Avoid Joining the Currency War!

By Chi Lo

Why China benefits little from renminbi devaluation.

China's renminbi has entered a "new normal" environment characterized by two-way trading and higher volatility since 2014. Market players have responded by increasing onshore foreign exchange hedging activity, which contributed to last year's drop in the RMB against the U.S. dollar. Will the RMB's weakness continue and fall sharply in 2015, as some analysts forecast? What is the People's Bank of China's exchange rate policy stance? Will it shift to target the RMB's trade-weighted exchange rate, or will it continue to target the RMB-U.S. dollar cross rate, and why?

Answers to these questions will help us understand the behavior of the RMB in its new paradigm, with implications for other central banks' currency policies. In particular, will the RMB be the next currency to join the currency war? In this regard, a policy shift toward targeting a stable trade-weighted exchange rate would prompt the People's Bank of China to devalue the RMB against the U.S. dollar. But my research shows that it would likely continue to ignore the trade-weighted exchange rate and target a strong RMB-dollar cross rate for good reasons.

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TEMPORARY NEGATIVE FLOWS

The People's Bank of China intervened heavily to push down the RMB-dollar exchange rate between February and April in 2014 to stamp out a one-way bet on RMB appreciation, which had gone on for many years. Since then it has intervened less even when the RMB rebounded, allowing the currency to enter a "new normal" paradigm in which two-way trading and foreign exchange volatility have finally become a reality. In fact, the People's Bank of China has been loosening its grip on the RMB since 2006, albeit very slowly, amid its appreciation trend, suggesting a gradual policy shift towards a freer RMB regime unnoticed by most players.

The RMB weakness in late 2014 that contributed to its 2.5 percent decline against the U.S. dollar for the year was due to temporary factors, which should not affect the RMB's medium-term appreciation trend. First, Chinese oil importers increased their purchases, and hence, their demand for U.S. dollars to pay for the imports, as the decline in oil prices picked up steam in the fourth quarter of last year. Monthly crude oil imports totaled more than U.S. $16 billion in the quarter, which was 90 percent of the U.S. $18 billion daily onshore RMB-dollar spot trading volume.

The exchange rate plays only an auxiliary role in helping China's GDP growth, and the significant costs involved in devaluing it far outweigh the benefits.

More crucially, onshore foreign exchange hedging activity rose sharply in late 2014, owing to RMB depreciation concerns in the context of the "new normal" era. The Bank for International Settlements estimated that the U.S. dollar liability of onshore Chinese companies totalled U.S. $1.1 trillion. There is no official data for the amount of onshore hedging activity. But if hedging amounted to only 1 percent of this liability, it would equal U.S. $11 billion, or more than 36 percent of daily onshore U.S. dollar spot and forward trading volume (about U.S. $30 billion). This could easily weaken the RMB, especially should the activity be concentrated.

WHAT EXCHANGE RATE DOES THE PEOPLE'S BANK OF CHINA TARGET?

Some analysts have jumped to the conclusion that the RMB would drop sharply in 2015. The market's forecast for the RMB exchange rate has focused predominately on the RMB-dollar cross rate, ignoring the Chinese currency's trade-weighted exchange rates (or nominal effective exchange rate and real effective exchange rate). The People's Bank of China's foreign exchange policy stance towards the trade-weighted exchange rates affects the RMB-dollar cross rate directly.

According to the Bank for International Settlements' estimates, the U.S. dollar, the euro, and the Japanese yen have the biggest weights (21 percent, 18.4 percent, and 16.8 percent, respectively) in the RMB currency basket. My estimates differ from those of the Bank for International Settlements in that the dollar has a bigger weight (40.3 percent) while the euro and yen have smaller weights (16.0 percent and 12.3 percent, respectively), as I have included the weights of the Hong Kong and Taiwan dollars with those of the U.S. dollar. The reason for doing this is because Hong Kong serves as China's *entrepot* and the Hong Kong dollar is linked to the U.S. dollar; this argument generally applies to the Taiwan dollar too.

If the People's Bank of China targets a stable trade-weighted exchange rate, weakness in the two heavy weights against the U.S. dollar implies that it would have to devalue the RMB against the dollar. For example, using these currency weights, if the euro and yen each depreciates against the dollar by 10 percent, the RMB-dollar cross rate would have to be devalued by 3 percent to 4 percent to keep the same average exchange rate, all else being equal. However, all other things are not equal, as the other currencies have also fallen against the dollar. So the People's Bank of China would have to devalue the RMB by more than 3 percent to 4 percent against the dollar to keep its trade-weighted exchange rate from rising.

