A market-based RMB.
What does it mean for China and the international economy?

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Afternoon Seminar: Economic Reform and Currency Policy in China - More Turbulence Ahead?

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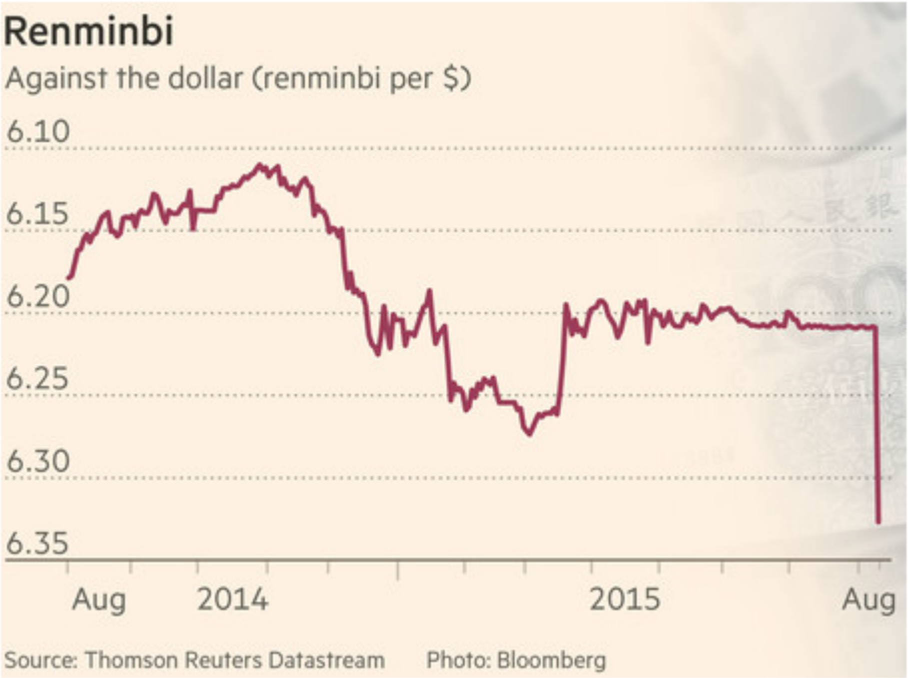
August surprise move.
Introduction

- *On August 11th, Chinese authorities surprised the global financial markets, by unilaterally devaluing the yuan against the US dollar, without any advance communication.*
- *In two days, Beijing quickly engineered a 3% devaluation of the yuan in a "one-off" operation, sending various financial markets around the world into a panic.*

