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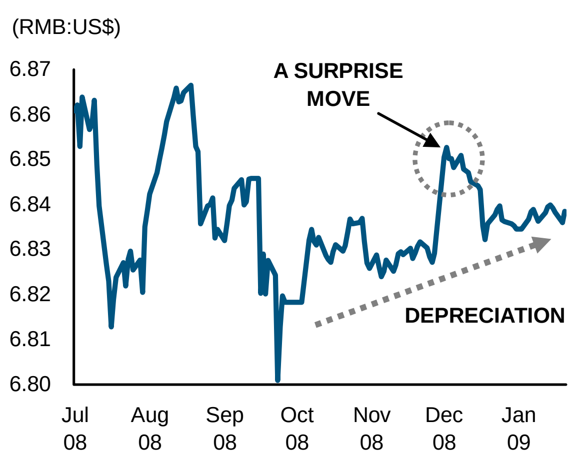
Asian Economic Perspectives

Fear of Jobs Crisis Keeps Beijing Under Pressure to Depreciate RMB

Since July 2005, when China switched to a policy of steady appreciation for the renminbi (RMB), the currency has strengthened by a cumulative 18.5% against the US dollar. A closer look at the trend, however, reveals a change of direction. After the global financial crisis began to unfold in July, Beijing essentially stalled the RMB/USD spot rate at 6.82–6.83; then, in early December came the surprise overnight fall to 6.85 (**Display 1**). This was a few days before former US Treasury Secretary Paulson's final official visit to China, and the fall was widely interpreted as a test by Beijing to see how financial markets and the US administration would react to a depreciation policy. While there have been no other dramatic movements since then, RMB/USD has depreciated marginally by about 0.5% overall in the last two months. We believe this signals China's keenness to adopt a weak currency amid the global economic down-cycle.

Display 1: Beijing Is Keen to Weaken RMB

RMB/US$ Exchange Rate



Source: CEIC Data and AllianceBernstein estimates

Expectations Gap Divides China and US

Economists may argue that a competitive currency is relatively irrelevant in boosting exports at a time of collapsing overseas demand. In our view, Beijing's thinking on exchange-rate policy is directly related to job creation. With export growth falling off a cliff and the closure of small- and medium-sized factories becoming rampant along the export-dependent coastal regions, a strong exchange rate makes no sense from a political-economy perspective. China needs to create 10–15 million urban jobs each year to absorb the millions of rural workers migrating to the cities. Failure to do this would jeopardize social and political stability, and pose a serious challenge to the Communist Party's one-party rule.

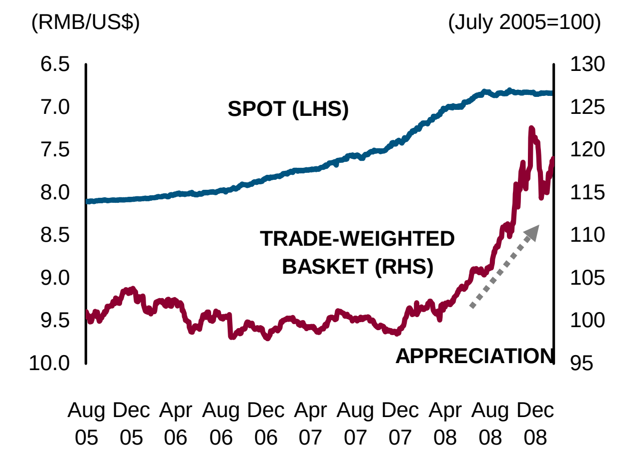
We expect that foreign governments—particularly those of the US and major European countries—would react to a renewed RMB depreciation by characterizing it as China's unwillingness to contribute to global rebalancing through an accelerated depreciation of RMB/USD. The US is keen to see the RMB emulate the performance of the Japanese yen under the Plaza Accord during 1985–1995, when JPY/USD appreciated by about 200% cumulatively. This ignores the fact that the JPY/USD revaluation did not put a dent in Japan's huge trade surplus either during that period or afterwards. We believe the debate would be better served by a more mature and reasoned analysis of the dynamics of bilateral external imbalances, rather than by a narrow focus on exchange rates. This could be achieved, in our view, by addressing such issues as deregulation of market access and the relative shifts in saving and investment behavior between the US and China. The bottom line is that China and the US have very different views on RMB/USD exchange-rate policy, leading to a huge expectations gap between the two countries that will remain intact for the foreseeable future.

