4 Dispelling policy uncertainties is key to stabilize tumultuous financial markets

Policy uncertainties lurk behind financial turmoil

Rising financial turmoil and escalating capital outflows at the beginning of the year cannot be fully explained by economic fundamentals. Growth deceleration is still on its projected trajectory and there is no sign of significant deterioration in real activity indicators yet. Moreover, the continuing economic rebalancing and the authorities’ pro-growth policy initiatives are expected to sustain growth before the economy find its new growth engines.

Lurking behind China’s recent financial turmoil are policy blunders and uncertainties along the way of financial liberalization. To ensure smooth proceedings of inextricable financial reforms, the authorities need to strike a nuanced balance between giving more powers to market and maintaining the stability of its financial system.

The authorities were not well prepared for the relevant challenges and underestimated market forces in the first place. Unfortunately, not every policy misstep can be immediately reversed and forgiven by market participants just like the in-time suspension of “circuit breaker” rules after its four-day implementation. The authorities’ mishandling of the exchange rate reform is far more costly. Indeed, after the unexpected currency devaluation last August, the authorities had spent a vast amount of foreign reserves to stabilize the exchange rate and avert a self-fulfilling cycle of currency depreciation and capital outflows. However, the authorities engineered another wave of currency depreciation at the beginning of this year, which has nullified all the previous efforts by the PBoC to stabilize people’s expectations. Moreover, the authorities’ poor communication did not help to prevent unnerved investors from flocking to deplete foreign reserves for different reasons, ranging from early payment of their USD denominated debt to diversification of their asset portfolios.

In essence, the FX market panic reflects the authorities’ policy quandary. After the August devaluation and the depreciation at the start of 2016, the authorities have effectively shattered the old regime of FX policy in which the RMB exchange rate was loosely pegged to the USD. On the other hand, it is much more difficult and time-consuming to introduce a new FX policy regime, and more importantly, establish its credibility to the public than eradicating the old regime.

We have reasons to believe that the authorities intended to loosen their grip on the exchange rate and leave the price discovery to market. The direction is correct because a flexible exchange rate is not only a key element in China’s mega project of financial liberalization but also will lay down foundations for pressing ahead with other important items on the country’s reform agenda such as capital account opening and the RMB internationalization.

However, the current environment, surrounded by concerns over China’s growth outlook and US monetary policy normalization, doesn’t favor the implementation of such a FX policy regime change. After seeing their two previous attempts in this respect (last August and this January) achieve nothing but roil financial markets around the globe, China’s authorities look as if they want to claw back for the moment.

Unfortunately, financial markets, once being agitated, cannot offer any respite. In face of strong depreciation expectations and accelerated capital exodus, the authorities have been forced to intervene in both the onshore and offshore FX markets to stabilize the exchange rate. They have also tightened certain restrictions under the capital account to crack down illicit capital flows across borders. However, these efforts,
at the cost of burning through China’s foreign reserves, could become futile if the authorities fail to establish a new and credible FX policy regime and manifest it to the public.

The authorities need to choose among unpalatable options

Regarding the new FX policy regime, the authorities now have three options with some variants for each.

- Option I: The authorities could have another one-off devaluation of the RMB value and maintain a peg with respect to the USD at the new level;
- Option II: the authorities could link the RMB value to some index constructed from a basket of currencies, such as the BIS Effective Exchange Rate index, the SDR index or the recently constructed CFETS index;
- Option III: The authorities could give FX markets the full pricing power and achieve a clean float of the RMB as they intended to do in the first place.

All of three options appear unpalatable with different characteristics (Table 4.1).

Table 4.1
Different Options for the new FX policy regime

<table>
<thead>
<tr>
<th></th>
<th>Option I (one-off devaluation)</th>
<th>Option II (Linked to a basket of currencies)</th>
<th>Option III (Clean Float)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technical difficulties for implementation</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td>Requirements for coordination of capital flow restrictions</td>
<td>Medium-High</td>
<td>Medium-High</td>
<td>High</td>
</tr>
<tr>
<td>Financial market volatility</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Impact on trade competitiveness</td>
<td>Neutral-Positive</td>
<td>Neutral</td>
<td>Positive</td>
</tr>
<tr>
<td>Impact on corporate financial condition</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Degree of Loss in monetary policy independence</td>
<td>Medium-High</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td>Time to establish credibility of the new regime</td>
<td>Long</td>
<td>Medium</td>
<td>Short</td>
</tr>
<tr>
<td>Whether is the ultimate goal of FX reform</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Source: BBVA Research

Technical difficulties for implementation

- In terms of technical difficulties for implementation, Option III and II should be relatively easy. The thorny issue for Option I is to find an appropriate level of devaluation. If the one-off devaluation appears too little compared to investors’ expectations, they will continue to attack the new pegged level and cause more capital outflows.

