

The increasing Renminbi's flexibility: from a perspective of foreign reserves and capital flows

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Abstract

Since July 2005, the RMB has experienced both appreciation and depreciation cycles. By using rolling currency basket regressions with a variable of exchange market pressure (EMP), we found that the flexibility of the RMB exchange rate against a currency basket often changed. When the RMB was in a stable region and an appreciation trend, foreign exchange reserves played a major role in absorbing the EMP, while its influence decreased when the RMB shifted into a devaluation trend. From the perspective of capital flows, although China's capital account remains controlled, it can still positively affect the EMP through a VAR model. Foreign reserves can play a stabilizing role in hedging capital flows, however, when the RMB shifted into a depreciation trend, the smaller amount of foreign reserves made it difficult for the Chinese authorities to hedge the capital flows as before. This means that the RMB would need to exhibit more flexibility if the Chinese authorities want to eliminate or reduce their foreign reserves loss.

Key words: exchange market pressure, foreign reserves, capital flows