8/11 Exchange Rate Reform: Review and Prospect

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The People’s Bank of China Announcement on August 11, 2015:

- For the purpose of enhancing the **market-orientation and benchmark status** of central parity, the PBC has decided to improve quotation of the central parity of RMB against US dollar.

- Effective from 11 August 2015, the quotes of central parity that market makers report to the CFETS daily before market opens should refer to the **closing rate of the inter-bank foreign exchange market on the previous day**, in conjunction with demand and supply condition in the foreign exchange market and exchange rate movement of the major currencies.
Main Achievements

1. The central parity formation mechanism has become more market-oriented.

- Since Feb. 2016, after deep and adequate communication with 14 market makers, the central bank has made it clear that the pricing of central parity should reflect “the closing rate of the previous day and the exchange rate movement against a basket of currencies”.

- From March to June 2016, the central parity of RMB against USD had an annualized volatility of 4.28%, while the CFETS RMB exchange rate index had an annualized volatility of only 2.31%.

- This shows that the exchange rate of RMB against USD is becoming more flexible under the current central parity formation mechanism; it also shows that pegging to a basket of currencies can help stabilize the exchange rate index of RMB against a basket of currencies.
Main Achievements

1. The central parity formation mechanism has become more market-oriented.

- Under the new pricing mechanism, the gap between central parity and the average of bank quotes has narrowed, and the gap among quotes of different banks has also narrowed. This shows that the new formation mechanism is more market-oriented and transparent.
Main Achievements

Yi Gang: G20 has reached a consensus – no competitive devaluation of currencies
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- The PBC has adhered to the direction of market-orientation, continuously improving the formation mechanism of RMB exchange rate. Since February 2016, PBC has gradually built up the central parity system based on closing rates and the movements of a basket of currencies. **This new mechanism is more regular and more transparent, and can help the market form stable expectations.**

- The central bank released Shanghai CFETS RMB exchange rate index, while at the same time referring to the currency basket of the Bank for International settlements, and the currency basket of SDR. In general, the RMB has maintained stability at a reasonable equilibrium level, and the movements of RMB against the several baskets are also steady. In a relatively long term, it can be seen that RMB is by and large stable despite ups and downs.
Main Achievements

The status of central parity as a market benchmark has further strengthened.

- Before the reform, the trading rate of RMB against USD in the domestic interbank market (CNY) deviated greatly from the central parity rate, and stayed long in the depreciation zone. The central parity’s benchmark status was undermined.

- From the 8/11 reform to the end of June 2016, the greatest deviation of CNY-USD trading rate from the central parity of the same day was 0.22% on average, far below the 1.53% level from early 2015 to right before the reform.
Main Achievements

2 The status of central parity as a market benchmark has further strengthened.

- The spread of the onshore and offshore RMB exchange rates is narrowing.

• From the 8/11 reform to the end of 2015, the daily average spread of CNY and CNH was 440 basis points, shooting to above 1000 basis points at some point.
• From January 2016 to July 2016, the daily average spread of CNY and CNH narrowed to 149 basis points.
Main Achievements

2. The status of central parity as a market benchmark has further strengthened.

- The decreased deviation of trading rate from central parity rate as well as the narrowing of CNY-CNHF spread have removed the technical obstacle for the valuation of RMB exchange rate and smoothened the process for RMB’s inclusion into the SDR basket.
Main Achievements

- The decreased daily deviation of CNY-USD trading rate from the central parity rate shows that the central parity can reflect adequate market information.

- The narrowing of CNY-CNH spread shows depreciation expectations are easing.
Main Achievements

The central bank’s communication skills with the market have strengthened.

- From “work more talk less” in the early days to “combining actions with talks” at present, the central bank has greatly improved its communication skills with the market.

- After achieving stability during the first four months in 2016, the RMB exchange rate weakened again in May, but this time it didn’t cause market turmoil like the last two times.
Main Achievements

3 The central bank’s communication skills with the market have strengthened.

- The market knows that this round of RMB depreciation was due to a stronger dollar pushed by expectations for a Fed rate hike and Brexit rather than competitive currency devaluation.

