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# RMB: the sooner the depreciation, the better

From June 2005 to July 2015, Renminbi (RMB) appreciated 26% against United States Dollar (USD). Meahwhile, RMB's real effective exchange rate appreciated 57%. Since the second quarter of 2014, the appreciation expectation of RMB against USD in the market has been reversed to the depreciation expectation, which could be demonstrated by that the CNY-CNH spot exchange rate spread turned from negative to positive since then. The key reason of the reversal in the exchange rate expectation is that the effective exchange rate of RMB appreciated too fast between 2013 to 2014, which could not be supported by the economic fundamentals. During that period, RMB was still largely pegged to USD, and the effective exchange rate of USD appreciated very fast due to the exit of QE and the expectation of interest hikes.

From the second quarter of 2014 till July 2015, although there was a depreciation pressure, the exchange rate of RMB against USD remained unchanged. The intervention tool of People's Bank of China (PBC) was the management of the daily opening price of RMB against USD. Before August 2015, the daily opening price of RMB against USD did not equal to the closing price of the previous trading day. Therefore, PBC could offset the depreciation pressure by pushing up the daily opening price of RMB against USD persistently. The evidence of this intervention by PBC was that, from the second quarter of

2014 to July 2015, the daily opening price of RMB against USD was consistently lower than the closing price of last trading day.

To show that PBC is determined to decrease the intervention of exchange rate and to facilitate RMB's inclusion into SDR basket of IMF, PBC initiated a reform of RMB's daily opening price on August 11, 2015, and the key point of this move was to let the daily opening price of RMB against USD more determined by the closing price of the previous trading day. This reform meant that PBC was giving up the intervention on the opening price of RMB. However, because there was a significant depreciation pressure on the exchange rate of RMB against USD, the result of August 11's reform is the sharp depreciation of RMB against USD during the mid of August 2015. On the one hand, the depreciation pressure was so strong that is seemingly beyond the expectation of PBC. On the other hand, PBC began to be criticized because RMB's depreciation was thought to be the critical factor which caused the turmoil in both domestic and international financial markets. As a result, several days after August 11's reform, PBC was forced to intervene on the foreign exchange market again.

Because PBC had already given up the management of daily price of RMB against USD, the new tool used to stabilize RMB's exchange rate was the open market operation, which meant that PBC has to sell USD and buy RMB. Moreover, as a result of RMB internationalization, there are two RMB exchange markets now, the CNY market (onshore) and the CNH market (offshore). If PBC only conduct open market operation on the CNY market, the exchange rate spread between the CNY and the CNH markets would expand, which would bring about stronger pressure for RMB depreciation. Therefore, although without official acknowledgement, PBC was believed to be conducting open market operations on both the CNY and the CNH markets to avoid the depreciation of RMB against USD.

However, if there was the depreciation pressure of RMB against USD and PBC did not allow this pressure to be released, there must be certain costs. Therefore, instead of asking whether PBC should let RMB depreciate against USD, we ought to examine whether we can afford the costs of maintaining RMB stability.

The first cost of refusing RMB's depreciation is the persistent capital outflow. The logic is, if there is a continuous depreciation expectation of RMB against USD, both residents and non-residents would like to exchange their RMB denominated assets into USD denominated assets, resulting in capital outflows. China began to incur financial account deficit since the second quarter of 2014. From the second quarter of 2014 to the second quarter of 2015, the accumulated financial account deficit was USD 200 billion. However, the amount of financial account deficit increased to USD 160 billion and USD 200 billion in the third and the fourth quarters of 2015, respectively. The reason of the worsening capital outflow was that, after the August 11's exchange rate reform, the depreciation of RMB against USD aggravated, not mitigated. If there is no significant depreciation, PBC's effort to stabilize RMB's exchange rate against USD could not eliminate the depreciation expectation.

The second cost of refusing RMB's depreciation is the shrinking of China’s foreign exchange reserve. By the end of January 2016, China's foreign exchange reserve was USD 3,230 billion, which implied that the scale of this reserve had decreased nearly USD 800 billion from its peak level. Although the valuation effect of the fluctuations of major currencies might have contributed to the shrinking of foreign exchange reserve, the author's own calculation suggests that such valuation effect could explain only about one third of foreign exchange reserve's shrinking; and the rest would be attributed to PBC's open market operations. In fact, the real loss of foreign exchange reserve might be much larger than the above mentioned number, if some market rumors are to be believed that PBC tried to hide the real amount of USD assets they sold on the market. If the depreciation pressure persist and PBC continue to conduct the open market operation, it is possible that China's foreign exchange reserve could declined further to below USD 2,500 billion by the end of 2016. To make things worse, the fast shrinking of foreign exchange reserve might intensify RMB's depreciation expectation against USD.

The third cost of refusing RMB's depreciation is the weakening of monetary policy autonomy of PBC. According to the classical impossible trilemma, if PBC could not control the capital outflow and would continue to maintain the exchange rate of RMB stable against USD, PBC could not implement independent monetary policy. Under the current circumstance, the decline of economic growth and the exacerbating of deflation pressure require PBC to loose monetary policy by lowering required reserve ratio (RRR) or cutting benchmark interest rates. However, due to the concern that monetary loosening would push down interest rate spread between China and US and then exacerbate the depreciation pressure of RMB against USD, PBC has postponed RRR and interest rate cuts for quite a long time, which not only increased the downward pressure of real economy, but also resulted in the fluctuation of stock market. However, for a large economy like China, independent monetary policy should be considered more more important than maintaining a stable exchange rate.

The final cost of refusing RMB's depreciation is the negative impact of overvalued RMB to China's export growth. Although China's goods trade surplus was USD 578 billion in 2015, the reason of the huge trade surplus was not the good performance of exporting sector, but rather the very bad performance of import growth. out of the 12 months of 2015, China's export growth year over year was positive in only February and June. The weak external demand was one reason behind the dismal export growth, and the strong appreciation of RMB's effective exchange rate was another important reason. If RMB continues to remain stable against USD and USD continues to appreciate against other major currencies in 2016, China's exporting sector would continue to face downward adjustment pressure. If the pressure is too significant, both economic growth and labor market would suffer serious setbacks.

To summarize, if PBC continue to maintain the exchange rate of RMB against USD stable and refuse to release the depreciation pressure, Chinese economy would continue to face huge capital outflow, foreign exchange reserve shrinking, the loss of monetary policy autonomy and negative export growth. As time goes by, these costs would rise further and finally become unaffordable for Chinese economy. Therefore, the sooner to release the depreciation pressure of RMB against USD, the better for PBC and for the Chinese economy.

Last but not least, to avoid the downward overshooting of RMB's exchange rate against USD, PBC should strengthen the control on short-term capital flows, the aim of which is to avoid the vicious spiral between RMB depreciation and capital outflow. In addition, Chinese government should consolidate the macro-prudential regulation regime to minimize the potential impact of RMB's depreciation, such as the bursting of USD denominated debts borrowed by Chinese enterprises in the past several years.