Escalator Up, Elevator Down? Recent RMB Weakness

China's currency recently experienced its sharpest decline since it unpegged from the US dollar nearly nine years ago. China wants a more volatile exchange rate to introduce two-way risk in the currency market, meaning a continued steady rise in its currency is not a foregone conclusion. To help offset slowing investment growth, Chinese authorities may welcome a gradual decline in the currency, which would present a headwind for emerging markets and other exporting countries (such as Europe and Japan), and create another deflationary force in the global economy. A collapse in China's currency can be avoided so long as Chinese authorities keep the capital account closed—any aggressive opening of the capital account could trigger a financial crisis and a sharp currency decline.

This research brief reviews what happened in February and March, discusses the case for continued weakness in China's currency and its impacts, and what to watch for as China opens its economy.

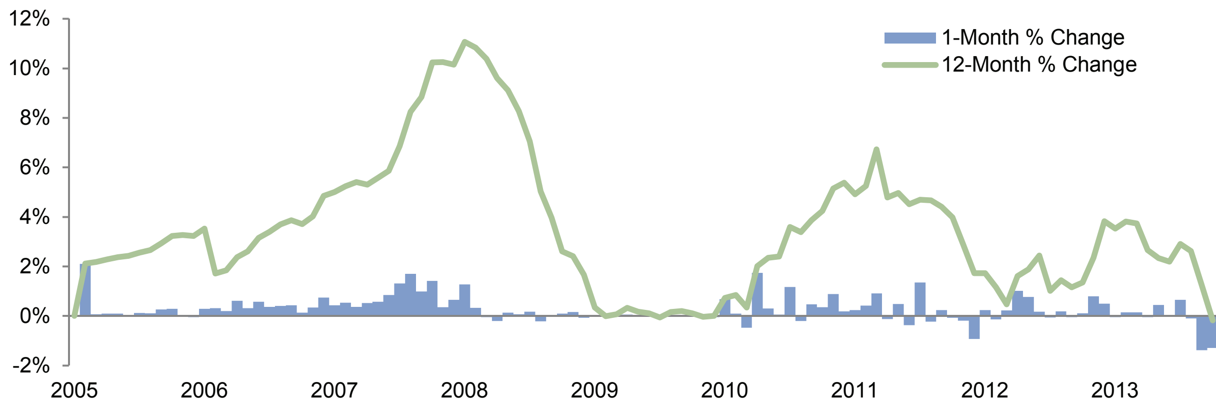
The RMB's Decline

The Chinese renminbi (RMB)[1] declined abruptly in February, and in March the Chinese central bank (the People's Bank of China, or PBOC) widened the daily trading band for the currency to +/- 2% from +/- 1%, sending the currency down further. Since the beginning of the year, the currency had declined nearly

[1] The Chinese currency, known as the renminbi or yuan, has two different exchange rates. CNY is the rate for onshore RMB, while CNH is the offshore, Hong Kong–traded RMB. The PBOC sets a daily "fixing" rate for the CNY and allows the currency to move within a daily limit. The CNH is technically free floating and can diverge from the CNY rate, but effectively tracks the CNY rate closely. We refer to the currency as the RMB throughout this paper, and use the CNY rate.

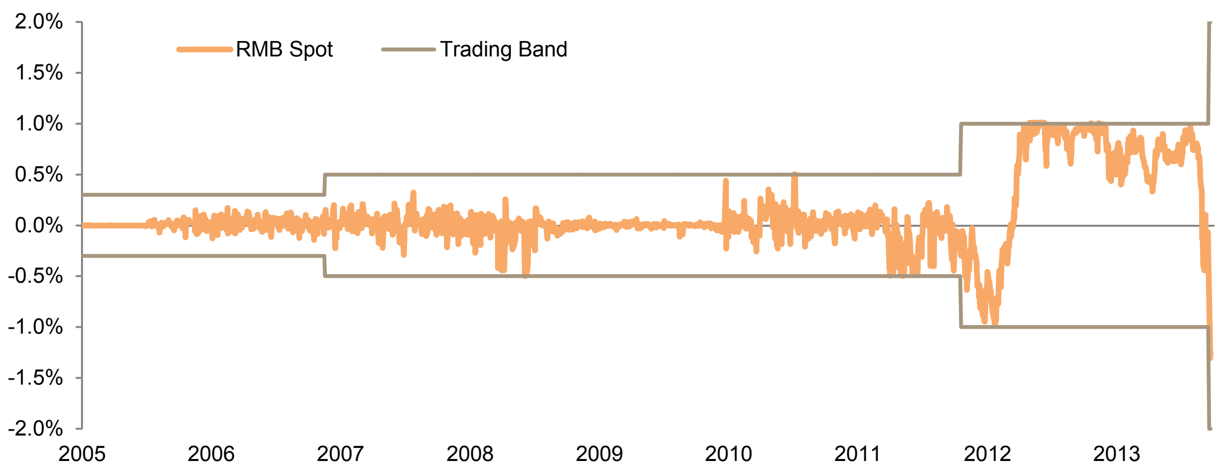
3% against the US dollar (USD), reversing its entire 2013 rise. While such a decline is small in the context of emerging markets currency swings, it is the largest decline in the RMB since the currency was unpegged from the USD in July 2005.