HOW DO WE KNOW?

The People's Bank of China has never disclosed its foreign exchange policy stance, so how do we know which exchange rate it targets? An analysis of the sources of the change in the RMB real effective exchange rate shows that the People's Bank of China is not at all focusing on the trade weighted-exchange rate, which in

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turn suggests it is still targeting the RMB-U.S. dollar cross rate.

A change in the RMB real effective exchange rate comes from two sources and their interaction: the RMB nominal effective exchange rate and inflation differentials between China and its trading partners. Until recently, the People's Bank of China has been intervening heavily, albeit with a diminishing force over time, in the foreign exchange market to slow the RMB's appreciation against the dollar. As a result, China's foreign exchange reserves have mushroomed seventy-fold between 1994 and 2014 to almost U.S. $4 trillion.

The RMB exchange rate is not overvalued.

For the People's Bank of China to buy a large amount of foreign exchange, it has to print RMB, increasing its supply and thus arresting its appreciation pressure. The liquidity spillover of such foreign exchange intervention should create inflation, pushing up the real effective exchange rate. And indeed, the RMB real effective exchange rate has risen by more than 50 percent since the mid-1990s. A large inflation differential between China and its trading partners should explain the real effective exchange rate's sharp appreciation.

However, this is not the case. To see why, we broke down the appreciation of the RMB real effective exchange rate between 2005 and 2014 into the relative contributions from the nominal effective exchange rate and China's trade-weighted average CPI differential, and compared them with the corresponding statistics from its major emerging markets trading partners.

Within the decade, the RMB real effective exchange rate rose by 32.4 percent, second only to Brazil's 42.7 percent, while the real effective exchange rate of most of its emerging market trading partners dropped. Instead of devaluing the real effective exchange rate to gain competitiveness, China simply endured the RMB's strength, suggesting that it was not targeting the real effective exchange rate. The RMB has indeed become the dearest currency in real effective exchange rate terms among its major Asian peers since 2010.

Further, more than 86 percent of the RMB's real effective exchange rate appreciation was due to a rise in the nominal effective exchange rate, which has increased the most among its emerging market trading partners since 2005. Relative inflation has played a minor role in the RMB's real effective exchange rate appreciation, as China's trade-weighted inflation differential is significantly smaller than those of its emerging market trading partners, except that of South Korea. So the People's Bank of China was not targeting the nominal effective exchange rate either.

NO INTENTION TO DEVALUE

This evidence, in turn, suggests that the People's Bank of China is still targeting the RMB-U.S. dollar cross rate. Crucially, the persistent strength of the RMB-dollar daily fixing (exchange) rate, which is set by the People's Bank of China before the start of each trading day, on the back of a soft RMB in late 2014 that saw the spot rate trading lower towards the floor of the official trading band, strongly argues that the authorities were not engineering RMB weakness.

A strong currency is the easiest way for Beijing to force economic restructuring in the face of reform resistance. In my view, this is the strongest reason for the People's Bank of China to continue to let fundamental factors drive a mild appreciation of the RMB. Other reasons include the risk of capital flight if market expectations are built into RMB devaluation, and a significant global political backlash against such a policy.

The RMB exchange rate is not overvalued, so there is no technical reason to expect it to fall sharply. It has played a minor role in affecting Chinese export growth, which is predominately a function of global demand, and the contribution of China's net exports to GDP growth has been negative since 2009. All this argues that the exchange rate plays only an auxiliary role in helping China's GDP growth, and the significant costs involved in devaluing it far outweigh the benefits.

In a nutshell, devaluing the RMB is not China's best policy option. Unless the major currencies, especially the Japanese yen, drop excessively against the dollar, Beijing is unlikely to join the currency war. The medium-term fundamentals, in essence the sum of China's current account balance and net long-term capital flows, suggest that the RMB's underlying appreciation trend remains, albeit with higher volatility in the "new normal" era. Onshore hedging activity will continue to rise as the People's Bank of China further relaxes control on the currency. The Chinese authorities are still targeting the RMB-U.S. dollar cross rate, using mild RMB appreciation as a tool to force economic restructuring. They have other policy tools to boost GDP growth if they want to, but devaluation is not one of them. ◆