ECONOMIC ANALYSIS

ASIA | Tackling China's currency woes – Policy references from India

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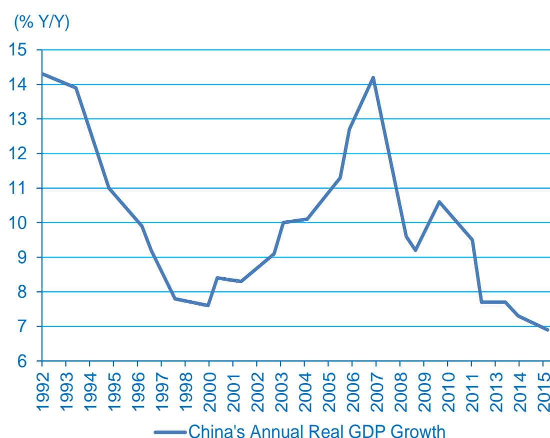
Summary

- In this watch we focus on China's lack of clarity and policy mis-steps in managing its exchange rate, which has often, in the past, unnerved investors and led to significant capital outflows from the economy. While Chinese policymakers remain cognizant of such risks and are taking various steps to address them, we examine whether past or current measures adopted by Indian policymakers to stem similar risks can be considered by China as a point of reference in its domestic policy toolkit.
- Chinese policymakers could take cues from the Reserve Bank of India (RBI) in enhancing clarity and credibility in its monetary policy approach. RBI's FX interventions are mainly done to curb excessive currency volatility rather than target a specific level of the rupee – a currency objective that RBI has consistently maintained for several years now, which in turn has helped build investor trust.
- Amongst several past measures to boost foreign capital inflows, RBI's credible Non-Resident Indian (NRI) Deposit scheme during the 2013 Quantitative Easing (QE) taper tantrum was highly effective in backstopping rupee weakness and rebuilding crucial FX reserves for India.

China's economy faces rising tail risks from capital outflows

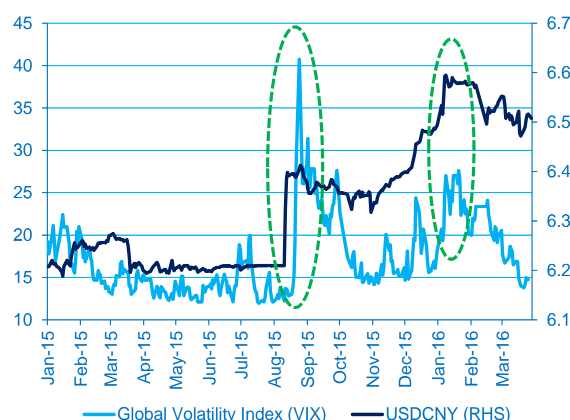
At 6.9% y/y in 2015, China's real GDP growth registered its weakest pace in 25 years (Figure 1). Prima facie, the current magnitude, pace and breakdown of China's GDP outturn suggests limited cause of concern.

Figure 1
China's GDP growth moderation to continue



Source: BBVA Research, CEIC database

Figure 2
China's unclear FX policy communication fuelled recent spikes in global financial volatility

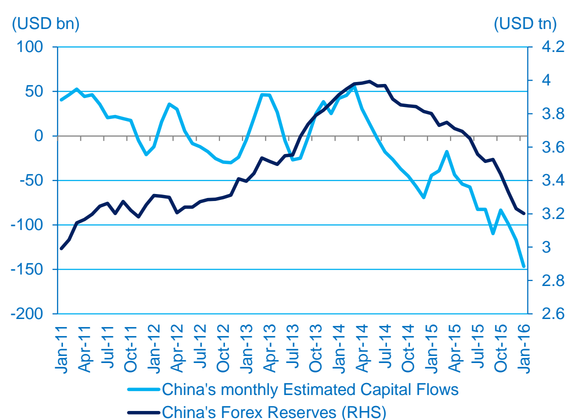


Source: BBVA Research, Bloomberg database

GDP growth has moderated in line with market expectations, while the much needed economic rebalancing remains on track as slower investment activity and weak external demand is partly offset by stronger consumption. However, under the hood, China's headline growth outturn masks rising tail risks, in particular associated with the potential vicious circle of currency depreciation and capital outflows. In this watch we

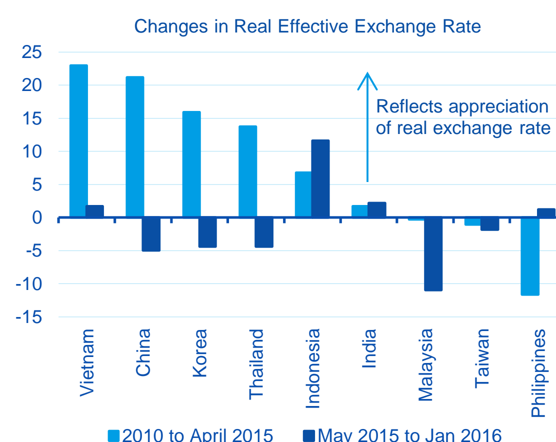
focus on China's lack of policy clarity and policy mis-steps in managing its exchange rate, which has often, in the recent past, unnerved investors and led to significant capital outflows from the economy. China's FX reserves have declined sharply from more than USD 4 trillion in 2014 to USD 3.2 trillion at end January 2016, in turn undermining investor confidence over China's domestic policy credibility. While Chinese policymakers remain cognizant of the risks that capital outflows entail for China and are taking various steps to address them, we examine whether past or current measures adopted by India to stem similar risks can be considered by China as a point of reference in its domestic policy toolkit.

