

# OBSERVATION

## TD Economics



April 16, 2012

## CHINA'S FX POLICY: ONE MORE STEP TOWARDS A GLOBAL CURRENCY

### Highlights

- The People's Bank of China has just announced a move to bring more flexibility into the renminbi foreign exchange rate.
- This policy change should not be construed as a sign of imminent appreciation of the Asian currency, but as an element of a broader strategy towards financial liberalization.

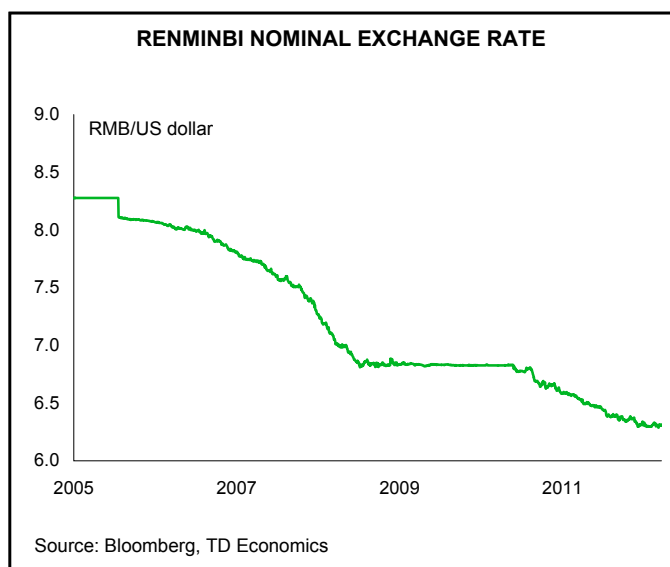
On April 14th the People's Bank of China announced it will allow the renminbi (RMB) to trade on a wider band around the central parity established daily by the China Foreign Exchange Trade System. The band is being expanded from +/- 0.5% to +/- 1%. At the same time, the PBoC also allowed banks to widen their bid-ask spreads on RMB/USD foreign exchange transactions by up to 4% of the central parity from 2% prior.

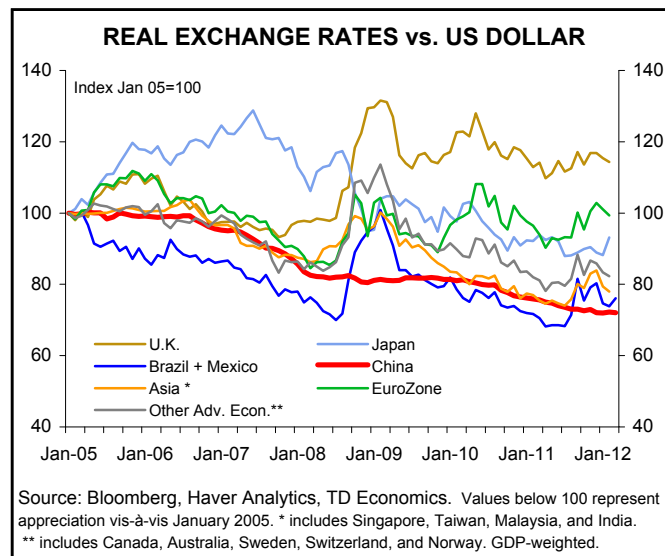
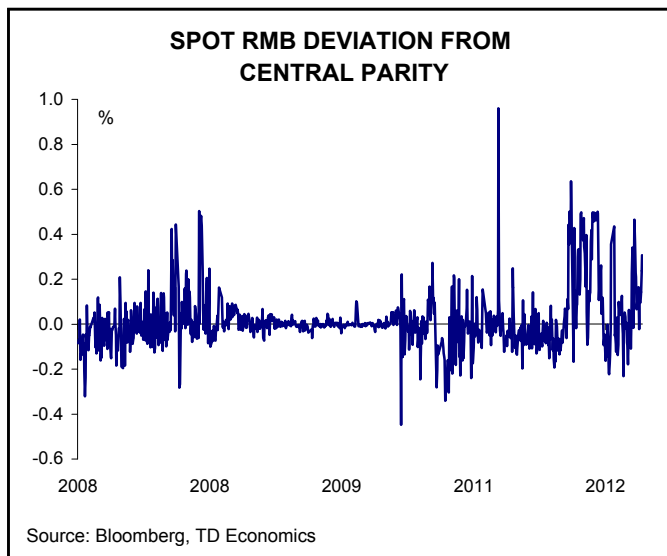
This initiative, which will bring more flexibility to the Chinese currency, should not be analyzed in isolation, but as a component of a broader strategy to boost the role of the RMB as a global currency. It also constitutes a further step towards liberalization of China's balance of payment capital account. Other recent measures of the same intention included China's Securities Regulatory Commission (CSRC) increasing the foreign investment quotas under the Qualified Financial Institutional Investors (QFII) scheme to US\$80 billion from US\$30 billion. The CSRS has also expanded a similar scheme – the RM-BQFII – that allows foreign investors to make RMB investments into China. Furthermore, in February the CSRC announced its intentions to launch a regulated “junk” corporate bond market in the mainland.

