Renminbi rising

By Zhang Monan
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On October 26, the renminbi's spot exchange rate against the US dollar reached the upper limit of its floating range for the second consecutive trading day. The rise began when the trading band for the renminbi's dollar exchange rate was widened to ±1%, and has now reached an all-time high since 1994's currency reform. With little sign of improved economic fundamentals, rapid currency appreciation is a potentially dangerous development for China – in part owing to the risk of an abrupt and painful reversal.

The renminbi's rise over the past month can be attributed to greater global liquidity since the start of the third quarter, as policymakers have responded to the eurozone's sovereign-debt crisis and stagnating output. Indeed, according to Morgan Stanley, monetary authorities in 16 of the 33 countries that it follows – including seven of ten advanced-country central banks and nine of 23 central banks in emerging markets – have either cut their benchmark interest rate or lowered reserve requirements.

After two rounds of quantitative easing (QE), the balance sheets of the European Central Bank and the United States Federal Reserve have grown to €3.2 trillion ($4.1 trillion) and $2.9 trillion, respectively. The ECB's new outright monetary transactions (OMT) program in secondary sovereign-bond markets, and the Fed's open-ended "QE3" continue this trend, while the Bank of Japan has expanded its asset-purchase program for the eighth time.

The spillover from the developed countries' latest round of QE is beginning to show up in emerging markets, where nearly a year of short-term capital outflows has given way to a new wave of short-term inflows. With US domestic bond yields continuing to fall and US equities reaching an upper price limit, owing to the real economy's sluggish recovery, more money is expected to flow to commodity markets and higher-yielding emerging countries. Given China's adherence to a stable monetary policy, the renminbi has become a more attractive asset to hold.

Indeed, as the renminbi strengthened over the last month, the People's Bank of China did not intervene strongly to repurchase dollars from commercial banks – a decision rarely seen in recent years. This indicates that the renminbi's appreciation was driven mainly by short-term arbitrage by outside funds.

Another reason for the appreciation is the renminbi's peg to the dollar, which has fluctuated increasingly widely since October 2011. As a result, while the renminbi performed poorly against the dollar in the first half of this year (even depreciating temporarily), America's year-end "fiscal cliff," together with QE3, has weakened the dollar since the start of the third quarter, with the exchange rate falling back to its level at the start of this year.

But there is still a need to be vigilant. While the onshore and offshore renminbi markets remain decoupled, the start of renminbi settlement under the trade account enables Hong Kong's offshore renminbi (CNH) currency market to coexist with the onshore (CNY) market, leaving significant room for arbitrage. Given that the renminbi's real and expected rates of return are higher than the real rate of return of other currencies, it has become a positive carry against foreign currencies, reinforcing the tendency to hold assets in renminbi and liabilities in foreign currencies.

Because China is still enforcing capital controls, it is not easy for foreign investors to put their money into the CNY market. Therefore, most short-term foreign inflows have detoured

through the CNH market. Indeed, the Hong Kong Monetary Authority has had to inject liquidity into its banking system four times in recent months – more than HK$14.4 billion – to stabilize the Hong Kong dollar's exchange rate, which clearly indicates that the international hot money flowing in is actually heading to the mainland.

Even with its recent strengthening, the renminbi is within a balanced exchange-rate band that is appropriate to its foreign-trade balance; still, China's economy could not bear sharp exchange-rate appreciation. Fortunately, that seems unlikely. In fact, both the deliverable and non-deliverable forward rates anticipate one-year renminbi depreciation of 2.35% and 1.75%, respectively.

In fact, the renminbi could be shorted again – most likely via the CNH renminbi market. In early December 2008, the worldwide crisis led to a global capital outflow from China, and the exchange rate of the renminbi fell to its lowest limit four days in a row – a record since the exchange-rate reform of July 2005. Then, beginning on November 30, 2011, the exchange rate approached the bottom of the trading band for seven days, causing panic in the market. These events are not distant memories.

After all, a currency's exchange rate is not determined only by economic fundamentals. There will always be foreign short-term flows that can increase a currency's volatility. Indeed, after its recent sharp appreciation, the renminbi could turn out to be a prime target for short sellers.

Zhang Monan is a fellow of the China Information Center, fellow of the China Foundation for International Studies, and a researcher at the China Macroeconomic Research Platform.