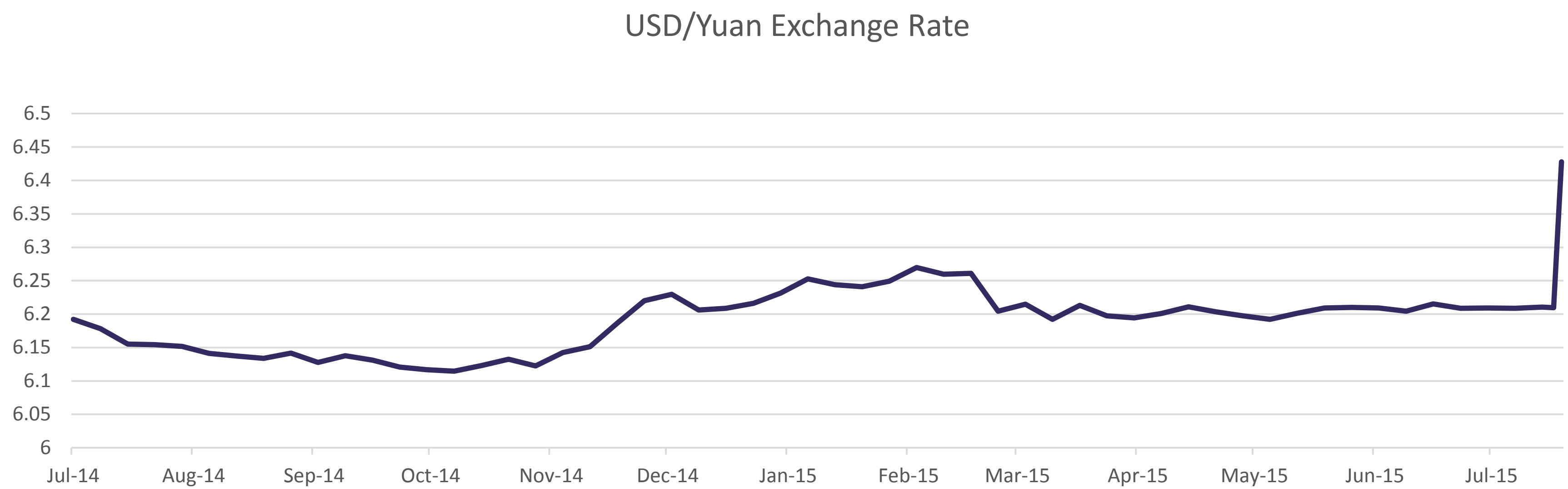
Changes to China's Renminbi Exchange Rate

Wednesday, August 12, 2015

WHAT HAVE CHINESE POLICY MAKERS DONE IN REGARD TO SETTING THEIR EXCHANGE RATE?

- Each day at 9.15am in Beijing the People's Bank of China (PBoC) sets a "midpoint" currency exchange rate for its semi-officially managed currency, the Renminbi (RMB)
  - When the market opens 15 minutes later, investors are allowed to trade the currency within a band 2 per cent either side of this "midpoint"
- On 11 August the authorities announced that the official fixing for the RMB for the day would be USD/RMB 6.2298, nearly 2% lower than the previous day's fixing at USD/RMB 6.1162
  - This was reportedly the <u>largest downward daily movement in the fixing in two decades</u>
- But, more importantly, the authorities also announced a change in the way in which daily fixings will be determined from now onward
  - Prior to yesterday, daily fixings were determined via a process whereby currency market makers were asked for price quotations before the market opened
  - From now on, market makers will be asked to submit their quotations for an RMB midpoint by reference to:
    - the closing rate of the previous day, FX supply and demand, and changes in major currency rates
  - These new criteria were not previously included in the PBOC's guidelines
- The change to incorporate market movements from the prior day's trade has been widely interpreted as a <u>move toward greater market determination of the value of the RMB</u>
    - i.e. a small step toward a more freely-floating exchange rate
  - But it is not clear how truly "market-determined" this process might be

THE USD/CHINESE RMB EXCHANGE RATE



Source: Bloomberg

- The chart shows the number of RMB required per 1 US Dollar
- Yesterday's sharp move in the RMB can be seen clearly – this was the sharpest move in two decades

HOW DID THE PBOC EXPLAIN THE DEVELOPMENTS?

