Challenges of the opening up of the Chinese foreign exchange market

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Over the recent months the latest steps in the process of the liberalisation of China's financial markets were, in many cases, perceptible in the increased volatility as well. We would like to give a brief overview of these steps and their impact. Our article will discuss what challenges the "re-balancing" of the Chinese economy and the renminbi's inclusion in the SDR basket pose to one of the largest economies of the world and its foreign exchange market, what factors may influence the renminbi's exchange rate and what instruments the Chinese central bank has at its disposal for managing this.

China announced the policy of reform and opening up in 1978, which can be seen as a period of prudent progress, and cautious and gradual opening up. While on account of its **2001 accession to the WTO China joined the world economy** and became a global leader **in primarily real economy terms, the faster pace of the steps aimed at financial opening up mainly characterised the recent years,** although the gradual opening up of the financial sector already appeared in the WTO accession documents. **The opening up of the financial and capital market entails several challenges for decision-makers,** most notably the **"trilemma"** between the following three variables, the concurrent achievement of which is impossible for a country: **independent monetary policy, an open capital account and a fixed exchange rate.** While earlier, in the context of a closed capital account, China managed a given exchange rate target and was substantially influenced by the changes in the monetary policy of the Fed that provided the main reserve currency of the world, now, **in the spirit of liberalisation, the long-term objective is an open capital account and a freely floating exchange rate coupled with an independent monetary policy.** However, by virtue of its nature, this process cannot happen smoothly: the volatility of several financial market variables that had been managed centrally has spiked, and this is expected to continue in the near future as well. In other words, **while earlier the interventions by the Chinese central bank (PBOC) aimed at a stable exchange rate mainly manifested themselves in the involuntary changes to the Chinese monetary conditions, i.e. monetary base,** such fluctuations **can now be observed in the exchange rate and the financial market interest rates,** while at the same time an independent monetary policy becomes possible.

The capital outflow that started with the slow opening of the capital account had previously been offset by the PBOC through foreign exchange interventions – which caused a significant drop in its foreign exchange reserves, and entailed the narrowing of the domestic monetary aggregates as well as the tightening of monetary conditions – **and by exchange rate depreciations of a few percentage points.** It has to be noted that the capital outflow can be partly seen as a healthy adjustment, within the framework of which **the Chinese domestic private sector started**

the global diversification of its wealth and investments. Earlier, due to the tight capital controls, this diversification was implemented through the foreign exchange reserves of the PBOC, principally in the form of US government securities purchases. According to certain statistics, the stock of the Chinese private sector's foreign assets is around 20 per cent of GDP, while this figure amounts to 100–120 per cent in the case of the US or Japan. **The reduction of the Chinese economy's foreign currency debt that started mounting in recent years,** and **the elimination of the positions established for the continuous appreciation of the renminbi** in recent years both point towards capital outflows. This has been and is expected to be **offset** by the anticipated **expansion of the volume of foreign investments** in China due to the more open capital account, which may also be supported by the **inclusion in the SDR basket.** Therefore, in the near future, one of the main questions will be what combination of instruments the PBOC will opt for to mitigate the volatility induced by capital flows and to foster the real economy's adjustment.

This leads us to the next important question, namely **the rebalancing of the Chinese economy.** The stated objective of the Chinese decision-makers is to transform the structure of the mostly investment- and partly export-oriented Chinese economy operating with an ever increasing leverage, so that a major part of economic growth is based on **higher domestic consumption and services in the context of lower debt levels, which may entail growth sacrifices. This adjustment could point towards a weaker renminbi** and may support the economic structure sought to be reformed, while the goal is to ensure an increasingly prominent role in global value chains and to increase households' consumption. According to certain experts, **the nature of the PBOC's measures is therefore expected to be much more defensive.** The potential depreciation of the renminbi will not be aimed at achieving a competitive exchange rate, but rather it will represent a **necessary element of the monetary policy mix linked to liberalisation and rebalancing. Regardless of this goal,** several countries may attempt to weaken their own currencies to protect their export sector, should the Chinese renminbi further depreciate.