Figure 3
Capital outflows from China have accelerated



Source: BBVA Research, Bloomberg database

Figure 4
Indian rupee has relatively most stable



Source: BBVA Research, Haver Analytics database

China's lack of clarity on exchange rate management is a key concern:

Chinese authorities have openly blamed China's 'immature market, inexperienced investors, imperfect trading system, flawed market mechanisms and inappropriate supervision system' to the 'abnormal volatility' in Chinese equity markets at the start of 2016, which triggered a global equity market sell-off (See Figure – 2). Unclear and confusing policy communication related to the stock market and exchange rate management by Chinese authorities has quite often amplified financial volatility and triggered capital outflows, in turn dragging further on the RMB (Figure 2). The direct spill-over effects of such volatility and its second order impact through the self-fulfilling prophecy have rattled global financial markets.

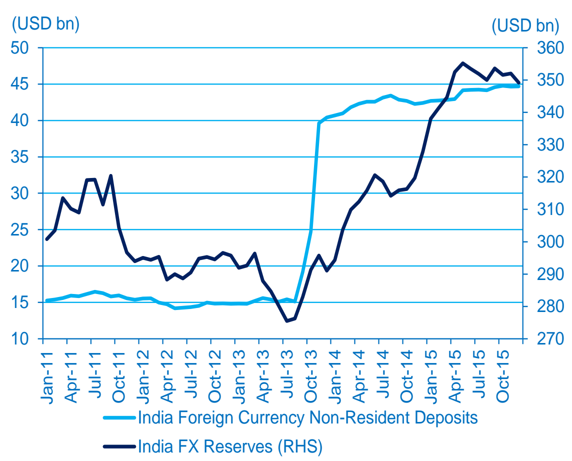
China's limitations in challenging the so called impossible trinity (a country cannot simultaneously determine its exchange rate and interest rate, and have free flowing capital) are reflective in weakening investor confidence, volatile capital flows and significant depletion in its foreign exchange reserves over the past year. Policymakers are cautious against aggressive interest rate cuts given its fallout on capital outflows, echoing the lack of monetary policy independence. Further, deliberate policy efforts to stabilize the Yuan and stem capital outflows through tactical capital controls such as limits on currency exchanges by large corporations have sparked capital flight, pushing China to ultimately devalue the Yuan twice over the past year (Figure 3). In this context, greater clarity in China's exchange rate management is a key to aid currency stability.

FX reserves are crucial for currency stability – Lessons from the RBI:

Chinese policymakers could take cues from the Reserve Bank of India (RBI) in enhancing clarity and credibility in its monetary policy approach. On a relative basis, the Indian rupee has been amongst the most stable currencies across Asia over the past year (Figure 4). Looking back, in the aftermath of the Fed's Quantitative Easing (QE) taper tantrum in May 2013, the RBI undertook a series of measures aimed at curbing rupee volatility and boosting FX reserves (Table 1).

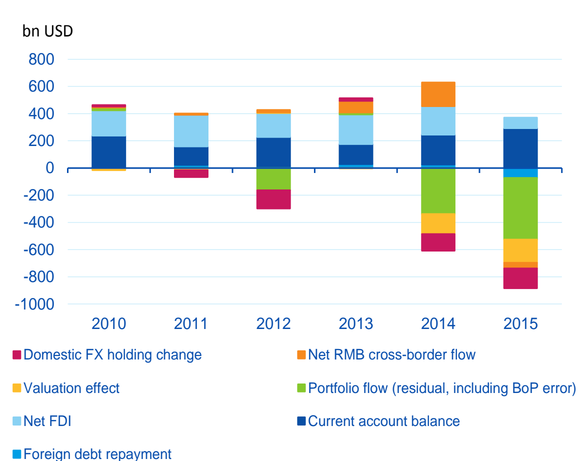
A credible Non-Resident Indian (NRI) deposit scheme: Key amongst RBI's policy measures to aid rupee stability was an attractive NRI deposit scheme which offered banks the option to swap their US dollar-denominated foreign currency non-resident bank (FCNR-(B)) deposits of 3+ years with the RBI at a fixed and attractive hedge cost of 3.5% a year. The scheme remained valid from September 2013 to January 2014. The rupee risk at such a time of high volatility shifted from banks and depositors to RBI's balance sheet. RBI allowed banks to offer an attractive rate of up to Libor/swap plus 400 basis points to NRIs on three-five years bucket of such deposits, which significantly reduced the cost of such deposit mobilization for banks. The entire cost of such deposit mobilization was reasonably less than what the banks could earn on their lending rates (around 8.5% vs. 11%). Banks also got exemptions on such deposits from Cash Reserve Ratio and Statutory Liquidity Ratio requirements, making it an attractive proposition, in turn mobilizing crucial US dollars for RBI. Between March 2013 and March 2014, the FCNR (B) deposits registered a record jump from USD 15.2 billion to USD 41.8 billion, bulk of it attributed to the new scheme. RBI's measures helped recoup steep losses for the rupee and strengthen its FX reserve position, which had weakened significantly in the first half of 2013 (Figure 5). The rupee had declined close to 25% against the US dollar between January and August 2013 but reversed part of its losses, strengthening 11% in the next six months.