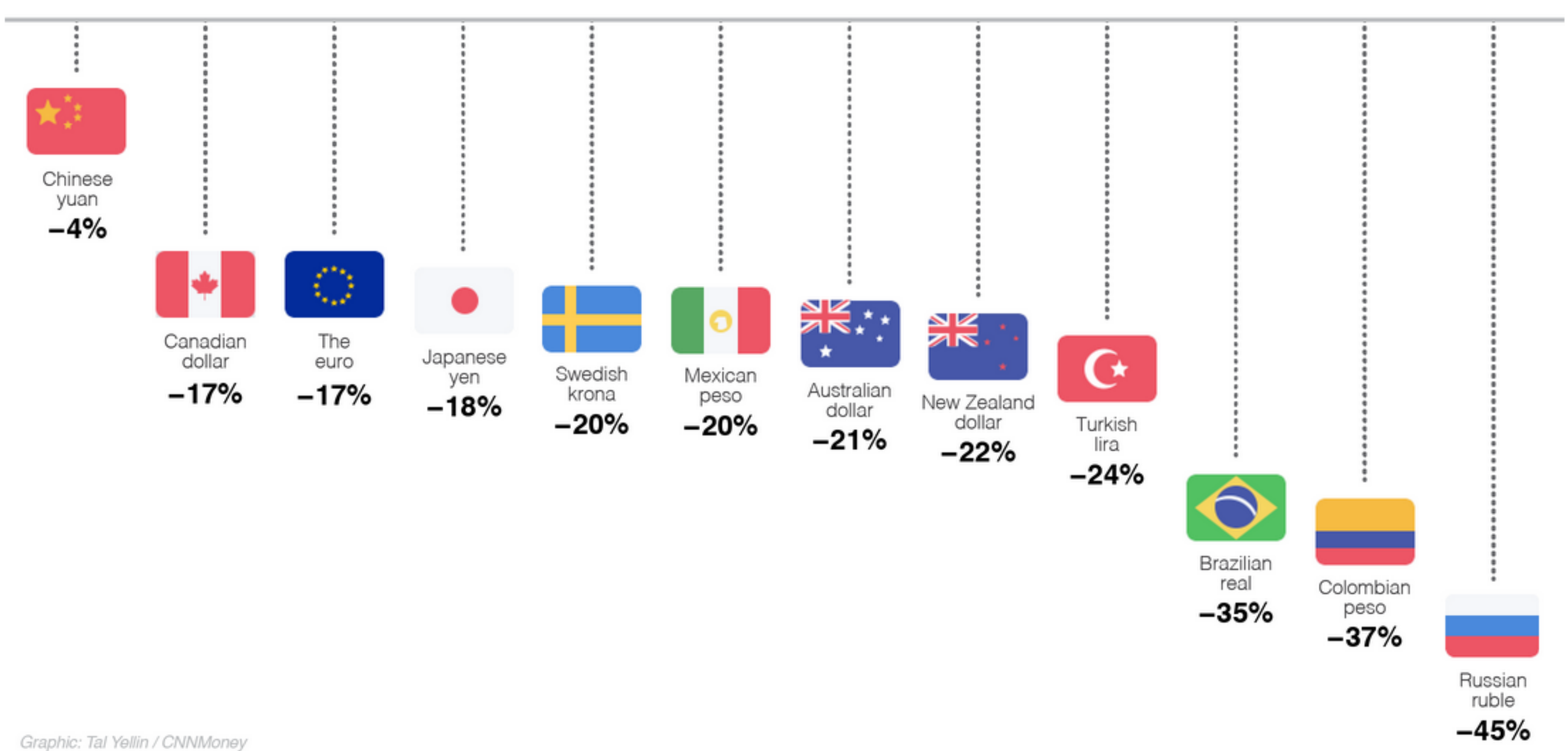
China’s Surprise Move

People look at the exchange rate at a moneychanger displaying a poster of U.S. dollar bill, Chinese Yuan and Malaysia Ringgit in Singapore August 24, 2015.

Devaluation Shock



One year currencies devaluation against the US Dollar (source: Graphic Tal Yellin/CNN Money).



The RMB competitiveness hypothesis.

- "Abandoning the US peg and allowing the devaluation of the RMB is just the right thing to do" (Guonan Ma 2015)
- Among the G5 currencies, **RMB real effective exchange rate showed sizable appreciation (35 percent) from 2007 to mid-2014.**
- Meanwhile, the other **four SDR member currencies (the dollar, euro, yen and sterling) had registered 5 percent to 15 percent real effective depreciation.**
- Especially **vis-à-vis the yen**, RMB appreciated noticeably between 2007 and 2012 until the start of the so-called 'Abenomics', RMB lost competitiveness **by March 2014 by 30 percent** from its peak in 2011 (Alicia Garcia-Herrero, 2015).

The mercantilist hypothesis.

A decrease in the secondary sector (the manufacturing and the construction sectors) which expanded 7.3 percent, is evidence that China in *a sign of desperation was ready in a campaign of "currency war".*

In the mercantilist hypothesis, China would abandon the "Strong Yuan" policy, and gradually weaken RMB against the dollar, and possibly, to keep the yuan on an "even keel "with other major reserve currencies, such as the euro and the Japanese yen

Yet, the China’s devaluation too tiny for a mercantilist trade policy.

