What we are watching during periods of volatility: The Chinese renminbi

Understanding developments in the RMB market is critical to understanding global markets

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Volatility in China has been a major driver of global markets, and Chinese foreign exchange policy has been a critical aspect of this volatility. The recent depreciation of China's currency, the renminbi (RMB), has increased the volatility of currency pairs across Asia and may affect markets across the world.

Since August, the Chinese have devalued their currency by nearly 7%.[1] The depreciation of the RMB has picked up pace since its addition to the International Monetary Fund's Special Drawing Rights (SDR) basket of reserve currencies on Nov. 30, depreciating by over 3%.[1]

In addition, the difference between the onshore-traded (CNY) and offshore-traded (CNH) RMB has been very volatile since the addition to the SDR basket. The difference between these two versions of the RMB reached a record wide level just after the New Year.[2]

Under control?

The Chinese authorities are using various tools in an attempt to control the pace of depreciation of their currency. Their primary tool is currency intervention. When intervening, the Chinese central bank purchases CNH or CNY in the open market. They have also intervened verbally, seeking to control market expectations by suggesting that the currency will remain stable.

Chinese currency, global effects

Volatility in Chinese currency has many global implications. Currency movements and currency policy significantly impact Chinese growth, global growth and global financial stability. Rapid, volatile depreciation of the RMB may be an indicator of increasing stresses with the Chinese economy. Chinese investors have built a large stock of capital onshore in China. As this capital flees China in search of better investment opportunities, it puts downward pressure on the currency and forces the central bank to intervene. The large size of these capital flows and the associated intervention can have a substantial impact on global financial markets.

Chinese currency depreciation also tends to cause depreciation among the entire Asian currency bloc, for example, the Korean won and Taiwanese dollar. In turn, Asian currency depreciation reduces the cost of imports in the US and could make it more difficult for the Federal Reserve to continue raising interest rates. Developed market policy makers are generally seeking to raise their rates of inflation, and importing Chinese deflation will likely make their task more difficult.

What we are watching

At Invesco Fixed Income, we watch the level of the Chinese currency very closely, both onshore and offshore. In addition, we closely monitor other indicators for signs of potential stress. For example, we monitor the spread between the CNH and CNY for an indication of how much control the Chinese authorities have over their currency. Authorities have preferred a tighter spread, therefore, a sharp widening may indicate a potential loss of control and could adversely affect markets. Additionally, we closely watch levels of RMB traded in forward markets as an indicator of potential speculation against the CNH. Speculators typically trade forward rates, and this type of transaction can add significantly to devaluation pressure.

Keeping a close eye on these levels and spreads allows us to understand and anticipate the effects of Chinese currency movements on other global market prices – on days when there is a large Chinese depreciation, risky assets have underperformed and global inflation expectations decreased. Going forward, we believe understanding developments in the RMB market will likely continue to be critical to understanding global markets.

[1] Bloomberg L.P., Jan. 8, 2016.
[2] Bloomberg L.P., Jan. 6, 2016.

Important Information

Spread represents the difference between two values.

The **Special Drawing Rights (SDR) basket** is an international reserve asset that was created by the International Monetary Fund in 1969 to supplement its member countries' official reserves.

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