Twitter Thread by Michael Pettis

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This is a really tough problem to resolve, especially if the massive increase in inflows from the trade and financial accounts are sustained, as I expect they will be well into 2021.

Clearly the PBoC would like to see the RMB gradually...

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strengthen. This would keep financial markets stable and promote rebalancing, but the RMB has already strengthened a lot, and this puts unwanted pressure on exporters and “international circulation”.

Although PBoC reserves have been flat, other state-controlled Chinese...

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banks have bought large amounts of dollars, but this is expensive. If these banks have half a trillion dollars of exposure, for example, they are losing at least $15-17 billion annually on negative carry, plus another $20-30 billion just this year from the rise of the RMB.

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Beijing seems also to be trying other measures to slow the rise. The regulators are relaxing capital controls on outflows. In mid October the PBoC cut to zero the reserve requirement ratio for banks doing FX forward trading. This requirement was created in 2018 to reduce...

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downward pressure on the RMB. In late October it suspended the counter-cyclical factor in RMB fixing, which was introduced in 2017 also to reduce downward currency pressure. But in both cases while the RMB dropped a few pips on the news, it quickly resumed its upward climb.

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As the problem with inflows becomes more urgent, Beijing has only few possible responses:

1) It can allow the RMB to appreciate rapidly, which would hurt exporters (partially mitigated by the positive effect on consumption) and could destabilize the financial system.

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2) It can continue to intervene directly or indirectly, running ever larger losses on its position.

3) It can try to discourage financial inflows by lowering interest rates, but this might just increase debt and worsen asset price bubbles, and could even backfire...

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if it causes foreign investors to pile into a surging stock market.

4) It can relax rules on financial and investment outflows, and even encourage Chinese companies to go on a buying spree abroad, although this becomes a problem if foreign investors ever decide to exit...

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the local markets.

My guess is that it will do some combination of appreciation, intervention, and above all a relaxation on financial and investment outflows. The main point I guess policymakers are learning is that while it is one thing to promise to internationalize...

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the RMB to gain prestige, this must inevitably come with real costs, including losing control of the value of the currency and of the capital account – and usually, if the financial system is not in great shape, at the worst time possible.