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The Impact of The Instability of External Economic Policy on The Exchange Rate of Renminbi

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Abstract: At present, the uncertainty of the international environment has increased significantly. It is of practical significance to study the exchange rate of RMB currencies from the perspective of external economic policy uncertainty to maintain the stability of the foreign exchange market. The article uses a panel quantile regression model to study the impact of external economic policy uncertainty on the exchange rate of RMB currency. The research shows that under the high quantile, the instability of external economic policy has a significant impact on the stability of the exchange rate. In this case, in order to maintain the relative stability of the exchange rate, the state should take into account the uncertainty of external economic policy in the formulation of corresponding policies.

Keywords: RMB rate, Panel quantile model, The uncertainty of external economic policy.

1. Introduction

The main goal of the monetary policy regulation by our central bank is to keep the exchange rate of the RMB at a logical and balanced level. This strategy is of great significance for China, which is forming a development model dominated by domestic market demand and promoting the synergy, mutual complementarity and common development between the domestic market and international market on this basis. The fluctuation of RMB exchange rate causes the fluctuation of financial market, and also affects the import and export trade, cross-border investment and so on [1]. According to the guiding ideology of the 20th National Congress of the Communist Party of China, we should continue to promote a high-level policy of opening up to the outer world. With the continuous expansion of China 's external level, the risk of instability of economic policies in the world market due to opening up is also increasing.

With the deepening of financial integration and economic globalization, the economic ties between countries are closer, and the government needs to take a series of measures to adjust its economy. However, the financial crisis, trade barriers, anti-globalization, hegemonism and power politics have made global economic growth in a slow state. It is difficult to coordinate international development. Countries are constantly adjusting their economic policies, especially the implementation of the Federal Reserve 's quantitative easing monetary policy, which has aggravated global instability [2].

Economic policy uncertainty is manifested in the government's unclear expectations of economic policies, as well as inconsistencies between policy implementation and shifts in policy positions and their intensity, which lead to uncertainty [3, 4]. The instability of economic policy has a significant spillover effect, which not only affects the economy of the country, but also affects the macro economy of other countries [3]. Under the continuous fluctuation in the global economy, the research of the influence of policy of economy instability on the RMB exchange rate has certain theoretical significance for studying the effect of outer economic policy instability on the macro economy and the impact on the transmission mechanism of the financial market. Maintaining our country's high-quality opening-up attitude, ensuring the stable operation of the foreign exchange market, and stimulating its development vitality are crucial for deepening the formation of a new economic development pattern dominated by domestic circulation and complemented by dual circulation at home and abroad.

The research on exchange rate fluctuation at home and abroad is mainly in the following aspects: In the 1920 s, Keynes put forward that the stability of exchange rates is one of the key factors for macroeconomic stability, and the variation of a country 's currency purchasing power determines the exchange rate volatility. The emergence of neoclassicism makes scholars begin to think as to the influence of micro factors on exchange rate fluctuations. The most representative is the study of Obstfeld and Rogoff Based on the M-F-D model, they add intertemporal rational expectations, producers (consumers) utility maximization and other equations to form a general equilibrium model with monopolistic competition dynamics between the two countries, referred to as the Redux model. In the subsequent research, Kollmann and Bergin investigated the impact of foreign policy changes on long-term exchange rate stability and short-term volatility. They use a Dynamic Stochastic General Equilibrium (DSGE) model to analyze the response characteristics of exchange rates under monetary policy shocks. Dou Feifei studied the effect of US monetary policy adjustment on the exchange rate of RMB by constructing an econometric analysis equation determined by the exchange rate. They believed that the US withdrew from the loose monetary policy and caused arbitrage capital flows through interest spreads. This dynamic has increased the pressure for depreciation of the Chinese yuan to the US dollar, thereby prompting an upward trend in the Renminbi exchange rate.

