Economic Analysis

The PBoC's exchange rate reform is to usher high volatility but not sharp depreciation of the RMB

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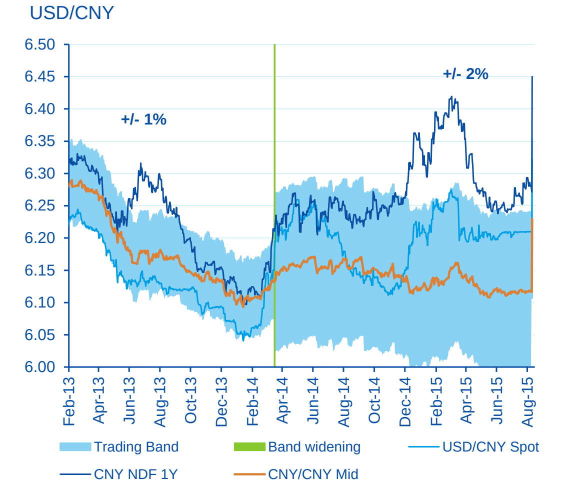
Today, the Peoples' Bank of China (PBoC) announced a reform of the RMB exchange rate formation mechanism, seeking to increase the flexibility of the exchange rate. In particular, the daily opening fixing rate of the RMB will be directly formed by market makers, namely 35 large banks designated by the authorities, in China's onshore FX market instead of being set by the PBoC previously. (Figure 1) The new policy has been immediately implemented. Meanwhile, the PBoC depreciated today's fixing rate (the last one being dictated by the central bank) by 1.9% to 6.2298 from yesterday's level of 6.1162. The move itself can be regarded as an important and welcome step in China's ongoing financial liberalization, which is to enhance the independence of monetary policy conduct and therefore enable China's economy to better accommodate external shocks such as the imminent US interest rate hike. Looking ahead, we anticipate the volatility of the RMB will rise significantly, in particular in the coming months. However, we deem a sharp depreciation of the RMB over the medium-term very unlikely and therefore lower our end-year projection modestly to 6.35 CNY/USD.

- **The reform of the RMB's fixing rate formation is a milestone in China's financial liberalization.** Previously the PBoC set a daily opening fixing rate of the RMB against the USD and then allowed the spot exchange rate of RMB/USD in the interbank market to fluctuate within the daily trade band (+/-2% henceforth). Therefore, the PBoC can manipulate the RMB exchange rate by setting the fixing rate at a level they desire. By giving away the power of fixing-rate setting to market makers, the PBoC has largely loosens its tight grip of the exchange rate. Nevertheless, we don't reckon that the PBoC will fully lose its influence on the currency. Like some of its peers in other countries, China's central bank can directly intervene in the FX market to affect the exchange rate. Moreover, it can also use moral suasion to influence market makers.
- **The move is likely to be motivated by a confluence of factors:** First, the recently sharp depreciation of emerging market currencies have weighed on China's export sector, prompting the authorities to initiate currency deprecation to ease intensifying pressure; second, China's authorities, in a bid to ensure the RMB's inclusion of the the IMF's Special Drawing Rights (SDR), are keen to demonstrate to the IMF and international investors that the financial reform hasn't stalled on the recent stock market rout; last but not least, the authorities need a flexible exchange rate to cushion against external shocks such as imminent Fed interest rate hike as well as provide more room for further policy easings.
- **We still deem that the RMB exchange rate will remain broadly stable over the medium-term despite the increasing volatility in the short run.** In essence we agree with the IMF's assessment that the RMB is now "fairly valued". Compared to exports, China's imports dropped much deeper, resulting in "recessionary surplus" under the current account. (Figure 2) Moreover, given that the IMF member countries are to determine whether to include the RMB in the SDR this November, it is equally unpalatable to see a sharp depreciation of the RMB in the run-up of the final decision. Therefore, we modestly lower our end-year projection of 6.35 CNY/USD but flag some downside risks.

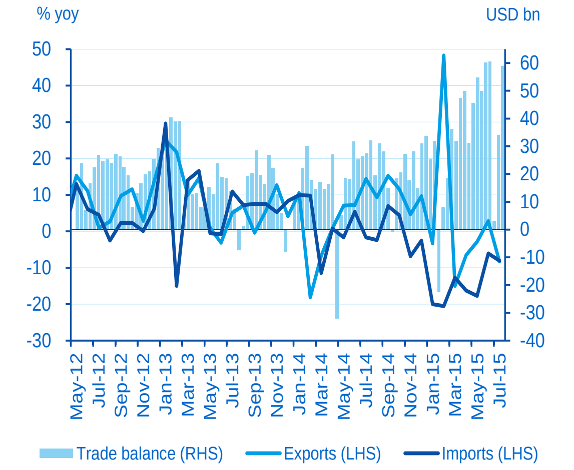
- **Some caveats are noteworthy.** The drastic change of the exchange rate comes at a moment of both elevated domestic financial tensions and increasing external uncertainties. The authorities therefore need to guard against the potential vicious cycle of currency depreciation and capital outflows. Moreover, the move could trigger another round of global currency depreciations, in particular for those currencies of commodity exporters which have already been afflicted by sluggish global commodity demand. In this respect, the currency depreciation itself can hardly lend much support to China's exports.

Figure 1
The PBoC reforms the RMB fixing rate formation mechanism



Source: CEIC and BBVA Research

Figure 2
Recessionary trade surplus continues



Source: CEIC and BBVA Research

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