For all the fascination of a mercantilist hypothesis , if numbers are considered , it falls short of a strategic assessment.

Nicholas Lardy of IIE of Washington wrote:

‘If they [Chinese authorities] wanted to revert to their mercantilist trade policies, they would have moved sooner and they would have moved by a much bigger amount”.

Getting to the core of the August actions and the SDR hypothesis.

The slowdown of the manufacturing outputs, capital outflows, and the weakening exports sector due to price competitiveness , and last but not least IMF recommendations, are mostly considered in this Presentation as the motivations behind the August move.

- *The mismatch of a RMB pegged to a strengthening dollar while a policy of lower interest rate was needed was the first cause for concern to Chinese policymakers. So, de-pegging the RMB from the US$ and introduce a market-based opening rate to the RMB was a move of necessity.*
- *Letting markets coming in would also prevent risks of RMB overshooting at the September Federal Open Market Committee (FOMC).*
- *Though these risks have yet not materialized, the Fed left the dollar rate on hold, a preemptive move on exchange rate would win China's most craved objective, seeing RMB graduating into the SDR basket.*

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The role of the IMF guidance and the SDR hypothesis.

In the push for the RMB inclusion into the SDR, China has led to the acceleration of financial liberalization reforms. Targeted reforms to further increase RMB convertibility include the opening of more offshore RMB clearing centers, increasing foreign access into onshore markets (QFII and RQFII), expansion of offshore investors by residents (QDII enhancements) and the widening of the currency trading band. Interest rate framework is also being reformed with the recent introduction of the deposit insurance system and the relaxation of deposit and lending rate caps.

By de-pegging in August the RMB exchange rate from the US dollar, and allowing a markets' valuation of the RMB's opening rate, China has clearly followed the IMF guidance, as expressed by the Informal Committee on the SDR Basket Review of August 4, 2015.

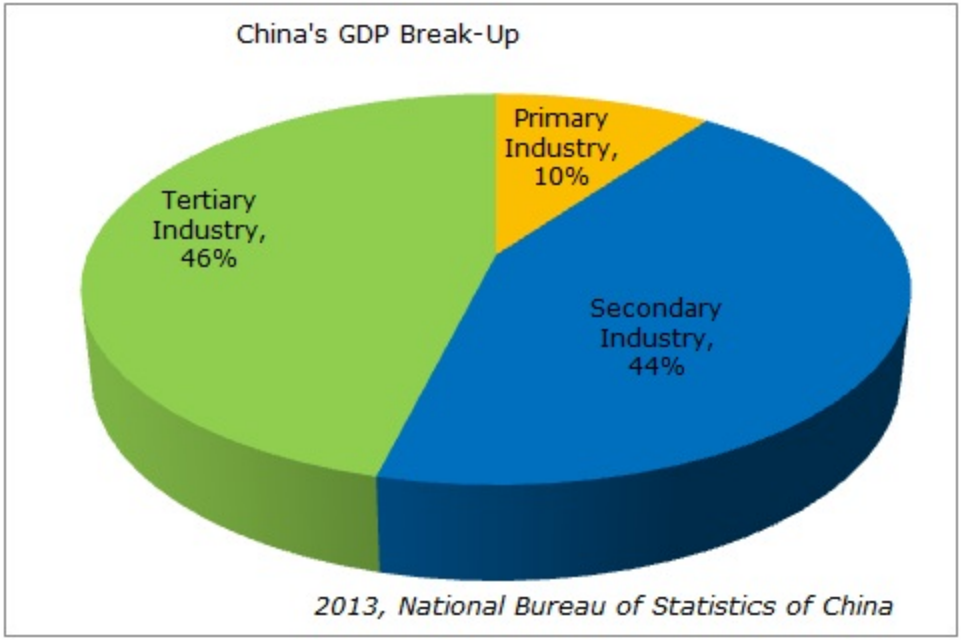
A market-based and reserve currency's RMB.