In summary, exploring how the instability of external economic policies affects the volatility of the Renminbi exchange rate is a crucial academic topic. Although there is a wealth of research results on the exchange rate of the Renminbi, most work focuses on exploring the impact of changes in domestic economic policies on the Renminbi exchange rate. Comparatively, there is relatively less research on how fluctuations in external economic policies affect the exchange rate of the Renminbi. Given this, the objective of this research is to in-depth analyze the specific impact mechanism and effects of external economic policy instability on the exchange rate of RMB currency, providing a new perspective for understanding the dynamic adjustment of RMB exchange rate under changes in global financial environment. The marginal contributions of this article mainly include: First, most of the available researches concentrate on the impact of the instability of domestic economic policies, while paying less attention to the effects of significant differences between countries in an international context on the fluctuations of RMB exchange rate. Due to the large heterogeneity of countries in the international market, there is not much research on how uncertainty in the external economic environment specifically affects the direction and stability of RMB exchange rate. This article aims to investigate in depth the impact mechanism and manifestation of external economic policy uncertainty on the fluctuation of Renminbi currency exchange rate under external environment through a combination of theoretical exploration and empirical analysis. Third, after explaining the effect of external economic policy instability, it further analyzes how to reduce the effect of outer economic policy instability and what can we do to stabilize the RMB exchange rate policy measures.

The layout of the following chapters is as follows: The next chapter explains the theoretical hypothesis of the impact of outer economic policy instability on the exchange rate of RMB. The third part introduces the data and variables of this article. The fourth part explains the empirical test, states the basic consequences, and the common trend test. The ultimateness and policy proposals of the fifth part are divided into two sections.

2. Theoretical Analysis

In this paper, the instability of external economic policy is mainly reflected in the study of the unsteadiness of American policy of economy. The instability of American economic policy is divided into monetary policy, fiscal policy, industrial policy and so on [5].

First, the effect of the volatility in US monetary policy on the exchange rate fluctuations of the Renminbi:

Because monetary policy itself has implications for inflation and the lagged effects on the economy, the Fed 's future monetary policy has great uncertainty. Monetary policy is mainly aimed at the interest rate level. When a country implements loose monetary policy, the country directly adjusts the interest rate to make more liquidity enter the market, and the supply of money in the market will increase. If the United States changes its monetary policy, that is, assuming that the United States lowers interest rates, then if it needs to meet investment demands the supply of money in the capital market must match the investment demand. The money supply in the domestic market of the US has increased. Given the reduction of U.S. interest rates, part of the US capital will flow into China because of China 's relatively high interest rates [6]. This trend may lead to a decrease in the value of the US dollar, which in turn could have an impact on the exchange rate of the Renminbi, prompting it to appreciate. Not only in this regard, due to the growth in domestic market supply, US suppliers' lending capacity has been strengthened. This can not only stimulate consumption and investment activities, but also lead to the augment in domestic demand in the United States, the number of imports in the United States will also increase, and naturally the number of exports in China will also increase.

The second part discusses how the volatility of US fiscal policy affects the dynamic changes in the Renminbi exchange rate:

The results of the November 2022 U.S. midterm elections have led the United States into a period of divisive Congress in the next few years. The differences between Democrats and Republicans on fiscal policy could lead to major changes in U.S. fiscal policy. When the U.S. government increases fiscal expenditure, such as increasing government purchases and reducing taxes, it usually stimulates economic growth, increases domestic demand, increases the demand for dollars in the international market, and leads to its appreciation of the dollar. More dollars are used to purchase goods and services on the world market. Because China is a major trading nation with significant trade relations with the United States, this has resulted in a depreciation of the Chinese yuan exchange rate. Wit reference to fiscal policy, the adjustment of tax rate is also an important aspect. If the US government cuts taxes, it will lead to an increase in money circulation in the market and drive the currency to depreciate. At this time, US domestic demand will rise, imports will increase, and the exchange rate of RMB is going up.

3. Put Forward the Hypothesis

The influence of policy of economy precarious existence on the exchange rate of Chinese yuan can be analyzed from the real economy. The influence of unsteadiness on the real economy can be explained by the real option mechanism and the financial friction mechanism. From the perspective of the real option mechanism, the company's investment and decision-making is an option behavior. The option value of delayed investment increases with the increase of uncertainty. When faced with the uncertainty of highly uncertain economic policies, enterprises will adjust their investment according to the actual situations, which in turn will have a certain impact on the output of the business, leading to a downward trend in return on investments. Financial friction theory is a supplementary mechanism. There must be corresponding frictions in economic activities. The frictions in economic activities can lead to increased investment costs for enterprises under the precarious existence of policies of economy, reduce the supply of credit funds, and reduce the allocation efficiency of funds. Then the overall productivity of enterprises will also decline [4]. Under such mechanisms, the pace of socio-economic development slows down, the speed of level improvement decreases, leading to a decrease in the value of Chinese yuan and a tendency for depreciation in RMB exchange rate. According to the above analysis, the following hypothesis is proposed:

Hypothesis: Under high quantiles, the precarious existence of outer economic policy exerts a significant influence on the foreign exchange market, especially on the Renminbi exchange rate.