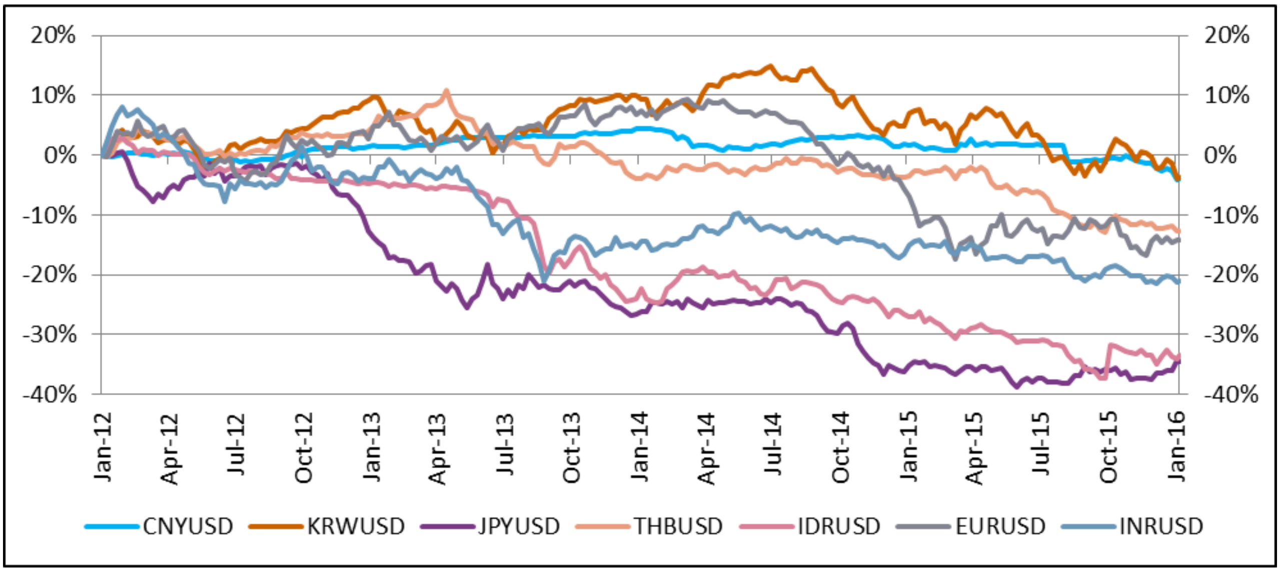
We believe that the PBOC and Chinese decision-makers focus on **managing several antagonistic processes and the conflicts of interest.** In line with this, further steps can be expected that point towards the expansion of the room for manoeuvre and the preservation of credibility.

The Chinese exchange rate policy may enter a new phase: the introduction of the CFETS RMB index

Earlier the Chinese authorities feared that an emerging market economy was overly exposed to the quite hectic capital movements induced by rapid changes in the developed markets' monetary conditions (see the 1998 Asian economic crisis), therefore they pegged the exchange rate of the renminbi to the US dollar. This was intended to prevent major fluctuations in the exchange rate, which would have considerably increased the vulnerability of an economy in the early stages of development. In addition, due to the lack of renminbi appreciation, the weak renminbi gave the mostly export-based Chinese economy a significant competitive advantage for a long time.

Currently the **index introduced by the CFETS** (the operator of the electronic system for foreign exchange trading on the Chinese interbank market) may address the challenges posed by the transition to a slower growth rate, and at the same time be one of the **instruments for managing the increasing international role of the renminbi and the more flexible exchange rate.**