- The International community spoke highly of China’s efforts in communication with the market and expectation management.
Main Achievements

In June 2016, capital outflows slowed down despite RMB depreciation pressure.
Main Achievements

4  The development of the foreign exchange market has made new progress.

- Further liberalized domestic interbank FX market;
- Extended the trading hours of interbank market;
- Released more reference rates for RMB exchange rate; and
- Set up self-discipline mechanisms for the FX market.
Main Achievements

1. Launched Mainland-Hong Kong Mutual Recognition of Funds on schedule
2. Further opened up domestic interbank bond market
3. Streamlined foreign exchange management for QFII and RQFII
4. Promoted macro-prudential policy for cross-border financing in foreign currency and RMB
5. Officially launched Cross-border Interbank Payment System (CIPS)
6. Established Shenzhen-HK Stock Connect
7. Relaxed or even removed restrictions on settlement of capital of FDI and settlement of foreign debt
8. By 2015, 37 capital account items had achieved partial or full convertibility, accounting for 92.5% of all items, much higher than the level of 72.5% in 2009. At the end of 2015, the IMF announced the inclusion of the RMB in its SDR basket.
9. On June 29, 2016, the Ministry of Finance successfully issued 14 billion renminbi worth of RMB-denominated treasury bonds in Hong Kong.
Main Achievements

6 New attempts at macro-prudential management.

1. Imposed foreign exchange risk reserve on derivatives trading with the nature of forward purchase

2. Imposed reserve requirements on RMB deposits in China held by non-residents

2. Raised trading fee ratio of participating banks of offshore RMB business for hedging their position in domestic interbank market

4. These are explorations for regulation of cross-border capital flows in the context of opening-up. Market-oriented and price-based tools are used to adjust cross-border capital flows, which is in line with international practices.
Main Achievements

Forward FX sales and purchases are converging.
Main Achievements

7. The pressure of capital outflow has eased.

- In the first quarter of 2016, net capital outflow (BOP definition) reached $123.4 billion, a decline of 26% compared with the previous quarter; net capital outflow (including errors and omissions) in the second quarter was $93.9 billion, a decline of 42% compared with the first quarter; net capital outflow during the first half of the year reached $256.5 billion, a 41% decline compared with the last half year.
Main Achievements

The pressure of capital outflow has eased.

- During the first half of the year, spot and forward foreign exchange sales and purchases, which can reflect supply and demand conditions in the foreign exchange market, totaled a deficit of $172.6 billion, a decline of 59% compared with the second half of 2015. The deficit in the first and second quarters was $145.5 billion and $27.1 billion respectively, a drop of 81% quarter on quarter.

- In July, the gap between FX supply and demand expanded to 36.6 billion dollars.
Main Achievements

1. **Capital flow pressure has eased.**

- In the first half of 2016, outstanding foreign exchange reserves decreased by $125.2 billion, a decline of 66% compared to the second half of 2015, of which 117.8 billion was gone in the first quarter and 7.4 billion in the second quarter, a quarter-on-quarter decrease of 94%.

- In the first half of the year, China's foreign exchange reserve assets decreased $163.6 billion (valuation effect +$38.4 billion), a 41% drop compared with the second half of 2015. The first quarter saw a decrease of 129.3 billion and the second quarter saw a decrease of 34.3 billion, a drop of 73%.

- In July, China's outstanding foreign exchange reserves decreased $4.1 billion to $3.2 trillion at the end of the month, a drop of $129.3 billion compared with the level at the end of last year and a fall of 33% compared with the same month last year.

- The decline of foreign exchange reserves has slowed or even reversed, which helped stabilize market expectations.
Cross-border capital outflow has slowed down since 2016.
Major Challenges

1. More tolerance of exchange rate fluctuations is needed.

- China aims to speed up capital account liberalization and RMB internationalization, during which process a more flexible RMB exchange rate is needed which should be able to fluctuate both ways.

- A mature market requires mature participants. The market needs to lift the spell that RMB exchange rate can only rise and never fall, be more tolerant of the two-way fluctuations of RMB exchange rate, and does not over-interpret and avoid moral judgment. Only in this way can we push forward RMB exchange rate marketization and achieve clean floating.
Major Challenges

2. The central parity formation mechanism needs to be improved.

- Bilateral exchange rate has been basically stable while multilateral exchange rate had experienced considerable adjustment.

  - From January to July 2016, the central parity rate of RMB against USD only dropped 2.4%, CNY dropped 2.2% and CNH dropped 0.9%. However, the CFETS index, BIS index and SDR index for RMB exchange rate dropped 5.6%, 5.5% and 2.9% respectively.