The exchange rate of Renminbi as the ratio of Chinese yuan to foreign currency, is not only affected by the instability of domestic economic policy, but also to a large extent by the instability of external economic policy. Although China is a socialist market economy, Chinese economic policy regulations will be largely controlled by the state, and the uncertainty of outer policy of economy is unpredictable. Therefore, compared with the instability of outer economic policy, the volatility of China 's policy of economy has a relatively minor impact.

4. Variable Description and Model Specification

4.1. Variable Descriptions

4.1.1. Explained variables

Changes in the exchange rate of the Chinese yuan (Δ ln EXR). Selecting the Chinese Renminbi to US Dollar exchange rate under the direct quotation method as a proxy variable for the Renminbi exchange rate, where EXR means the exchange rate of RMB to foreign currency under the direct quotation method. Taking log and difference on EXR represents changes in Renminbi exchange rates.

4.1.2. Explanatory variables

Changes in foreign (regional) economic policy uncertainty (Δln EPU). EPU represents the foreign (regional) economic policy uncertainty index by implementing logarithmic transformation and differencing on the Economic Policy Uncertainty Index (EPU), we aim to accurately measure the dynamic changes in economic policy uncertainty across nations and regions.

4.1.3. Control variables

(1) Changes in China 's policy of economy ($\triangle\ ln\,C\,NEPU$). CNEPU stands for China Economic Development Uncertainty Index. By taking its natural logarithm and performing differentiation, we can quantitatively assess the changing degree of uncertainty in Chinese economic policy.

(2) China 's inflation rate (Δ ln CNCPI). CNCPI, which stands for China's fixed-base period Consumer Price Index, can be quantified to represent the inflation rate in China by taking its natural logarithm and performing differential operations.

(3) Foreign (regional) inflation rate (Δ ln CPI). CPI, namely the Consumer Price Index based on a fixed base period for foreign or regional inflation, can be quantitatively analyzed by taking its logarithm and performing differential operation to measure the rate of inflation change in that region.

(4) The change rate of external spread (Δ RATE). RATE represents the difference between the yield of Chinese and foreign 10-year treasury bonds, and the differential treatment of RATE represents the change rate of Chinese and foreign spreads.

The sample period of this study covers the time frame from January 2015 to December 2021. This paper selects the data of exchange rate of China, the United States, the European Union, Japan, etc., in which the data of economic policy uncertainty involved in the explanatory variables are derived from the relevant websites. The explained variables and control variables are derived from the WIND database and the State Administration of Foreign Exchange.

4.2. Model Selection

The quantile regression model is different in different quantile regression curves, which is more advantageous than the traditional regression model in reflecting the complex relationship between variables. Therefore, this paper selects the panel quantile regression model for analysis [4]. The quantile regression method treats the dependent variable as its conditional distribution function, aiming to accurately assess the impact of independent variables on the dependent variable at specific quantiles by minimizing the absolute sum of weighted residuals. The uniqueness of this approach lies in its ability to capture the variation patterns of variable effects at different quantile points, thus revealing trends in the dynamic impact of economic policy uncertainty on the Chinese yuan exchange rate. By analyzing the differences in variable coefficients at different quantiles, we are able to gain a deeper understanding of the complexity and evolution path of this impact. The following econometric model is constructed in this article:

$$\triangle\ ln\,E\,XR_{i,t} = \alpha_0 + \alpha_1 \triangle\ ln\,E\,PU_{i,t} + \alpha_j X_{i,t} + u_{i,t}$$

This model aims to analyze how uncertain factors in external economic policies affect the exchange rate of the RMB.