Appreciation of the CNY Relative to the USD
June 30, 2005 – March 21, 2014



The stated reasoning for February's decline was to shake out speculative long RMB positions and prepare the market for widening of the band. The PBOC had been signaling its desire to increase the volatility of the RMB and make the currency a "two-way bet" and had also become concerned about speculative carry trades by domestic investors (mostly Chinese companies with operations in Hong Kong) borrowing in dollars to reinvest in higher yields on the mainland. Such activity had kept the spot rate at the upper limit of its trading band since the middle of 2012.

RMB Spot Percentage Deviation from Daily PBOC Fix
June 30, 2005 – March 21, 2014



The release of data showing large net capital inflows of $73 billion in January seemed to trigger the central bank to begin steadily lowering its daily fixing rate. Investors got the message, and drove the currency from a 1% premium over the daily fixing rate to deep discount, although still within the new +/- 2% range.

The Market's Reaction

The initial reaction to the PBOC's announcement has been largely positive. Widening the trading band allows the PBOC more flexibility in conducting monetary policy, and higher volatility will reduce speculative inflows. Some analysts view it as a vote of confidence by the PBOC that China can handle additional currency volatility and that recent growth jitters are not halting the reform agenda.

The consensus view is that any additional weakness in the RMB will be modest, and that the RMB will continue to rise on trend so long as China maintains trade and capital account surpluses.

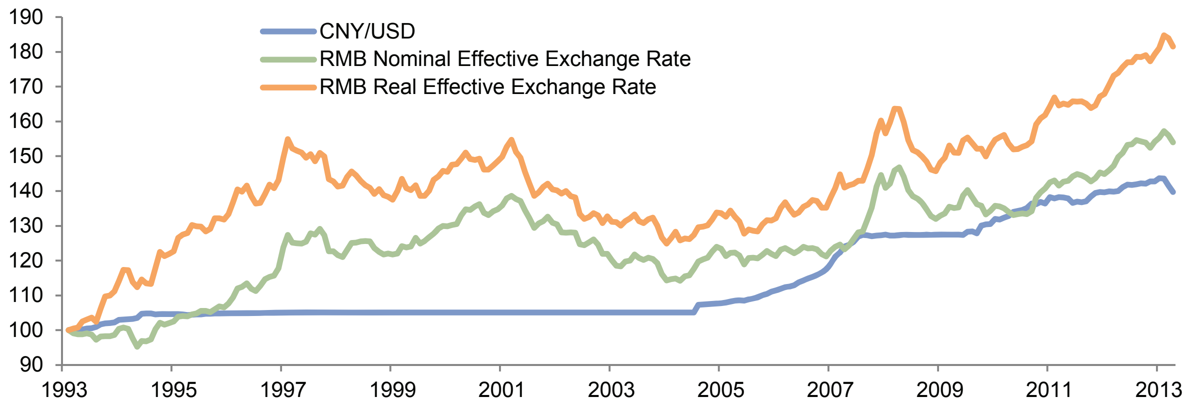
The Case for Continued Weakness

Despite the consensus view, a period of RMB weakness cannot be ruled out. China may allow further RMB weakness if growth conditions call for it as the PBOC does want a more market-driven exchange rate, and allowed the RMB to fall modestly (-1.5%) in mid-2012 as the euro crisis flared up and hit Chinese exports. The slide this February coincided with an easing of interbank interest rates, another signal that the authorities are trying to support the economy by modestly easing monetary policy.[2] In the near term, further RMB weakness above the $6.20 level could trigger a sharper unwind of long positions by Chinese companies.

China also does not view its currency as "undervalued." The recent rise in the RMB has occurred as other emerging markets currencies and the yen have fallen, which has made China's trade-weighted exchange rate rise much more than the bilateral RMB/USD exchange rate. China's rising wages and inflation have pushed up the real effective exchange rate (REER),[3] while other metrics we track imply modest overvaluation.

A continued gradual depreciation of the RMB is certainly not outlandish, and is perhaps necessary to help support growth in China amid a slowdown in investment spending.

[2] An alternative view is that attempts to drain liquidity via higher interbank rates were being undermined by capital inflows, and the PBOC sought to fight inflows by both lowering rates and allowing the currency to fall.
[3] A REER takes the trade-weighted average of one country's currency relative to a basket of other currencies, adjusted for inflation.



Will the RMB Collapse?

