China Flash

Wider trading band leading to less appreciation in the short term

The People's Bank of China (PBoC) announced the widening of the daily trading band last Saturday. The band of the RMB against the USD is expanded to +/- 2.0% (around the daily opening fixing rate) from +/- 1.0%, effective from today (March 17). In addition, the PBoC also raised the bid-ask spread for USD offered by the foreign exchange-designated banks to their customers from the current level of 2% to 3%. According to the PBoC's statement, the relaxation of the RMB trading band is an important effort that will "facilitate price discovery and enhance the flexibility of the RMB exchange rate."

Although we do not expect that it will change the RMB's long-term trend of appreciation, it can introduce more two-way volatility in the short run. In this regard, we project that the RMB to remain relatively stable in the first half of the year and continue to appreciate mildly thereafter. In particular, it should appreciate by 2- 3% from the current level by the end of this year. Moreover, a more flexible RMB should help hamper capital inflows (particularly "hot money"), which, in turn, may tighten the liquidity in the interbank market. This might explain recent announcements by Chinese authorities that reserve requirements (RRR) may be lowered if needed.

- **Widening the daily trading band of the RMB is a long-awaited move,** given that calls for increasing the flexibility in the RMB exchange rate have been increasing steadily since the PBoC widened it to +/- 1.0% from +/-0.5% in April 2012. Indeed, it is the third time that the band has been widened since China embarked on reforming its exchange rate policy in 2005. (Chart 1)
- **The move was in line with the market's expectation**, as China has frequently emphasized that it will continue to improve rules concerning the RMB exchange rate under the backdrop of further financial reforms. In the run-up of this widening, the authorities seem to have deliberately pushed the RMB exchange rate to the weak side of the daily trading band, which has been read as a sign of the imminent widening of the band.
- **The wider trading band will introduce more two-way volatility to the RMB in the short term.** Although we don't think the wider trading band will change the long-term appreciation trend of the RMB, it is very likely to introduce more two-way volatility to its exchange rate. The recently released weak activity indicators (Chart 2) might add further pressure on the RMB's exchange rate in the short term. In this regard, we project that the RMB will appreciate by 2- 3% from the current level toward 6.0 CNY/USD by the end of this year, lower than our previous end-year projection of 5.95 CNY/USD. In addition, all of the year appreciation should basically happen in the second half of the year with a pretty stable outlook for the first half of the year.
- **The widening of trading band might have tightening effects,** as a more flexible exchange RMB should slow down capital inflows. At the same time, less capital inflows would translate into lower liquidity in the interbank market, which is already tighter than in the past. Given the government's recently announced growth targets, there may be a need to loosen monetary policy, most likely RRR and/or open market operations, to ease the liquidity conditions.

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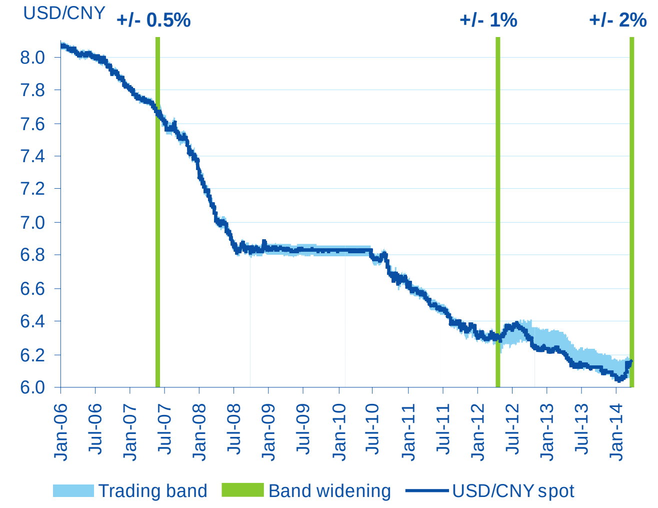
Chart 1

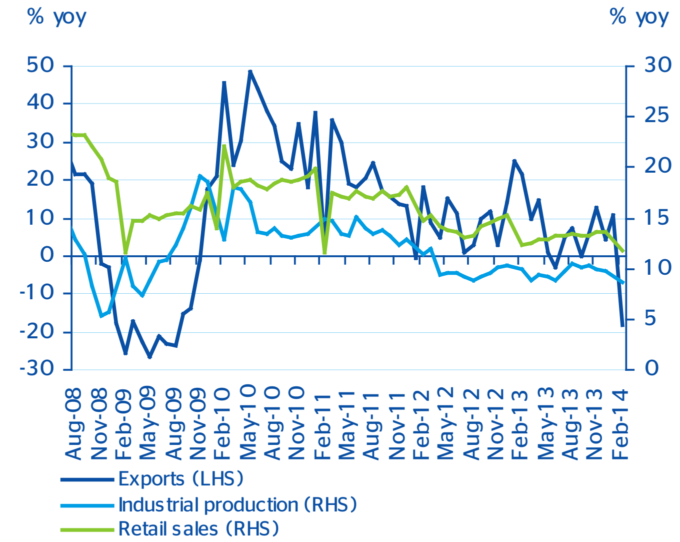
Trading band has been widened further



Source: Bloomberg and BBVA Research

Chart 2

Recent macro indicators disappoint



Source: CEIC and BBVA Research

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