In the model: $EXR_{i,t}$ means the exchange rate of Renminbi , $EPU_{i,t}$ represents the index of external economic policy uncertainty, and the differences of these variables after being logged indicate their changes, $X_{i,t}$ means the variation of the variable ; in order to control variables, including China 's inflation rate $\triangle\ ln\,C\,NCPI_t$, the United States ' inflation rate $\triangle\ ln\,C\,PI_{i,t}$, and the rate of change of interest spreads between China and foreign countries $\triangle\,RATE_{i,t}$; $u_{i,t}$ is the residual value ; α_0, α_1, α_j represent the coefficients in front of each variable in the model.

Table 1. Descriptive statistics of variables

variable type	Variable name	mean value	standard deviation	minimum value	maximum value	Sample size (number)
variable being explained	$\triangle\ ln\,E\,XR$	6.4814	0.0457	6.4142	6.5643	132
explanatory variables	$\triangle\ ln\,C\,NEPU$	5.4856	0.8384	3.2636	6.8781	132
control variable	$\triangle\ ln\,E\,PU$	4.9953	0.3855	4.1569	6.2225	132
control variable	$\triangle\ ln\,C\,NCPI$	4.6223	0.0084	4.6051	4.6434	132
control variable	$\triangle\ ln\,C\,PI$	4.6071	0.0053	4.5930	4.6210	132
control variable	$\triangle\ RATE$	0.0622	0.6604	-3.2189	0.8919	132

5. Empirical Analysis

5.1. Correlation Coefficient

Table 2. Correlation coefficient of variables

variable type	$\triangle \ln EXR$	$\triangle \ln CNEPU$	$\triangle \ln EPU$	$\triangle \ln CNCPI$	$\triangle \ln CPI$	$\triangle RATE$
$\triangle \ln EXR$	1					
$\triangle \ln CNEPU$	0.6133	1				
$\triangle \ln EPU$	0.5346	0.5685	1			
$\triangle \ln CNCPI$	0.1388	0.0326	0.0129	1		
$\triangle \ln CPI$	0.0364	-0.0157	-0.0868	0.1305	1	
$\triangle RATE$	-0.1509	0.1791	0.0183	-0.1067	-0.1673	1

Firstly, the correlation between variables is investigated. Table 2 shows the correlation coefficients of variables such as exchange rate change rate ($\triangle \ln EXR$), economic policy uncertainty change rate ($\triangle \ln CNEPU$, $\triangle \ln EPU$), inflation rate ($\triangle \ln CNCPI$, $\triangle \ln CPI$) and interest spread change rate ($\triangle RATE$).

By analyzing the correlation coefficients between various variables, we revealed a significant positive relationship between uncertainty in international and domestic economic policies and exchange rate volatility. This finding suggests that when the stability of economic policies decreases, the exchange rate of the Renminbi will correspondingly show an upward trend, indicating a higher likelihood of depreciation for the currency. Observing the relationship between the difference in yield rates of US and Chinese 10-year government bonds and the Renminbi exchange rate, we find a significant negative correlation between the two. Specifically, when the yield spread between US and Chinese 10-year government bonds increases, the exchange rate expressed by direct price method will correspondingly show a downward trend. This suggests that the relative value of RMB is strengthening, indicating an inclination for appreciation of RMB. The economic logic behind this phenomenon is that the higher interest rate differential between China and the United States usually attracts international capital inflows into China to pursue higher investment returns. This influx of capital increases demand for the renminbi, thereby pushing up its value. At the same time, capital inflows also reflect increased market confidence in China's economic growth prospects, further supporting expectations for RMB appreciation. Therefore, the negative correlation between the yield spread of Chinese and US 10-year government bonds and the exchange rate of Renminbi is a result of the combined influences of international capital flows, market risk preferences, and confidence in China's economic growth. According to the data in Table 1, China's average inflation rate is significantly higher than the international average level. Given this, the central bank may take tightening measures such as raising interest rates to deal with inflationary pressures, which has led to an increase in interest rate differentials between domestic and foreign markets. The increase in demand for the renminbi by the market has subsequently driven its appreciation trend.