Requirements for coordination of capital flow restrictions

- It is worth noting that all three options require for coordinative measures of reining in capital flows. It means that the authorities might need to roll back some of the liberalizing measures unveiled previously under the capital account, making the three options all the more unpalatable. In this respect, Option I and II appear to exceed Option III as we expect an announcement of a clean float will unavoidably cause more capital outflows in a short period. Therefore, more restrictive measures under the capital account need to be unveiled in coordination with the implementation of Option III.

Impact on trade competitiveness

- Unless a sharp one-off devaluation is to be enacted, Option I cannot significantly improve China’s competitiveness in its exports. In this respect, an important side effect by implementing Option I is to incur international critiques of currency manipulation and lead to more trade disputes with large trade partners.
Option II can at least ensure that the country’s competitiveness wouldn’t weaken further against the trade partners whose currencies are included in the basket. Option III exceeds in this respect.

Financial market volatility

- Both Option I and III are likely to destabilize the FX market for the short run. Comparatively, Option II could have less disruptive impact on financial markets. This point has become increasingly important as financial markets around the world are now surrounded by great uncertainty and doubt.

Impact on corporate financial condition

- One primary concern for the RMB depreciation is the enormous amount of USD denominated debt borrowed by Chinese firms. Although the previously wild movements of the RMB exchange rate have prompted many borrowers to pay back their USD debt, a sharp plunge in the RMB value, caused by the implementation of either Option I or III, can still exacerbate the debt burden of these firms substantially, even putting many of them in financial distress.

Degree of Loss in monetary policy independence

- The authorities also worry about the loss of monetary policy independence if Option I or II is to be implemented. As the US interest rate hikes are set in motion, the PBoC might not be able to trim its interest rates for growth stimulus since it could lead to a narrowing of two countries’ interest rate differential and trigger more capital flows away from China. Fortunately, the existing monetary policy framework in China can help to overcome it. For example, certain capital account restrictions can partially insulate the economy from external shocks like the US rate hikes. More importantly, China’s authorities have other ammunitions than the interest rate tool for policy easing. They can deploy quantitative policy tools such as the reduction of banks’ required reserve ratios (RRR) and implement expansionary fiscal policy to reinvigorate the economy if needed.

Time to establish credibility of the new regime

- It is much easier to shatter an old policy regime than introduce a new one, and more importantly, establish its credibility. There is no need to worry about this point if Option III is implemented. Investors can easily read the authorities’ let-go stance. However, both Option I and II need longer periods to establish their own credibility. In particular, implementing Option I will mean that the authorities break their vows of no more one-off devaluations made after last August devaluation. It is natural for investors to have doubts about whether the authorities will commit to the new pegged level with all their heart.

Whether is the ultimate goal of FX reform

- We believe that the ultimate goal of China’s exchange rate reform should be a clean float. A market-determined and flexible exchange rate is also the prerequisite for pressing ahead with other important financial reforms such as capital account opening and the RMB internationalization. That being said, both Option I and II look like intermediate arrangements which need to be reformed at some time in the future.

Apparently Option I is inferior to both the other alternatives in almost all areas except for boosting trade competitiveness. Comparatively, Option II is a more conservative but safer choice under current circumstances although it needs to transition to Option III at some time in the future.

The authorities now seem to lean toward Option II as revealed in a number of recent remarks by the PBoC’s senior officials, including the Governor Zhou Xiaochuan. However, the authorities still need to do more work to establish the credibility of the new FX regime as soon as possible. Toward this end, it is imperative for the authorities to communicate their intention to the market in a clearer manner and to
increase the transparency in the relevant mechanism as well as operational processes. To limit costs of foreign reserves loss during the process, the authorities could consider enforcing the existing restrictions under the capital account and even implementing additional macro-prudential measures to clamp down illicit capital outflows. More importantly, the authorities need to dispel policy uncertainty and show their commitment to press ahead with structural reforms, including not only financial liberalization but also other key ones such as SOEs reforms, fiscal system overhaul and land rights reform etc.
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China Economic Outlook
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