Should slowing growth turn into an investment bust, this would accelerate capital flight by Chinese nationals and foreign asset owners and increase the risk of a sharp, disorderly devaluation in the RMB. However, with a capital account that is officially closed (although porous), China has enough FX reserves to stem the tide of outflows and achieve an orderly depreciation of the currency, or even temporarily re-peg the currency. As China showed in 1997–98 and 2008, it is willing to protect its currency amid crisis periods (even at the risk of having its value versus other emerging markets currencies rise sharply). While China did devalue the RMB 33% in January 1994 to help kick start the export industry, the double-digit inflation that followed would be far too disruptive economically and socially if repeated today. Further, the international political fallout would likely be large, given existing tensions over China's exchange rate.

Impacts of RMB Weakness

A modest fall in the RMB would put additional pressure on emerging economies, and on European and Japanese exporters (and others that sell to and compete with China). Global equity markets could come under pressure amid a falling RMB, to the extent it signals intensifying weakness in China or heightened trade tensions. A falling RMB is also deflationary for the global economy (given cheaper Chinese exports and/or weaker demand for commodities) and may force an unwinding of complex "commodity-financing deals" used to facilitate dollar borrowing and hot money flows, putting additional downward pressure on industrial metals prices.

In a scenario where the PBOC has to draw down China's FX reserves to defend the RMB, this would likely require the selling of US Treasuries. While this could put upward pressure

on Treasury yields and downward pressure on the USD, the "risk-off" circumstances of such an event would in our opinion see US Treasuries and the USD well bid.

What to Watch For

Watching how the Chinese authorities liberalize the capital account is important, as a closed capital account is key to defending the currency, but also a source of economic problems. Thus, recent moves to liberalize aspects of the capital account are a double-edged sword. A gradual opening is needed as it alleviates trapped domestic capital that finds its way into unproductive uses. But opening the gates sets in motion a mechanism to hurt the banking system and trigger a crisis. If capital flight occurs, China's FX reserves would quickly be drawn down, leading to rapidly tightening domestic liquidity, potentially exacerbating financial stress. Too rapid an opening of the capital account would be a policy error in our opinion.

Bottom Line

China wants a more flexible exchange rate and might welcome a flat to modestly lower RMB over the near term, while a controlled depreciation of the RMB of perhaps 5% to 10% could occur amid a serious growth scare, something that is not yet priced in to markets. Yet a sharp devaluation of the RMB (say 15% to 20%) is unlikely given China's current account surplus, FX reserves, and closed capital account. At a minimum, be wary of investments overly reliant on RMB appreciation for returns (such as CNH bonds) as it is not a foregone conclusion that the RMB will continue to appreciate at a steady 2% to 3% pace over the next few years. ■

Contributors

Aaron Costello, Managing Director
Jason Widjaja, Senior Associate

Exhibit Notes

Appreciation of the CNY Relative to the USD Chart
Source: Thomson Reuters Datastream.
Note: Chart based on monthly data except for March data, which are month-to-date through March 21.

RMB Spot Percentage Deviation from Daily PBOC Fix Chart
Sources: People's Bank of China and Thomson Reuters Datastream.

Actual and Effective RMB Exchange Rates Chart
Sources: Bank for International Settlements and Thomson Reuters Datastream.
Note: Chart based on monthly data except for March data, which are month-to-date through March 21.

Copyright © 2014 by Cambridge Associates LLC. All rights reserved. Confidential.

This report may not be displayed, reproduced, distributed, transmitted, or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC ("CA"). Copying of this publication is a violation of US and global copyright laws (e.g., 17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. Therefore, recipients may not disclose any information or material derived from this report to third parties, or use information or material from this report, without prior written authorization. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that may be described in the report. No part of this report is intended as a recommendation of any firm or any security, unless expressly stated otherwise. Nothing contained in this report should be construed as the provision of tax or legal advice. Past performance is not indicative of future performance. Any information or opinions provided in this report are as of the date of the report and CA is under no obligation to update the information or communicate that any updates have been made. Information contained herein may have been provided by third parties, including investment firms providing information on returns and assets under management, and may not have been independently verified. CA can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results made by a manager that are delivered to CA electronically, by wire, or through the mail. Managers may report returns to CA gross (before the deduction of management fees), net (after the deduction of management fees), or both.

Cambridge Associates, LLC is a Massachusetts limited liability company with offices in Arlington, VA; Boston, MA; Dallas, TX; and Menlo Park, CA. Cambridge Associates Fiduciary Trust, LLC is a New Hampshire limited liability company chartered to serve as a non-depository trust company, and is a wholly-owned subsidiary of Cambridge Associates, LLC. Cambridge Associates Limited is registered as a limited company in England and Wales No. 06135829 and is authorised and regulated by the Financial Conduct Authority in the conduct of Investment Business. Cambridge Associates Limited, LLC is a Massachusetts limited liability company with a branch office in Sydney, Australia (ARBN 109 366 654). Cambridge Associates Asia Pte Ltd is a Singapore corporation (Registration No. 200101063G). Cambridge Associates Investment Consultancy (Beijing) Ltd is a wholly owned subsidiary of Cambridge Associates, LLC and is registered with the Beijing Administration for Industry and Commerce (Registration No. 110000450174972).

C | A