5.2. Stability Test

Panel data contains the characteristics of cross-sectional data and time series data, and the construction of regression model must ensure the stability test of data [4]. This article uses the LLC test to conduct unit root tests on variables, with results shown in Table 3. The consequences of the stationarity test show that all variables are stationary sequences and can be used for subsequent model construction.

Table 3. Stability test

variable	$\triangle \ln EXR$	$\triangle \ln CNEPU$	$\triangle \ln EPU$	$\triangle \ln CNCPI$	$\triangle \ln CPI$	$\triangle RATE$
LLC (Note: the p value of the statistic in parentheses)	-7.654 (0.000)	-13.775 (0.000)	-13.863 (0.000)	-7.336 (0.000)	-15.293 (0.000)	-10.796 (0.000)
	stationary	stationary	stationary	stationary	stationary	stationary

5.3. Panel Quantile Regression

Assessing the impact of uncertainty in foreign economic policies on exchange rate fluctuations by using panel quantile regression technique for parameter estimation. Among the 10 % -90 % quantiles, a quantile is taken every 10 %, and a total of 9 quantiles are taken. The quantile regression results are shown in Table 4.

On the basis of the estimated data of various percentiles in Table 4, it is revealed that in lower percentile cases, the positive effects of foreign economic policies on the RMB exchange rate did not show statistical significance. The increasing unsteadiness in foreign economic policy changes has a growing effect on the exchange rate of RMB, and this effect is strengthened with the increase of percentiles [6]. It shows that the growth of foreign (regional) policy of economy precarious existence will push the Renminbi exchange rate towards depreciation, and foreign economic policy precarious existence has a strong explanatory power for the sharp change of RMB exchange rate. This strongly verifies Hypothesis 1.

From the perspective of each control variable, China 's economic policy instability changes between 10 % and 40 % quantiles, and the positive impact is significantly increasing. However, from 40 % to 90 %, the influence of China 's economic policy instability on the remittance of personal name currency is declining. It shows that the symmetry of Chinese economic policies in relation to the exchange rate of RMB. At the 50th percentile, foreign inflation changes exert a significant and negative correlation with the Renminbi exchange rate. Specifically, when the foreign inflation rate is in the range of 40% to 60%, observed phenomena further confirm that to a certain extent, as the foreign inflation level rises, the Renminbi exchange rate shows a clear appreciation trend.

There is a positive correlation between the inflation rate in China and the exchange rate of the RMB: an increase in the inflation rate leads to a tendency for depreciation of the RMB exchange rate. The strength of this effect can be measured by the coefficient value in statistical models. When the coefficient is positive, it indicates that an increase in inflation rate will lead to a decrease in the purchasing power of Renminbi relative to other currencies. Furthermore, through analyzing the impact at different percentiles, we found that this positive correlation gradually strengthens with the increase in inflation levels. This means that, as China's inflation rate continues to rise, market expectations suggest the possibility of greater depreciation pressure on the renminbi, reflecting a dynamic adjustment process between economic fundamentals and currency value. T The analysis shows that the international and domestic differences in the 10-year government bond yield rates have not significantly affected the trend of RMB exchange rate movements. Starting at 30%, changes in interest rate differentials have had a certain impact on the exchange rate of RMB.As the percentile rank increases, changes in interest differentials have a more consistent effect on the exchange rate of the renminbi. Given that the coefficient has a negative value, this indicates that as the spread widens, the RMB exchange rate shows an appreciation trend.

