

RMB Exchange Rate Trend after "New Exchange Rate Reform" Analysis and Prospects

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A brief abstract: The RMB exchange rate has gone through currency appreciation and depreciation since the "811" exchange rate reform. This article is based on a detailed analysis of the reasons for the devaluation and appreciation RMB and suggests the future trend of the RMB exchange rate, that is, the RMB will not be brought onto a path of continuous depreciation, forming a long-term sharp devaluation. It's more likely that the RMB exchange rate remains mostly stable within a reasonable and balanced range, but there is the potential for wide fluctuation.

Starting from "811" exchange rate reform, the RMB exchange rate has experienced a full circle of substantial depreciation and appreciation, during which there have been some ups and downs. The point is that from August 10, 2015 to January 4, 2017, the exchange rate of RMB against the US dollar fell from 6.1162 to 6.9526. The depreciation was about 13.7%; from January 4, 2017 to April 2, 2018, the exchange rate of RMB against the US dollar was generally strong, rising from 6.9526 to 6.2764, with an appreciation of about 9.7%; from April 2, 2018 to October 31, 2018, the exchange rate of RMB versus the US dollar began to recover, falling from 6.2764 to 6.9670, with a depreciation of about 11.0%. From November 2018 to June 2019, the exchange rate of RMB against the US dollar increased from 6.9351 to around 6.7. Now we take an in-depth analysis of the causes of RMB devaluation and appreciation and what can be expected from the future trend of RMB exchange rate.

1. An Analysis of the Reasons for the Sharp Depreciation and Appreciation of RMB

1.1. An Analysis of the Reasons for the Sharp Depreciation of RMB

The direct cause of the depreciation of the yuan is improving the mechanism of exchange rate formation with the predominance of intermediate prices. After reforming the exchange rate mechanism in 2005, the average price of the yuan as the base exchange rate was dominated by central banks, its high and low price fluctuations are largely dependent on the central bank's policy. Since the end of November 2014, the current market price continues to remain below the central bank's average price, and the spread between the current and average price is getting larger and larger, approaching the lower limit of 2% per day. The central bank initiated the reform of the quotation mechanism for the intermediate rate of exchange rate with a view to correcting the major deviation between the spot exchange rate and the central parity rate and regarded the closing price of currency as a significant reference standard of the intermediate rate, and took into consideration the fluctuation of the main currency exchange rate in the foreign exchange market and the effect of the supply and demand relationship, etc. Thus, it both gained ground on the benchmark position of the intermediate rate of RMB exchange rate and improved its market, strengthen the effectiveness of the foreign currency market, create stable external environment for the macro-economy, expand the real space of the market currency, and promote the yuan exchange rate formation mechanism to move towards marketization. Equally, the reform of the central parity mechanism can effectively neutralize the big deviation between the offshore and onshore yuan exchange rates, facilitate their convergence, and allow the RMB to join the SDR.

The long-term appreciation of RMB added up the pressure of RMB devaluation. Statistics of BIS indicate that since exchange rate integration reform in 1994, the nominal effective exchange rate has increased by 71% and the real effective exchange rate has risen by 98%. Based on the market transactions between RMB and US dollar, at the beginning of 2014, yuan appreciated to 6.04 and began to depreciate. Until People's Bank of China lowered the deposit reserve ratio in March 2015, the RMB against the US dollar was down to 6.3 yuan, but then began to slow down and gradually stabilize. It remained at the level of 6.2 yuan until the sharp depreciation on August 11, 2015. At this time, dominated by the central bank, the central parity of the RMB-dollar exchange rate was 6.11 yuan. However, it can be observed that the long-term appreciation of RMB has accumulated the pressure of RMB devaluation which still persists.

