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The History and Outlook of the Chinese Renminbi (Part 2)

After a surprise devaluation of the Chinese Renminbi (RMB) against the Dollar in August that shocked the world markets, the Chinese Central Bank (the People's Bank of China, or PBOC) has quietly devalued its currency further during a 10 day period in December. In the last couple of weeks it has weakened and strengthened the yuan, creating volatility in the market. Why is this so important for the world economy and how does it affect anyone who has relations with China?

Current Situation

China has grown into the world manufacturing powerhouse since the 1990s. When you look around at all the products you have, there is a big chance most of them are either made in China or contain parts that are made in China. All these products are exported by Chinese firms, and the products are usually paid for in dollars. The companies need Renminbi (RMB) to pay their workers and procure production inputs, so they need to exchange dollars for RMB. The companies sell the USD and buy RMB, which increases the USD supply and lifts the demand for RMB. To keep the RMB/USD exchange rate stable, the central bank (PBOC) steps in to restore the balance. They buy the USD and sell RMB (which they can do by simply printing the money). This creates a scarcity of US dollars, which keeps the RMB/USD exchange rate at the level the PBOC desires. This leads to an accumulation of dollars in the foreign exchange reserves of China, which it needs to invest globally. It has done so by mainly investing in US treasury bonds, and China is now the largest owner of US treasury bonds in the world.

With the current slowdown in Chinese economic growth, the Chinese government and Central bank have taken several measures to dampen the slowdown. Investments are still very high in comparison to more developed countries, while consumer consumption makes up about 1/3 of GDP in comparison with almost 2/3 in the US. China wants to make the transition from an investment driven economy to a consumer driven economy. To facilitate this it has to become less dependent on exports and its manufacturing industry and create more domestic demand for products and services. This transition, however, will take many years to fully take effect. In the meantime, the government is trying to avoid a large drop in GDP growth, or 'hard-landing', that many people are expecting. To do so, it has to keep its manufacturing sector competitive and this can be achieved by devaluing the RMB.

Since the RMB has been 'pegged' against the US dollar for the majority of the time, it has risen together with the US dollar. The dollar has appreciated against other major currencies like the yen, the euro, and the British pound. This has made Chinese products expensive for countries that use these currencies, as they need to pay more of their own currency to buy the same amount of Chinese products. China has realized that their currency has to devalue if it wants to stay competitive in the global market. They started devaluing in August 2015 with a surprise 2% devaluation. Since then, the RMB has depreciated against the USD from a level of 6.2 RMB per USD to 6.55 RMB per USD.

Chinese people have noticed this depreciation and have started moving money outside of China, effectively selling RMB and buying USD. This is putting downward pressure on the RMB, so to counterbalance this the PBOC has to buy RMD and sell USD. They do this by decreasing their foreign exchange reserves (for example selling US treasuries), which stood at a little over 4 trillion dollars in August before the depreciation. Since then they have spent almost 800 billion dollars to prop up the RMB, as their foreign exchange reserves have declined to 3.23 trillion. If the outflow of RMB continues at the current pace of about 100 billion USD per month, they can still keep the volatility down for a while. However, if the pace picks up and they reach the end of their reserves, they have no other chance but to float their currency, which will most likely result in a big depreciation of the RMB against the USD and other currencies. This will cause significant volatility in the global financial markets and quite some trouble for Chinese policy makers.