Table 4. Estimates of quantile regression results

variable	10%	20%	30%	40%	50%	60%	70%	80%	90%
$\triangle\ ln\ E\ PU$	0.0191 (0.0063)	0.0137 (0.0120)	0.0128 (0.0127)	0.0150 (0.0133)	0.0301 (0.0119)	0.0312 (0.0142)	0.0410 (0.0146)	0.0326 (0.0145)	0.0449 (0.0192)
$\triangle\ ln\ C\ NEPU$	0.0281 (0.0029)	0.0313 (0.0055)	0.0444 (0.0059)	0.0418 (0.0062)	0.0403 (0.0055)	0.0387 (0.0066)	0.0297 (0.0068)	0.0237 (0.0068)	0.0126 (0.0056)
$\triangle\ ln\ C\ PI$	0.3493 (0.3855)	0.0969 (0.7284)	0.1837 (0.7733)	-0.0518 (0.8088)	-0.6079 (0.7234)	-0.3984 (0.8626)	0.1528 (0.8905)	0.1743 (0.8856)	-0.1668 (0.7246)
$\triangle\ ln\ C\ NCPI$	0.0011 (0.0010)	0.2988 (0.4527)	0.0154 (0.4805)	0.4222 (0.5026)	0.5068 (0.4495)	0.8119 (0.5360)	1.4097 (0.5534)	0.9965 (0.5503)	1.0812 (0.4503)
$\triangle\ RATE$	-0.0078 (0.0031)	-0.009 (0.0059)	-0.0232 (0.0063)	-0.0225 (0.0065)	-0.0202 (0.0059)	-0.0180 (0.0070)	-0.0240 (0.0073)	-0.0195 (0.0072)	-0.0126 (0.0059)

Note: The standard deviation of parameter estimation is in parentheses.

5.4. Robustness Test

The robustness test of this paper is estimated by phased panel quantile regression. Due to the event of ' 811 exchange rate reform ' in 2015, the year of 2015 is used as the time point to examine the impact of the instability of foreign economic policies before 2015 and after 205 years on the RMB exchange rate [4]. The regression results are shown in the following charts. The estimation of the panel quantile regression results in Table 7 shows that:

(1) Before 2015, the effect of outer economic policy changes on the exchange rate of RMB began to appear at 30 %. when the quantile was 30 % -60 %, the influence of external economic policy instability on the exchange rate of RMB generally showed an upward trend, which had a certain explanatory power for the exchange rate of personal name currency. This result is basically lined with the conclusion of empirical analysis.

(2) From 2016 to 2020, According to the chart, the uncertainty of external economic policies has not significantly affected the exchange rate of RMB. This indicates that during this period, fluctuations in the RMB exchange rate seem to lack market sensitivity to this type of uncertainty [7]. In other words, the exchange rate market has failed to clearly reflect the impact of external economic policy instability factors on exchange rates, implying that markets may not have fully priced in or reacted to such risks.

Table 5. Phased quantile regression estimation results

variable	10%	20%	30%	40%	50%	60%	70%	80%	90%
2010.1-2015.12									
$\triangle\ ln\ E\ PU$	0.0079 (0.0045)	0.0090 (0.0081)	0.0249 (0.0092)	0.0261 (0.0121)	0.0220 (0.0188)	0.0289 (0.0224)	0.0153 (0.0278)	0.0169 (0.0257)	0.0206 (0.0241)
2016.1-2020.12									
$\triangle\ ln\ E\ PU$	-0.0092 (0.01340	0.0019 (0.0176)	-0.0010 (0.0162)	-0.0021 (0.01610)	0.0045 (0.0130)	0.0066 (0.0133)	0.0094 (0.0084)	-0.0059 (0.0086)	-5.21e- 06

6. Conclusions and Policy Recommendations

This study conducts empirical tests using panel quantile regression method to reveal how economic policy uncertainty affects the exchange rate of RMB. Through empirical analysis, it is found that the uncertainty of external economic policies significantly affects the fluctuation of RMB exchange rate, demonstrating strong explanatory power. With the continuous deepening of RMB exchange rate reform, the market orientation of RMB exchange rate has significantly strengthened. The significant impact of uncertainty in external economic policies on the exchange rate of the Renminbi highlights the need for effective measures to prevent drastic fluctuations caused by such uncertainties. This paper proposes the following policy recommendations:

(1) Facing the constantly evolving external economic policy environment, the impact on the exchange rate of RMB can be mitigated by adjusting our country's exchange rate target strategy [6]. This strategy aims to take into account the uncertainty factors of external economic policies in order to enhance the adaptability and stability of the Renminbi

exchange rate policy. When formulating exchange rate adjustment strategies, special attention should be paid to the potential impact of economic policy uncertainty and targeted measures should be taken to address challenges that may arise from external economic policy changes [8].

(2) Strengthen the authenticity and timeliness of media coverage of economic policies. In the current international situation, we should strengthen the authenticity of self-media and news media reports. In order to guide consumers to better invest and measure risks, the official media should also provide objective criteria.

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