Other significant efforts to boost the global reach of the RMB included the creation in mid-2010 of a RMB-denominated corporate bond market in Hong Kong. Firms with operations in China are allowed to raise RMB funds in Hong Kong to be reinvested in the mainland.

There is also a political dimension to this decision by the PBoC. As it had been the case in the past – e.g., prior to the Toronto G-20 summit in June 2010 – Chinese authorities might have timed their announcement on the RMB to fend off potential criticism from both advanced and developing economies at the upcoming IMF-World Bank Spring meetings. The U.S. Treasury has just postponed its semi-annual report on currency manipulators required by the U.S. Congress, perhaps waiting for the upcoming round of Strategic and Economic Dialog between China and the U.S. government.

Allowing the RMB to move more freely would not only





defuse some of the external pressures from China’s main trading partners, but also reduce some of the costs associated with foreign exchange intervention. Such actions by the PBoC generate inflationary pressures. As the central bank buys U.S. dollars to keep the domestic exchange rate within its band, RMB liquidity is injected into the local economy and full sterilization of those funds is not always achieved. Therefore, having a wider band might reduce the magnitude of these interventions, thus removing some of China’s domestic inflationary pressures.

Indeed, the fact that China has observed higher inflation rates than the U.S. in recent years has largely contributed to the real appreciation of the RMB vis-à-vis the U.S. dollar. The inflation-adjusted exchange rate shows the Asian currency has appreciated by roughly 28% since January 2005. This is the largest appreciation versus the greenback among any leading advanced and developing economy – despite the fact that there’s no arguing that China firmly manages the movements of its nominal currency.

### Final Remarks

The move just announced by Chinese authorities regarding the expansion of the exchange rate band of the Chinese renminbi should be considered as one component within a

broader strategy to increase the global reach of the RMB and to gradually relax the country’s capital controls. This is a process that will require other significant structural adjustments in the Chinese economy, most notably to its banking system. Therefore, as with any structural shift, it will play out over a long period. Furthermore, it may also be part of ongoing efforts to change its growth model from one led by export/investments to one where aggregate consumption plays a more prominent role.

In the short term, however, a wider RMB trading band will most likely mean more volatility, but not necessarily more appreciation of the RMB. After all, the PBoC has widened the trading band, but has offered no guidance on the direction for the central parity. In addition, there are a number of factors that have lessened the case for a strengthening of the RMB. China’s trade surplus has been narrowing, economic activity has cooled, the inflation rate has tempered, and there has been modest capital outflows. All these elements offer a thinner foundation for RMB appreciation in the short term.

*Martin Schwerdtfeger*  
 Senior Economist  
 416-982-2559



This report is provided by TD Economics. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.