- In explaining the changes, the PBoC's official statement said that:
  - *"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 [China Foreign Exchange Trading System] 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"*

HOW DID THE PBOC EXPLAIN THE DEVELOPMENTS?

- In a subsequent release explaining the PBoC's statement (reproduced in full on the previous slide), the PBoC noted issues related to:
  - The competitiveness of the RMB; and
  - A desire to develop greater market-determination of the exchange rate
- Specifically the PBoC noted:
  - The influence of the appreciating US dollar and the impact this was having on China's trade balance and trade competitiveness (given that the prior exchange rate mechanism was generally causing the RMB to rise with the USD)
  - That the central parity of the RMB has recently been deviated from the market rate to a larger extent which "has undermined the market benchmark status and the authority of the central parity"
    - the large 2% adjustment was an attempt to close "the accumulated gap between the central parity and the market rate" in a "one-time correction"
  - That the "improving the role of market makers in the determination of the RMB will help enhance the market-orientation of RMB central parity enabling the exchange rate to play a key role in adjusting foreign exchange demand and supply"

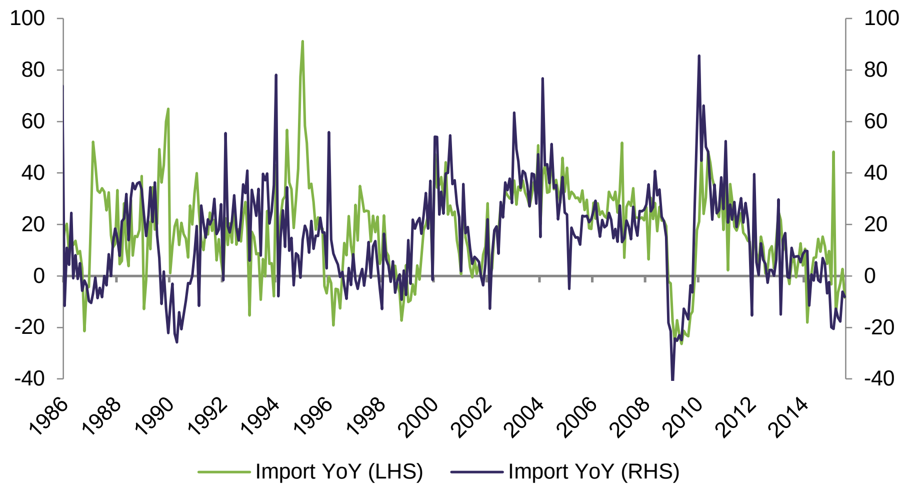
WHY DID THESE CHANGES OCCUR?

- Why did policy makers move the "mid-point" by such a large margin yesterday?
  - Probably to:
    - Boost what has been a softening trend in the Chinese economy; and
    - Address an increasing gap between the official fixing rate and the market's determination of the exchange rate
  - At the fixing on 12 August, the midpoint was reportedly reduced by a further 1.6%
- Why have policy makers changed the means by which they will now be setting the "mid-point" exchange rate?
  - This probably has much to do with the Chinese authorities' desire to have the RMB play a larger role in international financial markets
    - The current deliberations regarding the RMB's potential inclusion in the IMF's Special Drawing Rights (SDR) mechanism have likely highlighted the **need for the RMB to become more market determined**
    - The IMF has noted that an operational issue currently impeding the inclusion of the RMB in the calculation of the IMF's SDRs is that "a market-based "representative" RMB rate in terms of the US dollar would be needed to value the RMB against the SDR"
    - Because of this, the inclusion of the RMB in the SDR has been delayed by at least 9 months (to Sept 30, 2016)

The SDR basket comprises the four currencies with their respective percentage weights based on the relative share of each currency in reserve holdings by monetary authorities and the value of exports of goods and services. These four currencies are the Euro, Japanese yen, British pound, and the U.S. dollar