1. *On the domestic side, gaining monetary independence is critical to China's rebalancing. PBoC would enjoy more room adjusting RMB rate to the country's economic cycle. This objective is especially appreciable in the current economic circumstances, as freeing RMB interest rate policy helps smoothing out predictable downsides in the country's journey to a post-industrial economy.*
2. *On the international side, a market-based RMB would increase traction on trading partners, reinforcing its role of regional anchor-currency.*
3. *And last but not least, graduating to a reserve currency RMB would help Asian central banks, major purchasers of forex reserves, to diversify their assets out of the US dollar reducing risks of "all eggs in one basket".*

All in all, an exchange rate based on market valuation and the RMB reserve graduation would bestow China more rate freedom, and a growing role in the Asian monetary arrangements.

China's Rebalancing.
Cargo ship reverting home

How is China Rebalancing?
GDP 2013

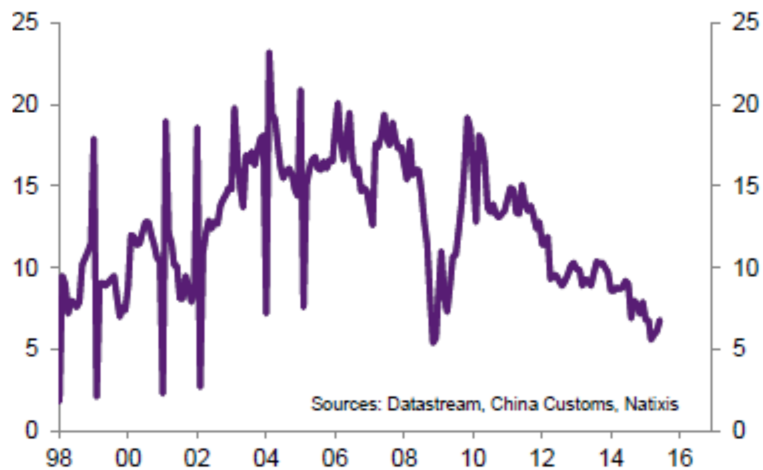


Export-led economic growth in decline.
China's exports destinations can tell something about RMB relative appreciation: vis-a-vis euro and yen.

Source: Datastream, Natixis

China’s manufacturing sector shrinking

Chart 6B
China: Manufacturing production (Y/Y as %)



China’s Purchasing Managers Index in down trend:
a signal to Chinese policymakers to accelerate on services and domestic consumption.

An indicator of the economic strength of the manufacturing sector.

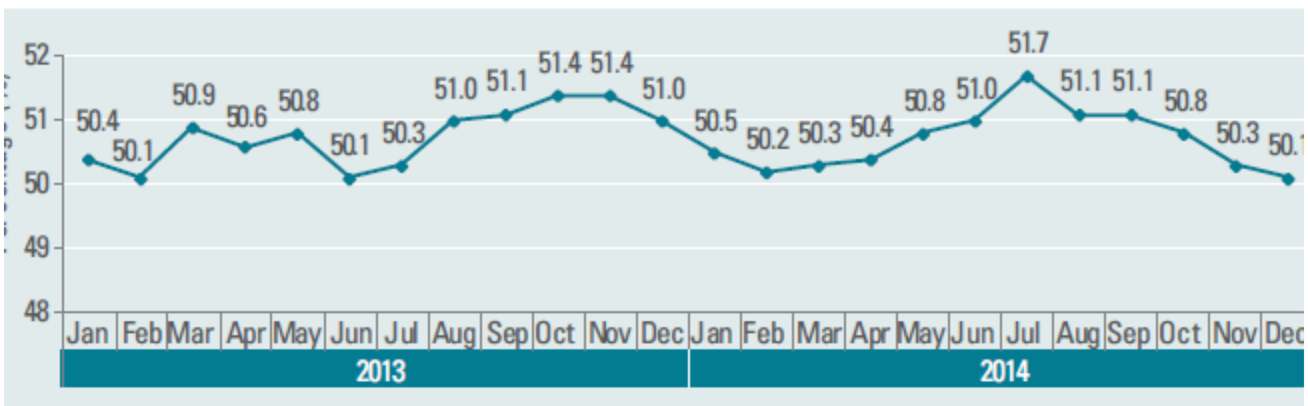
The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.
Over the 50 threshold it indicates expansion; under 50 contraction.