  - Since the 8/11 reform, the central parity, CNY, CNH and BIS index dropped 8.0%, 6.5%, 6.2% and 6.2% respectively, roughly the same as each other.
Major Challenges

2 The central parity formation mechanism needs to be refined.

- This is related to the design of central parity quotation mechanism.
  - \textit{Central parity} = \textit{closing rate of the previous day} + \textit{adjustment for exchange rate of a basket of currencies}
  - \textit{Overlapping effects}
  - \textit{Reinforcement of expectations}

- Many other factors could affect the exchange rate, which is not fully reflected by the new pricing mechanism
Major Challenges

China Monetary Policy Report (Q2 2016)

- According to the mechanism of “closing rate + changes of currency basket rate”, the central parity rate quoted by market makers consists of two parts: 1. the closing rate at 16:30 on the previous day in the interbank FX market, which mainly reflects the supply and demand of the market; 2. adjustment of RMB exchange rate against USD in order to maintain stability of RMB against a basket of currencies, which reflects the movements of currency basket rate.

- In terms of closing rate:
  - With the corporate sector deleveraging foreign debt and more willing to conduct M&A overseas, China’s FX market saw less supply than demand, and the closing rate of RMB against USD to a large extent shows a depreciation trend against the central parity.
Major Challenges

China’s Monetary Policy Report (Q2 2016)

In terms of a basket of currencies:

• Before May, due to weak global economic recovery and increasing volatility in the international market, the expectation for a Fed rate hike eased and the US dollar index decreased at some point. In response, the central parity rate appreciated against the closing rate of the previous day.

• After May, the expectation for a Fed rate hike strengthened, and Brexit caused much uncertainty in the international financial market. Therefore, the dollar was pushed up, and the central parity rate of RMB against USD showed smaller appreciation against the closing rate of the previous day.

• Since February 2016, as the US dollar index showed slight depreciation among fluctuations, the central parity rate of RMB against USD needs to appreciate so as to maintain the stability of RMB against a basket of currencies.
Major Challenges

China Monetary Policy Report (Q2 2016)

➢ From February to June 2016, the accumulated depreciation of the closing rate against the central parity rate of the same day caused by supply and demand in the market exceeded the accumulated appreciation of central parity rate against the closing rate of the previous day in order to maintain stability of the RMB exchange rate against the currency basket rate, therefore, overall the central parity of RMB against USD depreciated.
Major Challenges

3. The central bank has yet to improve its communication skills with the market.

- It’s difficult to tell which way works better when it comes to communicating with the market, as there are always multiple perspectives and perceptions, and opinions within the government could be divided.

- Facing a divided public in the market who have different demands and views, it’s difficult to please all.

- There are both advantages and disadvantages to every policy decision. No matter what the government does, it may come under fire from the market.

- Enhancing the transparency of policies and data entails costs and efforts.
Major Challenges

4 Regulation of capital flows needs to be improved.

- To counterbalance the pressure of capital outflows, window guidance was also enhanced in addition to introducing macro-prudential measures, loosening up restrictions on capital inflows and FX sales.

- These basically didn’t change the existing regulations, which shows that the Chinese government is determined not to regress to capital control.

- However, there is more non-obligatory window guidance than mandatory rules, which reduces transparency and enforcement of the policies.
Major Challenges

5  The independence of monetary policy needs to be strengthened.

- An independent monetary policy needs an anchor, and in the past the RMB-USD exchange rate has played the role of a currency anchor in guiding market expectations. Giving up this anchor without setting up a credible new one, an independent monetary policy cannot fully enjoy the benefits a floating exchange rate regime can offer.
Looking Forward

Bad

Mediocre

Good
Governor Zhou Xiaochuan told the press at the G20 meeting on February 26, 2016 in Shanghai -

“Capital outflows essentially have to do with the macro economy. There are some volatilities in the international market, which could affect public confidence in the domestic economy. If we could make our macroeconomic policies more convincing and boost economic growth, people will have more confidence in domestic economy and the structural reforms. Then the volatility will only be temporary and capital flows will gradually return to a reasonable level, without causing much trouble.”
Looking Forward

The implications of SDR basket inclusion to further reform on RMB exchange rate regime.

- It is argued the August 11th policy move was intended to meet with the technical criteria for reviewing on RMB’s inclusion into SDR basket in late November of 2015.
- The IMF is satisfied with the reform of RMB exchange rate regime in the past year, but it urges China to improve the transparency of exchange rate policy and to achieve effective floating exchange rate regime no later than end of 2018.
  - How could RMB exchange rate regime evolve from current basket currency peg to free floating within about two years?
  - Is it possible for China to get the better chance for further liberalization of RMB exchange rate under the condition of resuming capital inflow?
    - How likely it would be the effective inclusion of RMB into SDR basket could help increase the appetite for international investors on RMB assets allocation.
    - How likely it would be China could enjoy the improvement in internal and external fundamentals in the coming years.
    - How likely it would be China could be forced to freely float RMB exchange rate under undesirable environment.
THANKS