What Is The PBOC Really Up To?

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The People's Bank of China sprang a surprise this morning, lifting the daily fixing rate for the US$-CNY exchange rate by 1.9% and triggering an effective 1.8% devaluation of the renminbi—the currency's biggest one day move since July 2005 when Beijing started its exchange rate reforms. At first glance today's move looks like a response to months of dismal trade data. In our view, however, today's exchange rate move is a lot more than a panic reaction to deteriorating exports. It is part of a longer term reform process aimed at partially liberalizing China's exchange rate policy ahead of the expected inclusion of the renminbi in the International Monetary Fund's Special Drawing Rights basket. Successfully implementing this policy over the coming days and months, however, will confront the PBOC with some tricky challenges.

Today's move is part of a long term reform process

The central bank explained its move by saying it was aimed at "improving the quoting mechanism of the US$-CNY fixing price". In recent months the PBOC has kept its daily fixing rate steady, effectively pegging the renminbi to the US dollar. Meanwhile, the spot exchange rate has remained glued to the weak side of the renminbi's permitted trading band (the fixing rate plus or minus 2%), reflecting market beliefs that by linking the renminbi to the strong US dollar, Beijing was allowing the Chinese currency to become increasingly over-valued.

Exchange rate stability served Beijing's short term needs

But while maintaining exchange rate stability against the US dollar served Beijing's short term ends—notably by helping Chinese companies which have accumulated sizable US dollar liabilities—it conflicted with the central bank's longer term objectives. That is partly because the PBOC wants to reduce its daily involvement in the market, but also because SDR inclusion will necessarily require greater renminbi exchange rate volatility.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
Japan Eco Watchers Survey ticked up to 51.6 in Jul, from 51 in Jun	N/A; outlook component fell from 53.5 to 51.9; consumer confidence also dropped in Jul	Major consumption & service sector slowdowns would be a worry after relative strength
Russia GDP shrank by -4.6% YoY in 2Q, from -2.2% in 1Q	Below -4.5% expected; worst since 2009; consumer buying power hit by ruble devaluation	Unlikely to recover soon; the damaging influence of low oil price and sanctions persists
Chinese new bank lending rose RMB1.48trn in Jul, from RMB1.28trn in Jun	Significantly beat RMB725bn expected	Driven by surge of loans to non-bank financials to support stock market
China aggregate financing rose by RMB719bn in Jul, from RMB1.86trn in Jun	Missed RMB1trn expected	The stock of outstanding credit will continue to grow, despite slowing flows of new credit

Surprise move

The PBOC abruptly shifted the renminbi's fixing rate after keeping it steady for months

Gavekal Data/Macrobond

SDR inclusion requires more day-to-day exchange rate volatility

This last point may sound counter-intuitive, but actually makes good sense. Beijing believes SDR inclusion to be central to promoting the renminbi as a successful international reserve currency. However, if the PBOC were to continue to keep the renminbi stable against the US dollar, the effect of including it in the SDR would simply be to increase the weighting of the US dollar in the basket—the opposite of what the IMF wants to achieve. As a result, to justify its inclusion in the SDR, the renminbi must show greater volatility against the US dollar (see **So You Want To Be A Reserve Currency?**).

The PBOC appeared to take an important step in this direction today, when it announced that it would reform the daily fixing mechanism to let the market play a more important role in determining the price. Under the new mechanism, the PBOC will ask marketmakers—mostly Chinese banks—to submit rates for the daily fixing with reference to the previous day's closing spot rate. In theory this would indeed allow a greater role for the market in determining the renminbi's exchange rate and for greater volatility. In practice, implementation will present some challenges.

Stepping back from the market would risk an exchange rate overshoot

1) If the PBOC were really to let the market set the fixing rate, tomorrow's fix would move into line with today's spot rate, which would mean another 1.5%-2% devaluation. Similar moves would follow on subsequent days as the market tested the central bank's will, with the renminbi's exchange rate very likely overshooting to the downside in what would amount to a significant devaluation.

2) If the PBOC itself determines the fixing rate tomorrow (and on subsequent days) in order to calm the market, the fixing mechanism will have not changed, and the central bank will have achieved nothing by today's move.

In reality, the PBOC is likely to attempt to steer a middle course, dictating the fixing rate tomorrow and on subsequent days to calm market jitters, but gradually allowing the market to play a greater role in determining the daily fix, in order to allow greater day-to-day volatility in line with its longer term aims.

Getting things right will be tricky...

Getting things right—stepping back from the market while continuing to direct the long term trajectory of the renminbi's exchange rate—will be tricky, and the PBOC's degree of success will only become apparent over the next month or two. But by moving now to introduce more exchange rate volatility—months before either we or the market expected—the PBOC has shown a deft sense of timing and an improved understanding of market psychology.

...but could mean more tolerance for RMB weakness against the strong US$

In the longer run, we expect today's move to herald not only greater day-to-day volatility, but a greater tolerance of renminbi weakness against the US dollar in a strong US dollar environment. While today's move was not aimed directly at enhancing China's export competitiveness, the PBOC does have domestic as well as international goals in setting the exchange rate. With it now widely acknowledged after a decade of substantial appreciation that the renminbi is no longer undervalued—and with SDR inclusion probable next year, making the promotion of renminbi internationalization less urgent—the international goals are fading in importance. Meanwhile, weaker domestic demand and poor export growth give the PBOC more reason to focus on its domestic goals. That does not mean China will indulge in competitive devaluation. But it does mean that in a strong US dollar environment the authorities will be more inclined to tolerate a degree of renminbi weakness against the US dollar in order to maintain exchange rate stability against a basket of currencies.