The index measures the nationwide manufacturing activity, focusing on smaller and medium-sized companies, and filling a niche that isn't covered by the official data.

Purchasing Managers Index on the down trend

2014

Monthly Purchasing Managers Index (PMI), 2013-2014

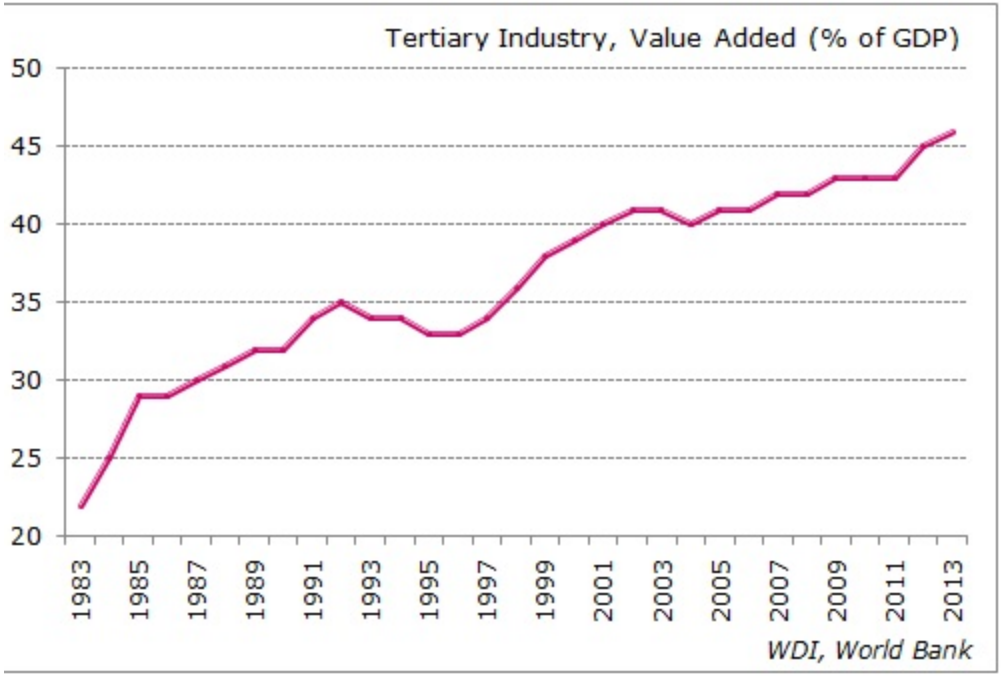


Source: 'China's PMI Was 50.1 Percent in December', NBS, 4 January 2015,
http://www.stats.gov.cn/english/PressRelease/201501/t20150104_662879.html

Caixin Manufacturing PMI in China decreased to 47.20 in September from 47.30 in August of 2015 (Markit Caixin)

