Lowering Interest Rate and Stabilizing Exchange Rate Are Not in Conflict[1]

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Abstract: Despite the depreciation pressure on the yuan, lowering policy rate is not in conflict with stabilizing exchange rate. In addition to interest rate spread, economic fundamentals are more critical to stabilizing capital flows and RMB exchange rate. It has been found that the more prosperous the domestic economy is, the higher the business demand for the yuan and hence the stronger the support for the yuan. The policy implication is that either lowering interest rate or fiscal expansion can strengthen the yuan as long as it can contribute to China's economic prosperity.

Two important phenomena have emerged recently in the currency and forex markets. **One is that the market-oriented short-term interest rate DR007 continues to remain significantly lower than the central bank's short-term policy rate (open market operations rate**). This occurred this March and the divergence between the two rates is widening despite fluctuations.

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The other phenomenon is the weakening yuan against the US dollar, which occurred this April and seems to be sliding more sharply after mid-August; another related phenomenon is that the opening price of the RMB central parity in late August is substantially higher than the closing price of the previous trading day, which is assumed by the market that the central bank may reuse the countercyclical factor (the central bank once announced phasing out the use of countercyclical factor in 2020).

The reason for the fact that the more market-oriented interest rate in the currency market is lower than the open market operations rate is because **the credit demand is insufficient with a given supply**, and therefore the more market-oriented interest rate in the currency market has declined while the policy rate has not. The phenomenon has prompted arbitrage behavior. While the short-term interest rate in the currency market has plummeted, the long-term interest rate fell even more sharply due to the impacts of policy rate. Hence the large spread between short-term and long-term interest rates has incentivized arbitrage.

The depreciation of the yuan against the dollar is partly caused by the continued strengthening of the dollar and partly caused by the market's lower demand for the yuan. Recently, the US dollar index has continued to rise. Under the RMB exchange rate mechanism based on a basket of currencies, even if the supply and demand remain unchanged in the forex market, a stronger dollar will still weaken the yuan. The RMB exchange rate experienced two rounds of large depreciation in April-May and August respectively. But the yuan depreciation is not in line with the appreciation of the dollar, and weaker demand for the yuan is also the reason for the depreciation.

The declining market interest rate and a weaker yuan seem to place the monetary authority in a dilemma. When focusing on the economic fundamentals and the supply and demand of credit, the monetary authority should lower policy rate. The policy rate should not only catch up with the decline of market interest rate but also lead the decrease of market rate. By doing so, the US-China interest rate spread will widen further, which will raise the market's concern over the weakening of the yuan and intensify the conflict between lowering policy rate and stabilizing exchange rate.

In fact, the concern is not valid. Many domestic studies on short-term capital flows have found that, China's capital flows are not sensitive to interest rates and spreads, and that sometimes changes in interest rates even head in the opposite direction against the expectations of capital flows. In our soon-to-be-published research titled "China's Capital Flows with Its Own Characteristics", we examined the trading entities and motives behind China's capital flows and presented the following findings:

1. The main entities behind China's capital flows are enterprises, particularly those engaging in foreign trade business or foreign-funded; under the current capital account management policy that allows limited openness of certain channels, **the impacts of financial institutions and households on capital flows are of secondary importance.** When making a choice between the yuan and foreign currencies, foreign-invested companies with trade businesses have to take into account a lot of factors. **Interest rate spread is only one of them, while other factors are more important, such as expectations of exchange rate and the fundamentals of domestic economy.**

2. The choice of exchange rate mechanism is crucial. With the right choice, it can act as a stabilizer of capital flows; otherwise, it could be an amplifier. In the past, the number one reason for the volatility of China's short-term capital flows is that the market's supply and demand fail to be reflected in the changes in exchange rate, making continued one-way appreciation or depreciation expectations that drive substantial short-term capital outflow or inflow. Since a more flexible RMB exchange rate mechanism was adopted, Cinna's short-term capital flows have remained relatively stable. The policy takeaway from the history is that, the central bank should refrain from intervening in the forex market simply to stabilize exchange rate and be very cautious with the use of counter-cyclical factors, so as to avoid one-way market expectation that will lead to greater pressure on short-term capital flows.

3. Economic fundamentals are critical to stabilizing capital flows and the RMB exchange rate. China's capital flows are closely related to PMI (Purchasing Manager's Index) and the correlation is higher than the interest rate spread and the US dollar index. The reason is that the more prosperous the domestic economy is, the higher the business demand for the yuan and hence the stronger the support for the yuan. The policy implication is that **either lowering interest rates or fiscal expansion can strengthen the yuan as long as it can contribute to China's economic prosperity.** In the current environment, while rate cut would widen the interest rate spread, it can also strengthen the balance sheets of businesses, households, and the government, increase credit demand, and improve economic performance, which will shore up the RMB exchange rate.