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Chinese reform or currency war?

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Is China about to devalue? The question seems to pop up everywhere I go — most recently in Frankfurt, Sydney and New York. Economists here in Tokyo, too, are buzzing about the chances of a big decline in the yuan in the next few months.

A new report from Lombard Street Research explains why all these folks may have reason for concern. According to London-based Charles Dumas, China's slowdown will soon drag down gross domestic product growth below 5 percent (whether Beijing admits it or not).

A continued downtrend, Dumas says, would represent "a major, slow-motion shock for the world economy and financial markets" that will slam everything from commodities to growth rates from Japan to Germany. Growth significantly below Beijing's 7.5 percent target also complicates President Xi Jinping's efforts to shift China to a services-based economy from an export-and-investment-led one.

The obvious solution: a weaker exchange rate that boosts exports and thus buys Xi time to recalibrate growth drivers. While Chinese leaders aren't dropping clear hints of a devaluation, it's a logical next step. Since the crisis, Chinese corporate debt has also reached $14.2 trillion, topping that of the U.S., according to Standard & Poor's. Recently, China's central bank set out to measure activity in China's $6 trillion shadow banking industry, implying that officials worry it's even bigger than we know. And while estimates of the true size of liabilities facing local governments differ widely, roughly $1.65 trillion of their debt is already held by major banks, including Industrial and Commercial Bank of China and China Construction Bank. Borrowing more to gin up growth isn't an option for a highly-indebted developing nation. Debt must be reduced.

The International Monetary Fund left no doubt of that in its latest assessment of the global economy. Of China, the IMF said: "Measures to contain local government debt, curb shadow banking and tackle excess capacity, high energy demand and high pollution will reduce investment and manufacturing output."

As Xi's reform process kicks in, a weaker yuan offers an obvious shock absorber. "China needs to keep growth up while getting excessive investment down, if only to avoid delaying for too long the moment when consumer spending comes to lead the economy, rather than — as now — slowing less than other sources of demand," Dumas says. "The bridge to the desired result has to be greater net exports. There is nothing else. But if a decline in the yuan worsens an already alarming race to the bottom with other currencies, the world may find itself in shock."

As I wrote earlier this week, the yuan's 11 percent surge since the start of the global crisis has placated officials in Washington, who have traditionally accused China of beggar-thy-neighbor policies. It also is helping China spread its tentacles around the globe (see this week's deal to buy New York's iconic Waldorf-Astoria hotel for $1.95 billion). A big devaluation now would irk officials not just in Washington, but in Tokyo and Seoul, risking another currency war that destabilizes markets and sours relations. Ahead of the annual meetings of the IMF and World Bank this weekend, U.S. Treasury Secretary Jacob Lew warned: "It's wrong to get into exchange-rate competition for the purpose of promoting advantage, one over the other." A devaluation isn't inevitable. "We still predict very gradual yuan appreciation as the currency, rather than economic, fundamentals are still supportive," says Simon Grose-Hodge, head of South Asia investment strategy at LGT Group in Singapore. "China is systematically moving to a domestic-demand led economy and we don't see them diverting from that path. While a weaker yuan may help exporters, it also stokes imported inflation, so would be a Pyrrhic victory."

Then again, if like Xi you're looking to turn China Inc. upside down without stoking social instability, any victory might sound attractive. As the Chinese president mulls his stimulus options in the weeks ahead, he's very likely to see a weaker yuan as a win-win.