Guideposts to RMB Depreciation

We believe Chinese policymakers will focus on two key trends when formulating exchange-rate policy in the coming year.

Display 2: A Less Competitive Currency

Renminbi Exchange Rates



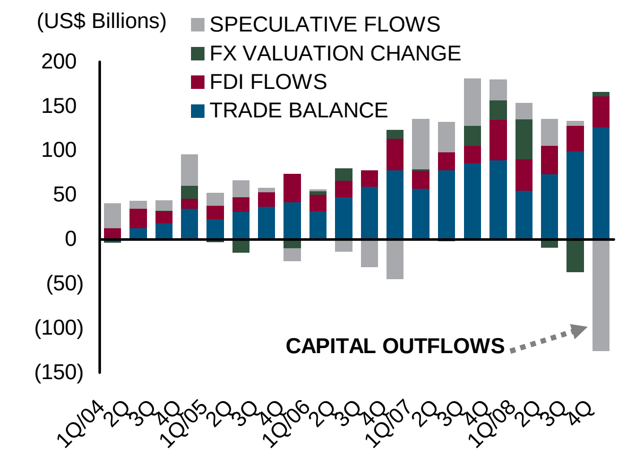
Source: Bloomberg, CEIC Data and AllianceBernstein estimates

The first is the direction of the US dollar. This is of key importance: ultimately, its impact on the competitiveness of the trade-weighted RMB currency basket will be crucial. Put simply, a strong US dollar would reduce the incentive for China to appreciate the RMB, while a weak US dollar would potentially mean an upward trend for the currency. In 2008, RMB/USD appreciated by about 7% while the trade-weighted RMB effective exchange rate gained nearly 18%—a result of the sharp depreciation of the euro and major Asian currencies (**Display 2**). For as long as weakness in major currencies persists, simply holding RMB/USD at the current level will continue to exert upward pressure on the RMB effective exchange rate. A depreciation of RMB/USD would be needed to restore China’s exchange-rate competitiveness.

The second is speculative capital flows. An analysis of sources contributing to China’s foreign-exchange reserves reveals that huge speculative outflows took place in fourth quarter 2008. Hot money surged into China when the RMB began to appreciate against the US dollar; now that the currency is perceived to be at risk of depreciating, the hot money is leaving as quickly as it arrived. If the outflow starts to deplete FX reserves and banking-system liquidity, Beijing may need to rethink the timing of its depreciation policy.

Display 3: Hot Money Leaves as RMB Expectations Change

Sources of FX Reserves Change



Source: CEIC Data and AllianceBernstein estimates

We estimate that speculative outflows amounted to US$125.7 billion in the final quarter of 2008, completely offsetting the US$126.3 billion trade surplus (in balance of payments terms) during the quarter (**Display 3**). The US$40 billion buildup in reserves (to US$1.95 trillion in December) was entirely the result of foreign direct investment inflows and a net gain in FX valuation of reserves assets (mainly Japanese yen-denominated investments). The slower FX reserves accumulation has yet to affect overall liquidity, however, as it has been more than offset by domestic monetary easing, particularly the 250 basis point cut in banks’ reserve-requirement ratio during the fourth quarter. If the hot-money outflow turns out to have peaked last quarter and the marginal impact of future outflows greatly diminishes, policymakers will have fewer concerns about liquidity constraints, making it easier for them to set a weaker RMB/USD.

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