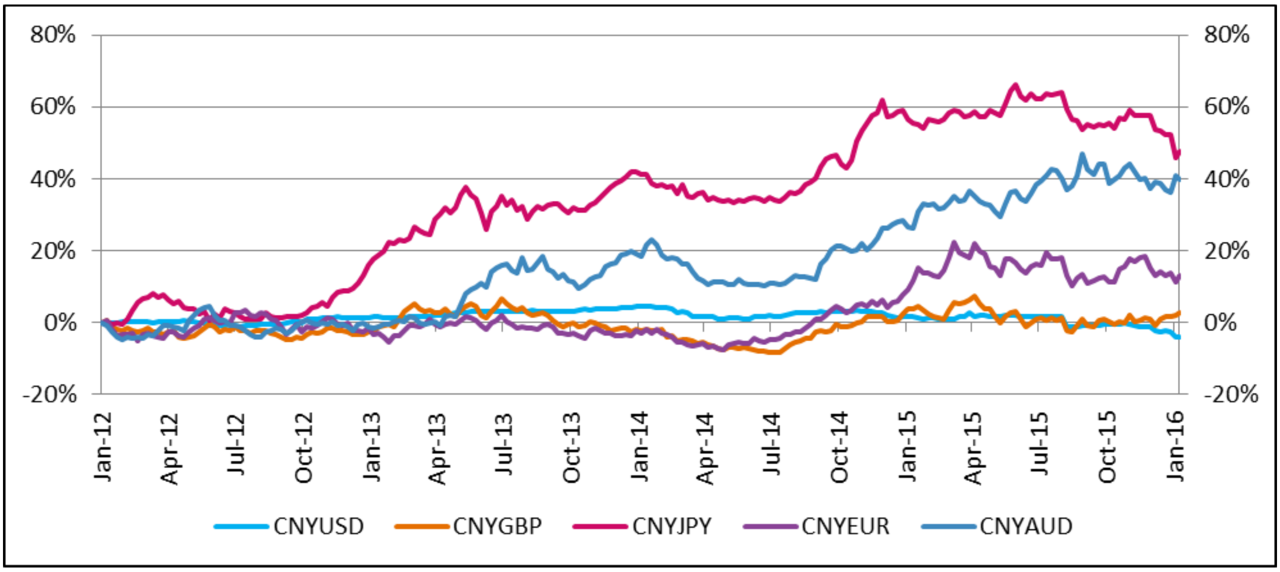
Chart 1: Exchange rates of major currencies against the USD (percentage change)



Source: Bloomberg

The importance of the long-awaited foreign exchange index is that the renminbi's exchange rate is pegged to a basket of 13 currencies weighted mainly on the basis of variables based on international trade. According to the statement of the Chinese central bank, the exchange rate has to depend on the trade and investment activities done with several countries. The weight of the three most important trading partners in the basket are as follows: USD – 26.4 per cent; EUR – 21.4 per cent; JPY – 14.7 per cent. The goal of the index might be to loosen the fixed link between the dollar and the renminbi, which may provide greater leeway for the Chinese authorities in managing the exchange rate and preserving the credibility of the PBOC. The latter may be enabled by the increased flexibility, since no strict commitment against the basket or a specific exchange rate target can be expected. This provides additional room for manoeuvre in the future without the PBOC making sacrifices in its credibility while defending or abandoning a potential exchange rate target.

Chart 2: CNY vs EUR, USD, JPY, AUD, GBP (percentage change, positive values indicate depreciation against the renminbi)



Source: Bloomberg

Managing the renminbi against the basket may also be warranted by the fact that the International Monetary Fund recognised and acknowledged the increasing role of the Chinese currency in the global economy by including it in the SDR currency basket during the basket's review on 30 November last year (Pivarcsi–Rékási[2015]). According to the IMF, in addition to the export requirement, the renminbi fulfils the other necessary condition, i.e. freely usable. The renminbi gained ground in the basket at the expense of mostly the euro and to a lesser extent the British pound. With its almost 11-per cent share, it will be included in the SDR basket with the third greatest weight right from the outset. Nevertheless, should the dollar peg be maintained, the weight of the dollar in the SDR basket would actually increase, which would be undesired from the perspective of the SDR's function, and this also supports the renminbi' management against the CFETS basket.

Another important result of the IMF's decision is that in line with the IMF's earlier statement, investments in the currencies included in the SDR basket form part of the official foreign exchange reserves. That is when the new SDR basket becomes effective (on 1 October 2016), Chinese investments will be considered – de jure – foreign exchange reserves. Therefore the expansion of the SDR mostly affects the asset allocation of the institutional sector. Nonetheless, the developments in the renminbi's exchange rate may also affect other players on the market.