Figure 5
RBI's measures to boost NRI deposits effective



Source: BBVA Research, Bloomberg database

Figure 6
China's FX Reserve drop meaningfully



Source: BBVA Research, CEIC Database

Addressing the non-inflow issue contributing to RMB depreciation: In the wake of uncertain financial markets and fears of Yuan devaluation, many Chinese exporters are choosing to keep their FX earnings offshore rather than bringing them onshore and converting into Yuan. This has exacerbated the ongoing pressure on Yuan from capital outflows. Besides portfolio outflows and valuation effect, we also find that the increase in domestic FX holdings (of which foreign currency export earnings form a part) have been a key

drag on China's FX reserves in 2015 (Figure 6) (See our recent watch on Projecting China's Foreign Reserves). Indian policymakers faced a similar issue in May 2012, when the Indian rupee came under intense selling pressure due to global financial volatility. The RBI noted that they were not intervening to protect any level of the rupee but intended to reduce rupee volatility. The RBI announced a series of measures to back-stop currency weakness (Table 1), the most effective amongst which was a temporary mandate for 50% of Exchange Earner's Foreign Currency (EEFC), i.e. exporter's foreign exchange earnings, to be converted to Rupees within 15 days. Furthermore, exporters were permitted to access the forex market for purchasing foreign exchange only after utilizing fully the available balances in their EEFC accounts. The EEFC balance during the time held around USD 5 bn, leading to an inflow of about USD 2.5 bn in the next fortnight.

Table 1

Key measures announced by the Reserve Bank of India to stem depreciation of the Rupee in the past

•	**November – December 2011**
1	Increased the limit for foreign institutional investments in government and corporate debt by USD 5 bn each
2	Modified External Commercial Borrowing (ECB) norms to allow for greater capital inflow including a) raising all-in-cost ceiling of 3-5 year loans to 350 bps above libor from 300 bps earlier, b) ECB raised for domestic expenditure to be brought in immediately
3	Forward exchange rate contracts booked by residents, once cancelled, cannot be rebooked; Forward contracts booked by FIIs cannot be rebooked once cancelled, but allowed to be rolled over on or before maturity
4	Forward contracts booked by exporters and importers to be on fully deliverable basis. Exchange gains in case of cancellations will not be passed on to customers
5	All cash/tom/spot transactions by Authorised Dealers on behalf of clients to be undertaken for actual remittances/delivery only and cannot be cancelled/cash settled
6	Reduction in Net overnight open position limits (NOOPL) of authorised dealers
7	Deregulation of interest rates on Non-Resident (External) Rupee (NRE) Deposits and Ordinary Non-Resident (NRO) Accounts
•	**May 2012**
8	Interest rate ceiling on Foreign Currency Non-Resident Bank Deposits (FCNR-B) of banks raised from 125 bps above corresponding LIBOR/Swap rates to 200 bps for maturity period of 1 year to less than 3 years, and to 300 bps for 3 to 5 years
9	Deregulating the ceiling rate on export credit in foreign currency
10	50% of the current and future balances in Exchange Earner's Foreign Currency (EEFC) accounts (primarily exporters) to be converted to rupees within a fortnight and credited to rupee accounts
11	Exporters and other EEFC account holders to be permitted to access the foreign exchange market only after utilizing fully the available balances in EEFC accounts
12	Tax provisions related to General Anti-Avoidance Rule (GAAR), which affect foreign investors, postponed by 1 year
13	Intra-day open position of Authorised Dealers to be fixed at five times the Net Overnight Open Position Limit available to them or the existing intra-day open position limit as approved by RBI, whichever is higher , for positions involving Rupee
•	**August-September 2013**
14	NRI deposit scheme which offered banks the option to swap their US dollar-denominated foreign currency non-resident bank (FCNR-(B)) deposits of 3+ years with the RBI at a fixed and attractive hedge cost of 3.5% a year.
15	Indian banks allowed to borrow up to 100% of their tier-1 capital from overseas (from 50% previously), which could be swapped with the RBI at a concessional rate of 100 basis points below the on-going swap rate prevailing in the market.

Source: BBVA Research, Reserve Bank of India, Government of India

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