worse than previously believed. It was not the currency move *per se* that concerned market participants, but rather its implications for the Chinese economy, trade flows, and global growth rates.

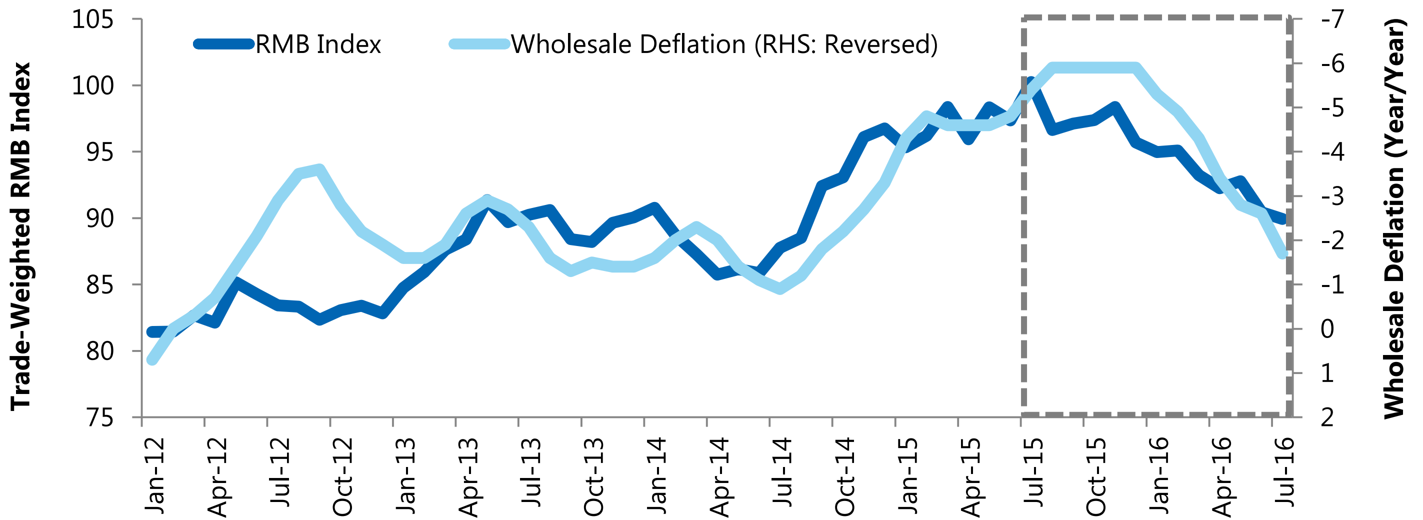
As we argued at the time, the search for a deeper meaning behind devaluation posed its own set of risks. On its face, RMB reform seemed to be a straightforward attempt to confront the deflationary pressures arising from the 30% increase in China's real effective exchange rate over the past four years. Rather than siphon demand from trading partners, RMB devaluation was an effort to ease domestic financial conditions, boost inflation, and create more space for domestic monetary policy.

These efforts have clearly borne fruit. Over the past year, wholesale price deflation in China has eased markedly. A year ago, producers' finished goods prices were falling at a 6% annual rate. Prices have declined by just 1.7% over the past 12 months and now appear to be rising on a sequential (month-over-month) basis. This shift in price trends is consistent with past evidence of the sensitivity of Chinese wholesale prices to exchange rate movements. When coupled with the 1.25% cut to reference lending rates and required reserve ratios since last August, real debt service burdens in the Chinese industrial sector have already declined by more than 4 percentage points.