The depreciation pressure from the strong dollar against the yuan currencies. Since the middle of 2014 the U.S. quantitative easing (QE) policy has been gradually withdrawn with its continuous economic recovery and improvement. Now the Federal Reserve will end the ultra-low interest rate state for more than six years, the U.S. dollar will continually recover, and the strong expectation of interest rate will continue to push the dollar index higher. The end of the first quarter of 2015 shows that the accumulated increase of the U.S. dollar exchange rate index (DXY) has reached more than 25%, in many countries. In many countries that are still in a quantitatively loose monetary environment, it is bound to increase the spread between the dollar and other currencies. International capital will flow into the US from emerging markets, which will facilitate to continue the new appreciation cycle to US dollar that has been already started. Against a background of a general tendency of the times, in combination with Chinese economy in the process of transformation and adjustment, the RMB capital flight is clear. The RMB funds outflow and the dollar rise show a great desire of importers, exporters and private investors to keep dollar holdings and yuan liabilities. The sharp depreciation of the currencies of emerging market countries has put de facto devaluation pressure on the RMB exchange rate.

The reduction in economic growth is an important factor of devaluation of RMB exchange rate. The exchange rate trend depends on the situation of a national economic development. In line with the continuous strengthening of the U.S. economy, Chinese economic growth slowed down considerably, in particular in the second quarter of 2018, the American economic growth expanded to 4.5%, while in the first three quarters of 2018 Chinese growth was 6.8%, 6.7% and 6.5%. With the steady reduction in Chinese economy, the supply and demand problems arose, the credit risk of enterprises increased, and then the financing problem limited the future development of enterprises. The decline has made the RMB exchange rate step into the depreciation, and this "positive stimulus" to devaluation will be used by short sellers, which will further exacerbate the devaluation range of yuan with strong leverage effect.

1.2. Analysis of the Causes for RMB Appreciation

In the event that the weakening of US dollar index makes the RMB appreciation trend. Starting with the "811" exchange rate reform in 2015 to October 2018, there was a significant negative correlation between the trend of RMB exchange rate and the US dollar index, namely the decline of the US dollar index and the appreciation of the RMB.. In the first quarter of the 2017, with the weakening of the dollar index and the stage wise improvement of the domestic macroeconomic operation, the RMB exchange rate started to appreciate.

The appreciation of RMB against the US dollar is the result of the expansion of bilateral interest rate China-US gap. The meeting of interest rate led to the inflow of brief arbitrage funds into China and the ensuing oversupply of US dollar in the foreign exchange market, and then the yuan appreciation against dollar. From May 2017 to March 2018, despite the disparity in Treasury yields of both countries widened markedly, the exchange rate of RMB against the U.S. dollar increased over the same period.

The large amount of capital inflow leads to the yuan appreciation. The short-term inflow of a large amount of capital can cause the passive appreciation of RMB exchange rate. In the first quarter of 2019, the current account surplus is \$49 billion, including \$94.7 billion of goods trade

surplus and \$38.8 billion of capital and financial account surplus, and the account deficit reaches \$30 million. According to the more detailed information on the difference between the internal bank and payment on behalf of customers increased rapidly from \$274 million in December 2018 to \$41.343 billion in January 2019, it could be seen as a huge inflow of short-term capital in January 2019. Also, it should be noted that it changed the supply-demand relationship in the foreign exchange market. No doubt, this appreciation is the result of the short-term effect of current account surplus, particularly the goods trade one. A big amount of capital inflow leads to the passive RMB appreciation.

2. The Chinese currency Will Not Enter the Channel of Continuous Devaluation Forming a Substantial Decline

As it was mentioned above, the direct consequence of RMB short-term sharp decline was the accumulated devaluation pressure of yuan long-term appreciation and the dominance of the strong US dollar on RMB exchange rate, the reform of the exchange rate middle price quotation mechanism has become a direct impulse to devalue the RMB in a short time. Experts within the country and abroad have different opinions whether RMB will enter a state of continuous devaluation. However, this article believes that the RMB will not follow this path, forming a long-term of substantial devaluation. The particular reasons are:

