

**POLICY CHALLENGES IN MAINTAINING
RENMINBI STABILITY IN CHINA**

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Executive Summary

1. The People's Bank of China's (PBOC) sudden move to adjust the renminbi (RMB) exchange rate regime on 11 August rattled financial markets. Despite attempts to stabilise the RMB to calm financial jitters, markets remain sceptical and doubts about government credibility were raised, underscoring concerns about China's commitment to market forces.
2. While a flexible exchange rate is key to RMB internationalisation, a flexible currency can be volatile and destabilising to the economy, particularly when the domestic financial system is still not fully developed.
3. Given China's gradually liberalised capital account and substantial relaxation of capital controls in recent years, China faces significant challenges in navigating exchange rate stability with the policy necessity of monetary autonomy.
4. The trade-off between maintaining a stable exchange rate and pursuing an independent monetary policy under an open capital account setting is known as the "Impossible Trinity". Such a trade-off has become increasingly binding.
5. Given that China is a large economy with a high degree of domestic orientation, an independent monetary policy is crucial for macroeconomic management.
6. To preserve monetary autonomy, the Chinese authorities have to either let the exchange rate adjust more freely and substantially, or use capital controls to tighten capital outflows.
7. However, restricting capital flows would go against the authorities' stated objective of further capital account convertibility and RMB internationalisation ambitions. It may also invite criticism that China is backtracking on its financial sector reforms.
8. The challenge in maintaining monetary autonomy and exchange rate stability has become greater. In the case of the yuan which has faced depreciation pressures lately,

China has to drain substantial foreign reserves to defend the exchange rate as well as constantly manage domestic liquidity which undermines the effectiveness of overall monetary policy easing.

9. By allowing the exchange rate to move flexibly and sufficiently, with the consequence of letting the yuan weaken through capital outflows, further depreciation pressures on the currency and the burden of managing domestic liquidity can be alleviated.
10. Meanwhile, PBOC Governor Zhou Xiaochuan has reaffirmed his commitment to continue with the existing policy of gradually liberalising both the RMB exchange rate (i.e. allow more “marketisation” of the exchange rate) and capital account.
11. The RMB is still facing strong depreciation pressures due to continued capital outflows and the need to service its huge external corporate debt.
12. The large trade surplus on the current account and the inclusion of the RMB into the Special Drawing Rights basket by the International Monetary Fund could give China more leeway in managing the various problems from the “Impossible Trinity”.