

Will China weaken the connection between the renminbi and the dollar?

[CINKCIARZ.PL ANALYST'S OPINION]

For a few month the investors are observing the rate of the renminbi with an increasing attention. What impact will the recent announcement from the People's Bank of China have on the renminbi's value to the dollar? And will it contribute to a further stabilisation on the currency market? Commentary from Marcin Lipka, Cinkciarz.pl currency analyst.

On Friday afternoon "The Wall Street Journal" wrote referring to information from the People's Bank of China (PBOC) that the authorities in Beijing intend to weaken the connection between the renminbi (CNY) and the American dollar (USD). There is a plan to make the rate of the Chinese currency dependent on the main currencies, included in the Chinese trade exchange (the renminbi index).

This information has clearly deepened a reduction in prices on the capital markets. It also had a negative impact on oil quotations, due to anxieties of repeat the situation from August this year. At that time the movements on the renminbi caused a depreciation of the American S&P500 stock market index by more than 10%. This was one of the reasons that made the Federal Reserve resign from the idea of raising the American interest rates in September.

The August's anxieties were mainly a result of an assumption that the devaluation's purpose is to most of all improve competitiveness of the Chinese products. There were also speculations that this movement means worse than expected perspectives of development in the Chinese economy. Therefore, a weaker currency's aim was to support an increase in the GDP. Additionally, this had a negative impact on evaluation of the currencies of the emerging markets, and the countries dependant on export of raw materials.

Is it really such a bad information?

However, it is worth thinking whether if a change in renminbi's evaluation will really have negative consequences in the future. Making the rate of the renminbi dependent from the dollar is risky. It was seen in the past quarters. A serious strengthening of the American dollar on the global markets, was causing similar movements on the Chinese currency. This happened despite the fact that according to information from the PBOC, the Chinese exchange with the USA is only 26% of total foreign trade.

As a result, according to the Bank for International Settlements (BIS), the renminbi gained 13% of value since mid 2014. This may cause the Chinese products to lose competitiveness quite quickly, especially to the Asian competition.

It is also possible that if the PBOC keeps a steady rate of the USD/CNY, the situation could deepen due to anticipated raising of interest rates in the USA, and an increase in the value of the American dollar. At a certain point investors would begin to doubt the possibility of leaving this strategy. This would cause an outflow of the foreign capital, and a necessity for the PBOC to aggressively use the currency reserves. However, in the end this could lead to a devaluation of the renminbi in a more sudden way than it is now.

How can the following weeks look like?

In an official announcement published on its website, the PBOC claims that a starting point for the renminbi is the beginning of 2015, and the level of 100 points. According to the PBOC information, the renminbi index increased by 2.93% to the level of 102.93, on November 30. It seems that the choice of a starting point for the index itself, is not coincidental.

If the end of 2013 (or as the BIS claims 2010) was considered as a starting point, this difference would be respectively approximately 15% and 25%. This could suggest a will of the PBOC to significantly weaken the currency. However, currently the index suggests that the renminbi is overvalued to the base case moment by approximately 3%, which is 100 points.

The way of communication between the central bank and the market is also very significant. It is possible that the higher quotations of the USD/CNY will still cause anxieties of condition of the Chinese currency and depreciations on the developed markets' stock markets. If, however, the PBOC will focus more on a proper presentation of its arguments, a negative reaction on higher quotations of the USD/CNY should decrease. This can happen, especially if the renminbi's basket remains on an unchanged level.

In a long-term a change in the Chinese central bank's currency strategy, should prevent tensions on the markets. It should also reduce the global risk related to continuously anticipated increase in value of the dollar, after initiation of hikes cycle in the USA.

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