The reasons and consequences of the differences between the offshore and onshore renminbi markets

The main characteristic of the Chinese economic and financial reforms, i.e. sequencing, can also be observed in the liberalisation of the capital account. The gradual approach that can be detected in connection with the policy of reforms and opening up launched in 1978 is implemented on the financial markets as well. However, in the 21st century, irrespective of how gradually the reform measures are implemented, sudden and large market turbulences can occur due to the interdependent and fast-paced structure of global networks and permanently changing (i.e. volatile) market conditions.

This sequencing can also be seen in the fact that the **Chinese foreign exchange market is also opened up step by step** to the various players of the economy (domestic actors, foreign players, companies, private individuals, banks, investment funds, central banks etc.). **The Chinese renminbi is traded on two markets, with different quotes and in different market environment.**

The difference between the onshore and the offshore foreign exchange market can be observed in their different degrees of openness, the different groups of market participants, the scope of products authorised for the individual players and the regulation of the markets (Erhart[2015]). **The different players of the two markets have different motivations** and they are authorised to make different types of transactions, which **may also be reflected in the market rates.** The differences can become especially perceptible during heightened market concerns.

The onshore market is strictly regulated, while on the offshore market, **possibly as a consequence of the free flow of capital, a concern about another segment – e.g. the equity market – may manifest itself more visibly on the foreign exchange market, causing greater exchange rate movements.** This could be observed in early 2016 in connection with the concerns about the Chinese equity market. In the case of the onshore renminbi, the exchange rate may fluctuate +/-2 per cent compared to the rate determined by the PBOC on the morning of the given day, while there is no such limitation in the case of the offshore renminbi, the exchange rate of which is shaped freely by market developments. The onshore renminbi's predetermined exchange rate band may be able to slow down the trend-like exchange rate movements assuming no other central bank measures.

The Chinese central bank may intervene in the development of the exchange rate on both the offshore and the onshore market. On the latter, this derives from the exchange rate regime itself and may be based on a unique decision, while on the offshore market interventions might be carried out based on a unique decision of the PBOC in response to a given situation on the market.

What can cause fluctuations that require an intervention from the central bank? This question may be rephrased to focus on **what can cause greater volatility in the renminbi's exchange rate.**

At least three factors can explain the fluctuations in the renminbi's exchange rate in early 2016.

First, the aforementioned **capital account liberalisation,** which on account of the appearance of the ever increasing number of players with an ever wider range of motivations on the renminbi's market may result in a more volatile exchange rate. For example a hedge fund can react to market developments more rapidly than a market participant pursuing a more conservative investment policy. Here we also have to mention the natural adjustment process discussed at the beginning of the article, i.e. that domestic actors start the global diversification of their assets. Second, the **concerns surrounding the future performance of the Chinese economy,** which are mainly fuelled by the level of indebtedness that has risen substantially in certain sectors in recent years. Third, the **market concern in the case of certain emerging countries, such as China, about the expected interest rate policy of the Fed, which may potentially entail large capital outflows** and also rapidly changing exchange rates may also point towards more volatile exchange rates. The exchange rate that is currently managed by the PBOC in a narrow band enables conversion in the context of a stable exchange rate, while the fear of a potential future depreciation may prompt certain players to use this opportunity as soon as possible.

Over the recent months, capital outflows have also been a concern. The sudden, substantial capital flows can make the gradual opening up of the financial markets more challenging. . Yet the Chinese leadership continues to be committed to the liberalisation of the capital account and the internationalisation of the renminbi (an important milestone of which was the inclusion in the SDR basket), and they respond to the challenges by taking into account all of the above.

