Olivar & Associates, LLC
Hua Xin Hai Xin Building, People's Square
+86 183 2144 4514 Shanghai, China January 11, 2016

The History and Outlook of the Chinese Renminbi (Part 1)

The Chinese Renminbi has been on the news a lot lately, both positively and negatively. The surprise devaluation in August shocked markets worldwide, while the inclusion of the RMB in the basket of international reserve currencies (Special Drawing Rights) of the International Monetary Fund was received on a more positive note. In this first part we will discuss the history of the people's currency.

History of the RMB

The Communist Party of China introduced the RMB in June 1949 as a unified currency for its controlled territories. In the early days of the RMB the currency was pegged, or fixed, against the Dollar at ¥2.46 per USD. When the Chinese economy started to make the transition from a planned economy to a market economy, the RMB was devalued to increase the competiveness of Chinese exports. When the RMB is devalued against the dollar, the owners of dollars can buy more Chinese goods for the same amount of dollars. Because China was exporting much more than it was importing, it had a large balance of trade surplus. This resulted in a large amount of foreign assets in China's current account, most notably dollars. China used these foreign assets to maintain a peg against the dollar of ¥8.27 from 1997 to 2005. It achieved this by using its foreign assets to buy or sell RMB in order to keep the rate fixed at ¥8.27.

After significant pressure from foreign countries that had a huge trade deficit with China, most notably the US, China decided to unpeg the RMB from the dollar on July 21, 2005. The RMB immediately started appreciating, until the global financial crisis hit in 2008. Because of the turmoil, China decided to re-peg the RMB against the Dollar, this time at ¥6.82 per dollar. When China continued the internationalization of its economy, it released a statement on June 19, 2010 that it would 'proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility'. China would let the market have greater influence on the value of the RMB, but would not allow large swings in the currency. Since then, the RMB has steadily appreciated to ¥6.04 per dollar in early 2014, after which a gradual depreciation began.

On August 10 of this year, the RMB had devalued to ¥6.2 against the dollar until the PBOC allowed it to devalue to almost ¥6.4 in a surprise move that send shockwaves through international financial markets. Many believe this move was necessary to fulfill the requirements of the International Monetary Fund (IMF) to be included in its basket of reserve currencies, also called Special Drawing Rights (SDRs). These SDRs are a kind of foreign exchange reserve asset that can be traded in for real currency if necessary. During their November review, they decided to include the RMB in their basket together with the U.S. Dollar, the Euro, Japanese Yen, and British Pound. Effective October 1, 2016, the Yuan will make up 10.92% of the basket, compared to 41.73% for the US Dollar. Although inclusion of the RMB in the SDR does not increase the usage by a significant amount, it makes it easier for countries to hold RMB assets in their official foreign currency reserve. By opening the financial system, it becomes easier for other countries to invest in, for example, Chinese government bonds. This in turn leads to better capital flow in and out of China, which is necessary for liquidity and the allocation of capital.

The Chinese RMB has transformed from a purely domestic currency to an international reserve currency over the last couple of years. To increase its role in international trade, it has to be more freely traded in the market. The current devaluation is part of that transition, and the next article will explain why this is also helping to avoid the 'hard-landing' of Chinese economic growth.