A post-Industrial China in the making?
Services Sector 2012

The new driver of the China's domestic economy
Services Sector :2013



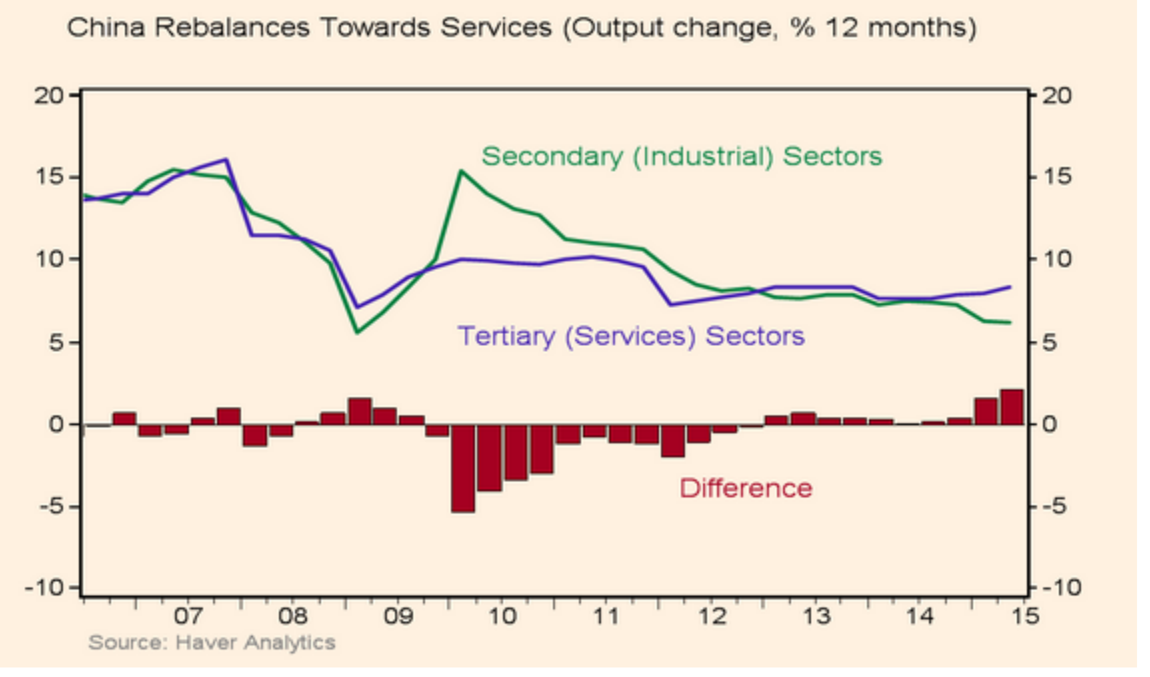
Services Sector
2013

- China's service sector has doubled in size over the last two decades to account for about 46% of GDP.
- In 2013, it surpassed China's the secondary industries for the first time. Within the service sector are transport, storage and post (5% of GDP), wholesale and retail trades (10%), hotel and catering services (2%), financial services (6%), real estate (6%) and mishmash of services categorized as 'other' (18%).

The Services Sector: Third Quarter 2015
51 % of GDP, slowing but surely on the rise.

- In October 2015, China reported 6.9 percent GDP growth during the third quarter of 2015.
- Services sector expanded 8.4 per cent, outstripping both GDP growth and the country's industrial sector, which grew 6 per cent during the same period. The services sector now accounts for 51.4 per cent of the country's total economic output and it is about 20 per cent larger than the declining industrial sector.

China rebalances.
Services Sector Third Quarter 2015



Concluding Remarks.

China's Rebalancing: Hic Rhodus, Hic Salta.

- Even is not very clear whether China is going to let its exchange rate float completely freely, there are "off radar" channels of monetary transmission in the periphery, which seem going in a different direction than the usually expected "herd behavior" toward US T-bonds. There are evidence that EM central banks especially in Asia are starting redeploying large shares of forex reserves in RMB, rather than typically in US T-bonds (Winkler et alii 2015).
- If these developments gain momentum, could the RMB escalate , even before a full-fledged free-floating, the monetary pyramid at the top?
- Yet, a final warning comes to Chinese policymakers that a failure to transition from an economy based on export-led growth to one based on private enterprise, innovation, and consumption is likely to bring social and political consequences. There is a risk – as Richard C. Bush of Brookings argues, "that China will peak in economic growth, before it reaches its development goals and will be the first major economy that grows old before it gets rich"(Bush 2015).

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