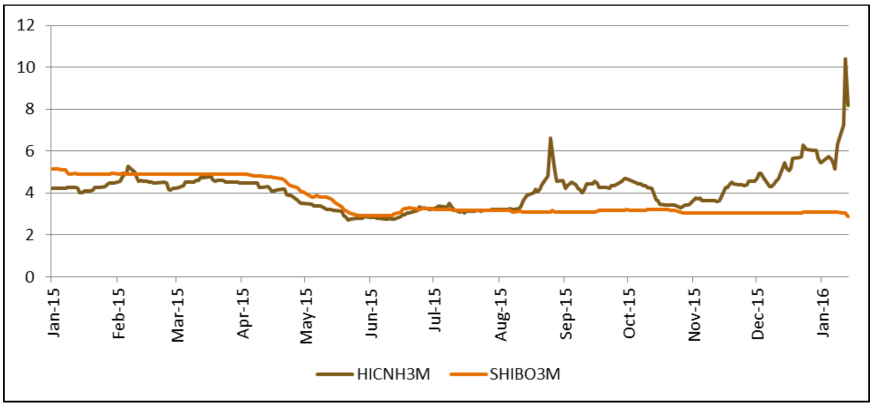
The PBOC assigned a greater role to market forces with its decision in August 2015, according to which the onshore renminbi fixing is determined based on the developments of the market rate over the previous day. This mechanism can not only ensure that market forces take hold, but at the same time continues to provide a large room for manoeuvre to the PBOC in determining the appropriate exchange rate path.

In connection with the renminbi's exchange rate, its development against the dollar is frequently examined, however, the PBOC pointed out that the performance of the renminbi should not be compared to only one currency but to the currencies of the country's major trading partners as well. In December 2015 the CFETS's new index was introduced, which calculates the renminbi's exchange rate based on this approach.

The central bank can not only influence the exchange rate through interventions. **It can exert an impact on market liquidity through open-market operations** (mainly repo and reverse repo transactions). On the onshore market the PBOC can withdraw renminbi from the system and provide renminbi liquidity through its 7-day liquidity operations, **which may influence short-term interest rates and thus also, inter alia, the exchange rate of the renminbi.**

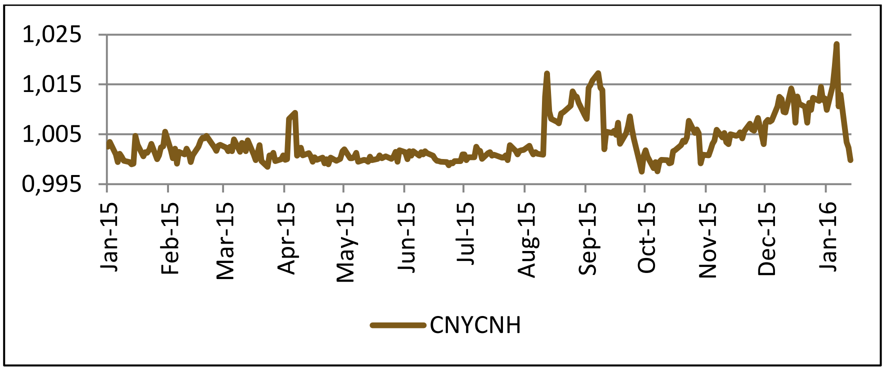
The difference in liquidity between the offshore and the onshore renminbi markets may also be significant for companies, as this can also influence the exchange rate of their (spot or derivative) renminbi transactions linked to their trade settlements. On the offshore market, authorised financial institutions may obtain liquidity from the authority in charge of the given market. The authority can provide renminbi liquidity to the market to the extent available under the swapline or other agreement concluded with the PBOC (for example it can provide liquidity to partner financial institutions within the framework of a repo transaction). Compared to the onshore market, renminbi liquidity is in shorter supply on the offshore market for banks and thus for other financial market participants as well, which may be reflected in the exchange rate of the offshore renminbi too (in the offshore short-term interest rates and in the difference between renminbi exchange rates on the onshore and offshore markets).

Chart 3: 3-month interest rates on the offshore (HICNH 3M) and onshore (SHIBOR 3M) renminbi markets



Source: Bloomberg

Chart 4: Difference between the exchange rate of the offshore and the onshore renminbi



Source: Bloomberg

The tightening of liquidity – which can happen through limiting the volume of money available in liquidity provision operations or through raising the interest rate of the transaction – **may be used to increase the price of previously established short positions and thus to eliminate speculative positions.** Liquidity tightening can also be implemented on the spot foreign exchange market, as we have seen in January 2016. However, this may point towards a more volatile exchange rate.

The developments surrounding the gradual opening up of the Chinese foreign exchange market, i.e. the approximation of the two – the onshore and the offshore – foreign exchange markets may be one of the major areas to watch on the financial markets in 2016.

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