2.1. The Relatively Good Economic Environment Will Not Lead the RMB to Enter the Continuous Depreciation

The future trend of RMB devaluation includes internal economic growth and international competitiveness. Economic realities and market mechanisms are still the main factors that affect the RMB exchange rate trend. The period from November 2018 to June 2019 showed that China macroeconomic reality was quite stable, and the strength of the country cyclical adjustment didn't change, whether it was either the budget and monetary policies or related industries. Thus, the adjustment policies continued efforts, and the effect was constantly emerging, supporting the steady economic progress and making a platform for the long-term firmness of the RMB exchange rate. According to the statistics from the customs data, Chinese foreign trade import and export reached 12.1 trillion yuan from January to May 2019, the annual rate increased for 4.1%, the export in May reached 7.7%, an increase of 2 percentage points compared with the previous four months. One belt, one road, has been developing fast, and has reached a growth rate with Russia, Saudi Arabia and Poland. According to the State Administration of foreign exchange data, by the end of May 2019, the foreign exchange reserves in China w \$3101 billion, up to \$6.1 billion as compared to April. Various data shows that although the incertitude of RMB exchange rate due to the external environment has continues unabated, the favorable macroeconomic realities and the foreign exchange reserves can play a good role in the soundness of RMB currencies in the future. Although there is a direct link between the devaluation pressure and the impact of external risk factors, the short-term fluctuation has no impact on the long-term firmness of the RMB exchange rate.

As it was written above, despite the Chinese economy is now in its transforming and adjustment, the relatively good economic environment and good expectation for future reform provide the stability of the RMB currencies, that can not lead to the RMB to enter the long-term and substantial devaluation.

2.2. The Main Party of Foreign Exchange Transaction in China is Limited and Closed, Which Will Not Cause Continuous Selling Pressure on RMB

The major bank is the main party of transactions in Chinese foreign exchange market. The foreign exchange business keeps the balance trade of foreign exchange and sale positions between banks. The banks themselves will neither hold a very big net liability, nor use foreign exchange derivatives for leverage operation. Therefore, there is no such force in Chinese foreign exchange market and reserves, that could trigger a continuous selling pressure on the RMB exchange rate.

3. The RMB Exchange Rate Will Fluctuate in a Reasonable and Balanced Level.

The RMB will not follow this path in the future, forming a long-term substantial devaluation. And at the same time, due to the nowadays drop in Chinese economic growth and the continuous improvement of the U.S. economy, rising dollar will have a tendency which complicates to RMB to be in the appreciation for a long time. Looking to the future, this article believes that the RMB keeps the basic stability at a reasonable level, and there is the chance of wider fluctuation.A

We look hopefully to what will come. The infirmity in the short term will be more balanced and the exchange rate will be more flexible while the RMB exchange rate will remain basically fixed in the long term. On one hand, as it was said by the person in charge of the central bank, this was determined by the basics of Chinese macro-economic development. At present, Chinese economic base still maintains a quite good development tendency, with positive results in economic restructuring, high-quality economic development performance, sufficient economic growth, stable macro leverage ratio, overall controllable financial risks, and full foreign exchange reserves. It helps to step stone for the long-term stability of RMB exchange rate. On the other hand, after the exchange rate reform of "811", the central bank has gained long experience and policy tools to deal with the fluctuation. If it happens, the central bank has the ability to guide the fluctuation of RMB exchange rate, take the necessary steps to stabilize the RMB exchange rate, and prevent decisively the fluctuation from Israel and the United States. The short-term operation of RMB exchange rate, represented by China, keeps foreign exchange market soundness and ensures the basic permanence of RMB currencies at a balanced way. But at the same time, we can not ignore the short-term impact of trade tensions between China and the America, the supply-demand of foreign exchange market and the volatility of the US dollar trend, especially the impact of the Federal Reserve sudden shift from a long-term interest rate increase policy to a loose monetary policy such as interest rate reduction, which makes the RMB fluctuate more widely.

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