



Our colleagues Zhiwei Zhang and Li Zeng recently offered at least a partial explanation.¹ We have for years emphasized that one needs to consider Asian exports from the perspective of regional production networks. An emerging literature demonstrates that exchange rate elasticities for exports are lower the more integrated countries are in supply chains. Zhiwei and Li re-calculated China's real effective exchange rate adjusting the weights for the importance of export processing. Chinese exports benefit from a depreciation of the Korean won, for example, to the extent that they embody imported components from South Korea. Recalculating the REER to incorporate such supply chain effects, they find that China's real effective exchange rate appreciated only 19% between 2010 and 2015 – and hardly at all for its high-tech export sectors – which is much less than the 31% appreciation of the BIS' conventional export-weighted REER.

Many exporters, of course, would welcome a depreciation and it may be that as the proprietor of the final stages of many regional production networks China's exchange rate versus the USD and EUR may be more important to regional export growth than that of South Korea or Taiwan, for example. But with a record trade surplus of USD602bn last year and rising we don't see a competitiveness-based need for a weaker currency.

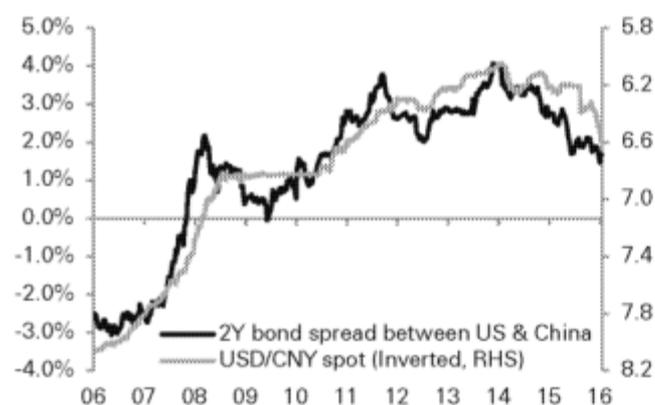
What do we expect from here?

That doesn't mean we don't see the currency continuing to depreciate. Zhiwei Zhang expects the exchange rate to reach 7.0/USD this year and our FX strategist Perry Kojodjojo thinks that could come earlier rather than later. A simple interest-rate based argument – the Fed expected to raise rates three times this year and China expected to cut twice – suggests 7.0 is a very plausible forecast.

Adjusting for supply chain influences, China's real exchange rate has appreciated far less than conventional measures suggest.

We still expect further RMB depreciation, just hopefully less rapid than in recent weeks.

Figure 9: Interest rates and the RMB



Sources: Bloomberg Finance LP and Deutsche Bank

But the pace of depreciation need not be as rapid as it has been. With an evolving strategy for managing the exchange rate the authorities have both surprised and confused investors. It is not clear what their intentions are beyond continuing to allow more flexibility in the exchange rate. Nor should investors expect perfect clarity – few countries that don't have fixed exchange rates are perfectly transparent. So investors and policymakers will both continue to learn how this new regime works. As capital outflows hopefully subside – and we think it's reasonable to expect they will -- there would be less pressure on the currency to depreciate.

¹ See Zhang, Zhiwei and Li Zeng, "A new REER index for RMB," Deutsche Bank Research, Jan. 5, 2016.