The Renminbi's New Normal

March 5, 2014

by Teresa Kong

of Matthews Asia

The gyrations in Chinese money markets in the last few weeks have caused much alarm in the financial press. The moves in these markets are not only inline, but healthy for an economy looking to increase the role of the market in allocating resources. Those who believe these moves indicate financial stress, or draw parallels between the recent volatility and that which preceded the subprime crisis in the U.S., might be looking through the wrong end of the telescope.

First, let's put the recent volatility in context. The renminbi (RMB) depreciated 1.4% relative to the U.S. dollar (USD) in February, making it the worst performing currency in Asia. The recent weeks have certainly been one of only a handful of periods of sustained depreciation. Such a historical comparison seems inappropriate, however, especially since the RMB is shifting to a more flexible exchange rate regime. Shouldn't China's central bank be managing the currency with an eye toward the future, rather than toward the past? Indeed, the experience of countries that have successfully transitioned from a fixed to a flexible exchange rate regime suggests that it is the job of authorities to foster a sense of two-way risk—meaning the currency could appreciate or depreciate to encourage investors to take both long and short positions. In other words, a successful evolution from a tightly managed currency to a more flexible regime actually seems to necessitate a rise in volatility. Even after the gyrations of recent weeks, the implied volatility of the RMB is still only at about half that of the Singaporean dollar, another managed currency; and about a quarter that of the Japanese yen, which is one of the most freely traded currencies in the world. Again, I believe this is healthy and also necessary in achieving China's goal of further liberalizing its capital markets. Consider it the new normal.

So why are market participants so surprised? Because being long the RMB—expecting that the currency should appreciate—has been the "no brainer" trade for many years. And for the past few years, people have not been using their brains when buying the RMB. They seem to be forgetting cause and effect. Currency appreciation, in and of itself, is neither a noble nor desirable goal. Managing the value of the currency is merely a means to an end. What might that "end" be?

One such "end" might have been to rein in inflation. An appreciating currency is a handy tool to slow inflation through lower import prices. Assume for a moment that the price of oil is constant at US$100 per barrel. That same barrel of oil would be 20% cheaper with an exchange rate of 6 RMB to the US$1 than 8 RMB/USD. In fact, there is an uncanny correlation between inflation and RMB appreciation ever since Chinese authorities transitioned from a fixed exchange rate to a managed band in 2005:

RMB vs Inflation

When wages could not keep pace with inflation, an ever-appreciating currency was necessary to help make imports cheaper, keeping inflation in check. But now that wage growth is surpassing inflation, there is less of a need to appreciate the currency. Indeed, the Chinese economy has arrived at a point where a continually rising RMB is not desirable. Consider the position of Chinese exporters. While the RMB has appreciated 9% relative to the USD in the last three years, it has appreciated an astounding 14% on a trade-weighted basis. In a world of quantitative easing, whereby three of the world's four largest currency blocks are racing to debase their currencies, the RMB stands at a competitive disadvantage.

And last, but certainly not least, the one-way appreciation of the currency has encouraged risky behavior, which together has heightened systematic risk in the Chinese economy. Among those engaged in one-sided bets are the global hedge funds that have raked in profits by being systematically short on the USD versus the RMB. Chinese companies also need to be weaned from the notion of a one-way appreciation that use offshore subsidiaries to borrow USD at low rates and then repatriate the proceeds disguised as RMB payment for goods that its parent firm invoices. The cash then gets invested in cash wealth management products yielding double digits. As we know, any product that offers a yield substantially higher than prevailing money market rates are neither cash equivalents nor risk-free. Then there are numerous chief financial officers who have told me that they believe issuing a five-year bond at 10% in USD is really only costing them 5% because they think the RMB is going to continue to rise 5% every year. These represent just a sample of individuals and companies with deeply vested interests in a rising RMB. By letting volatility creep into the currency movements, Chinese authorities are sending a wake-up call to those vested interests.

According to a Confucian proverb, bamboo does not break because it bends with the wind. Similarly, more volatility in China’s currency should be welcomed instead of shunned if the country is to fulfill its ambition toward a liberalized economy.