ECONOMIC ANALYSIS

China | Unrelenting market turmoil calls for the authorities' prompt actions

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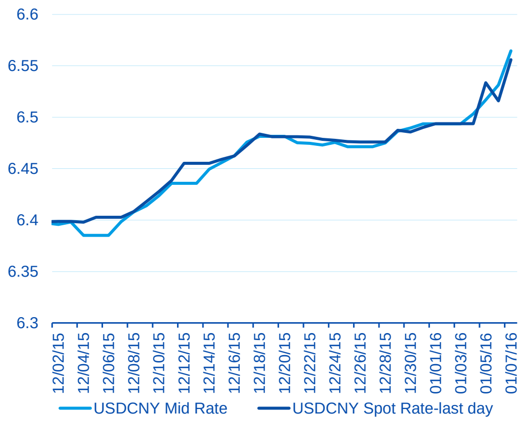
The woes of China's financial markets extend through the first week of the new year. Today the stock market repeated what happened on Monday with a much faster pace: it took only 15 minutes for the CSI 300 index to hit the newly launched circuit breakers (±5 % /±7 %) and halt the trading of the entire stock market. More worrisome is on the RMB exchange rates. A streak of sharp drops in the RMB this week have rattled investors in both the onshore and offshore currency markets, sending the dual exchange rates the lowest levels of the past five years. The market crashes in the stock and currency markets are aggravated by investors' fragile confidence in China's economy. Although we still hold the view that the fundamentals of the second largest economy in the world suffice to achieve a soft-landing, unexpected financial market turmoil could have a significantly knock-on impact on growth and lead to a self-fulfilling vicious cycle. Such a possibility was exemplified by the market selloffs in June-July of last year, which, we estimated, have lowered the last year's GDP growth by around 0.3 percentage points. We therefore expect the regulators to take prompted actions to stabilize financial markets and make efforts to regain investors' confidence. In this respect, the authorities could bail out the stock market again and revise, or even repeal the controversial circuit breaker rules (*Our Flash on Circuit Breaker Rules*). On the exchange rate, the authorities could revert to more market interventions in a bid to quell market panic. Nevertheless, the authorities are likely to continue their efforts to increase the exchange rate flexibility when the market regains stabilization.

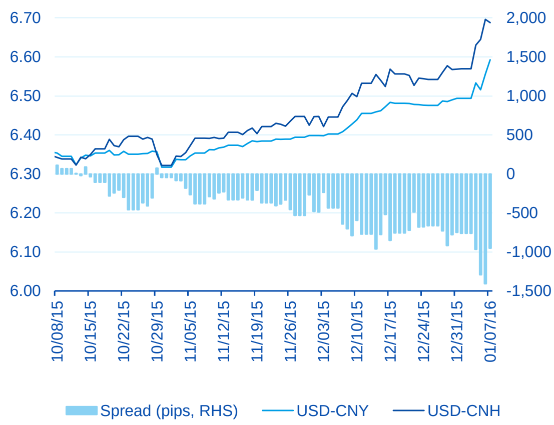
- **The sharp drops of the RMB are initiated by the authorities' efforts to increase the exchange rate flexibility.** After unexpectedly devaluing the RMB by -2% last August, the PBoC have been continually loosening its rein on the RMB exchange rate. The momentum has in particular accelerated after the RMB was accepted by the IMF to become one of basket currencies for Special Drawing Rights (SDR). The PBoC not only reduced market interventions but also chose to make the fixing price of the RMB exchange rate closely follow the market price of the previous day. (Chart 1) In theory the central bank's move of increasing the exchange rate flexibility should be a welcome initiative although it will unavoidably expedite the currency depreciation for the short run. However, the implementation of the flawed circuit breaker rules inadvertently amplified the equity market movements and increased the linkages between the equity and currency markets. As a consequence, investors' sentiment has been seriously dampened and lead to more selloffs in the market.
- **Prompt actions need to be taken to quell market panic.** Although the efforts to increase exchange rate flexibility are justifiable, the authorities now need to step back slightly and take quick actions to prevent market panic as these market selloffs could accelerate capital flight and destabilize the financial system otherwise. In the coming days the authorities could bail out the stock market again and revise, or repeal the controversial circuit breaker rules. On the front of the exchange rate, the authorities could be forced to do more market interventions to stabilize the RMB value and more importantly, investors' confidence in fundamentals of the economy. Indeed, the authorities have already started to intervene in the offshore market to narrow its gap with that in the onshore market (Chart 2). That being said, we maintain our USDCNY projection of 6.80 by end-year, a further 3% of further depreciation from its current level.

Figure 1
The PBoC intentionally leads the fixing rate close to the market price



Source: WIND and BBVA Research

Figure 2
The gap between onshore and offshore exchange rate has slightly narrowed due to interventions



Source: Bloomberg and BBVA Research

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