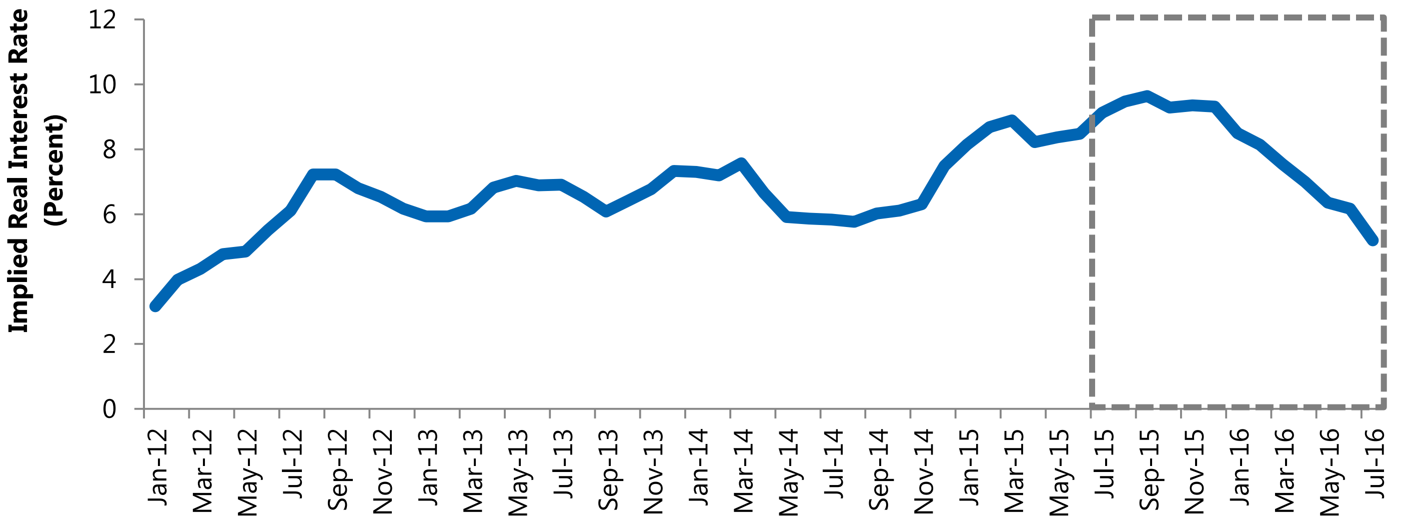
The property sector has also benefited. Easier financial conditions spurred a surge in transactions that reduced unsold residential property inventories by 45%. Rather than subtract from growth, real estate grew faster than the overall economy in Q2-2016.

China's economy continues to suffer from excess capacity, nonperforming loans, and declining returns on incremental capital. Monetary policy cannot solve these structural problems, nor was that the intention. Instead, Chinese policymakers deserve credit for acting decisively to short-circuit a potential deflationary spiral. As is often the case, the simplest explanation turned out to be the best.

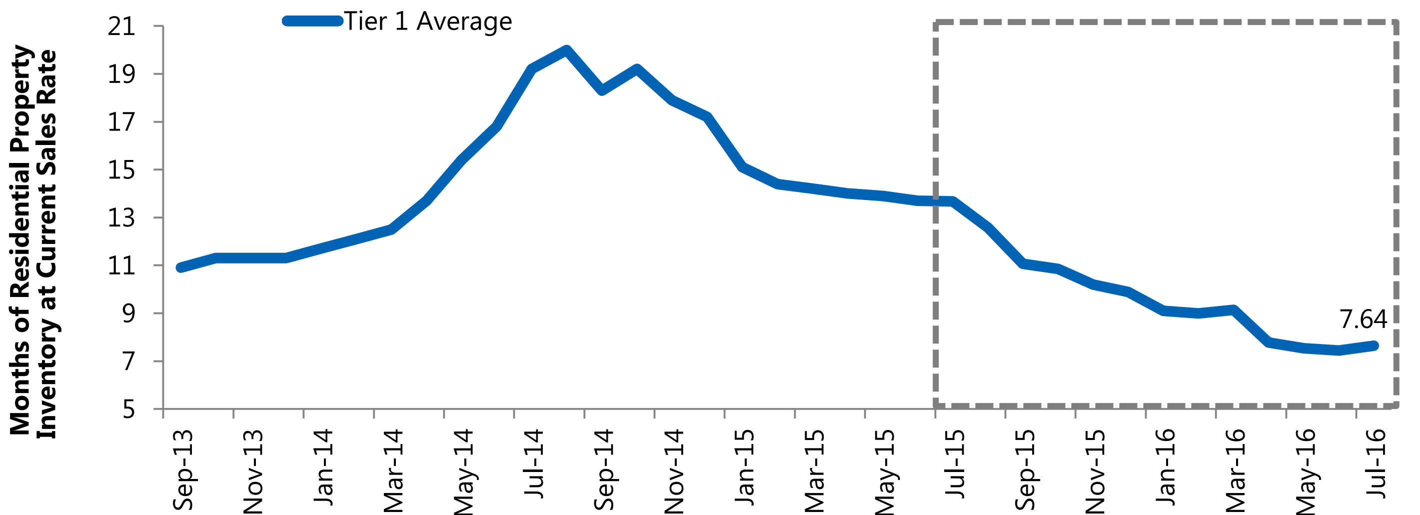
One Year Later: RMB Reform Reduces Deflationary Pressures[1]



One Year Later: RMB Reform Reduces Real Debt Service Costs[2]



One Year Later: Monetary Easing Spurs Real Estate Sales, Reduces Large Inventory Overhang[3]



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1. Source: Carlyle; Bloomberg; National Bureau of Statistics
2. Source: Carlyle; Bloomberg
3. Source: Carlyle Analysis of Portfolio Company Data

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