



July 2010

RMB & Purchasing Power Parity

The People's Bank of China issued a statement on 19 June announcing that it would proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility. Stock markets around the world rose in 21 June and RMB jumps to new high to USD. Most investors expect RMB will continue to appreciate against USD, however, some scholars in Mainland stated that there is downward pressure on RMB based on Purchasing Power Parity (PPP).

So, what is PPP? Is RMB going to appreciate or depreciate?

Firstly, let us look carefully on part of the PBOC's statement:

1) In further proceeding with reform of the RMB exchange rate regime, continued emphasis would be placed to reflecting market supply and demand with reference to a basket of currencies. The exchange rate floating bands will remain the same as previously announced in the inter-bank foreign exchange market^a.

2) China's external trade is steadily becoming more balanced. The ratio of current account surplus to GDP, after a notable reduction in 2009, has been declining since the beginning of 2010. With the BOP account moving closer to equilibrium, the basis for large-scale appreciation of the RMB exchange rate does not exist^a.

Clearly, the statement implied that there will be no one-off revaluation of the RMB vs the USD. The PBOC's spokesman confirmed this point by saying "A large fluctuation of the RMB exchange rate would bring considerable shocks to the domestic economic and financial stability, which is not in China's fundamental interest. Also, maintaining the RMB exchange rate basically stable at an adaptive and equilibrium level is an important element of further the RMB exchange rate reform. The basis for large fluctuation of the RMB exchange rate does not exist."

So, the central bank has ruled out a one-off RMB appreciation, how about depreciation? Is RMB going to depreciate as mentioned by the scholars in Mainland? Let us go through the basic concept of PPP.

Purchasing power parity (PPP) is a theory of long-term equilibrium exchange rates based on relative price levels of two countries. The idea originated with the School of Salamanca in the 16th century and was developed in its modern form by Gustav Cassel in 1918. The concept is founded on the law of one price; the idea that in absence of transaction costs, identical goods will have the same price in different markets.

In its "absolute" version, the purchasing power of different currencies is equalized for a given basket of goods. In the "relative" version, the difference in the rate of change in prices at home and abroad—the difference in the inflation rates—is equal to the percentage depreciation or appreciation of the exchange rate.

The PPP mentioned by the Mainland's scholars is the relative version, whereas the PPP mentioned by World Bank is the absolute one.

We think that PPP is not a comprehensive approach of forecasting the exchange rate and there are some difficulties and weakness when applying PPP. For example: purchasing patterns and even the goods available to purchase differ across countries, PPP numbers can vary with the specific basket of goods used, making it a rough estimate, differences in quality of goods are hard to measure and thereby reflect in PPP and some other important factors are ignored.

The continuous increase in labor productivity, huge trade surplus and net foreign capital inflow are the main reason why RMB/USD appreciated over 20% in the past 5 years. For the next 5 years, trade surplus may reduce and net foreign capital inflow may be lower, therefore, the pressure of RMB appreciation will be lower.

We expect that RMB will appreciate against USD within 5% per years for the next few years. Short term depreciation is possible but it will not affect the long term appreciation trend.

a. PBOC - *Further Reform the RMB Exchange Rate Regime and Enhance the RMB Exchange Rate Flexibility*

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