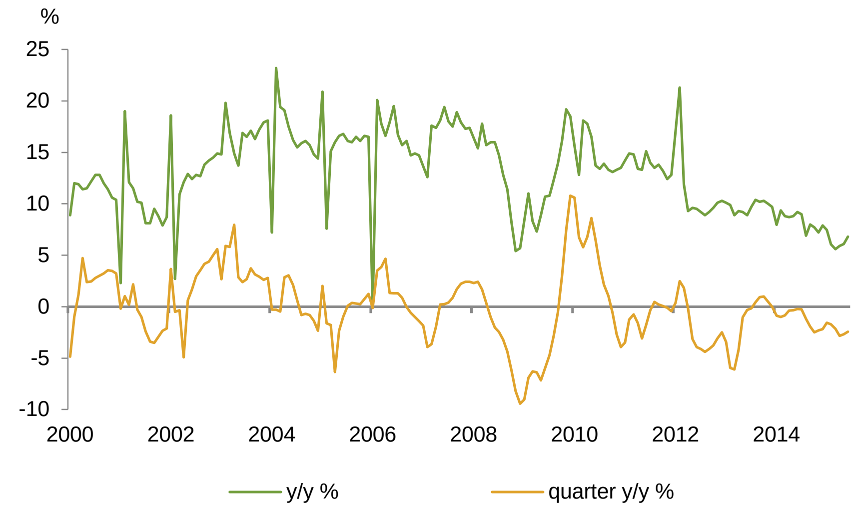
TRENDS IN CHINESE EXPORTS, IMPORTS AND INDUSTRIAL PRODUCTION

China - Exports and Imports



Source: DataStream

China - Industrial Production Index



Source: DataStream

- The weakening trends in these key measures of the Chinese economy can be clearly seen in these two charts
- It is very likely that part of the reason to move the determination of the currency exchange rate was to assist a lowering of the RMB, in the hope of providing positive impetus to Chinese growth

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HOW WILL WE BE ABLE TO INTERPRET THE IMPLICATIONS OF YESTERDAY'S CHANGES?

- Key to understanding the implications of yesterday changes will be future moves and developments in the RMB exchange rate – whether it continues to depreciate, and at what speed
  - It will likely take a few days or weeks for the market to fully understand the new mechanism, specifically the relationship between the closing rate on a prior day and new fixing on the following day
  - The gap between these two rates will likely be a guide to the degree of PBoC intervention
    - The PBoC can reportedly still influence the closing rate, and market makers' quotation and weighting
    - In theory the new daily fixing should be a weighted average of submitted quotations by market makers, but the weighting is determined by CFETS (China Foreign Exchange Trading System), a subordinate of the PBoC
    - It is not clear how "market-determined" this process will be in practice, and how much influence the Chinese authorities will retain in their currency exchange rate determination
- Given recent FX flows (increasing capital outflows), most market participants expect the RMB to weaken near-term, but in a measured and gradual pattern
  - Capital outflows could increase in the near term if market participants believe the 2% depreciation may not be enough
    - but Chinese authorities have huge flexibility to manage this given China's sizable FX reserves, an ongoing current account surplus and very low foreign debt
  - **<u>But a weaker RMB is likely to be a downward influence on commodity currencies such as the AUD</u>**

INVESTMENT IMPACT OF THE CHANGES

- RMB weakness is a global disinflationary shock and will act to tighten "monetary conditions", especially for very open economies where the RMB is a significant component of their trade weighted basket – like the US and Australia (in the absence of an AUD depreciation)
  - **However these changes to the RMB's determination and its recent weakening are unlikely, in isolation, to delay any Fed plans to raise the Fed Funds Rate**
    - The US Fed's decision making will still be most influenced by domestic US conditions with the USD/RMB exchange rate of relatively minor (but not irrelevant) influence
      - However, if significant market turbulence were to arise, that could influence the Fed's policy path
- The marginal global disinflation may in fact be "good disinflation" if it delays/tempers policy tightening
  - This could prove to be positive for risk assets such as equities, but this was not the market's initial reaction, given the immediate focus on what the depreciation suggested about weaker Chinese growth
  - The "reaction function" from key central banks will be important in determining the medium term impact of these changes
- The RMB's renewed decline is likely to be negative for the AUD, given the close relationship between the determinants of these currencies
  - While RMB depreciation might, longer term, boost the Chinese export sector – and demand for commodities – the first round impact is USD strength which is commodity (and commodity currency) negative

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