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A Thought on Chinese Managed Floating Exchange Rate System in 2017

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The China Foreign Exchange Trade System (CFETS), an agency administered by the People's Bank of China, changed its calculation method of the CFETS RMB Index from the beginning of this year[1]. The main point of change was the inclusion of 11 new currencies, e.g., Korean won and Turkish lira, into its original currency basket. When the CFETS Index was first introduced[2] a year ago, the basket consisted of 13 currencies, which gave us some impression of immature and incongruous standard, but after the expansion to cover 24 currencies, it seems to be improved as a matured and more reliable index.

The newly included currencies were those that became directly tradable with the RMB in the Shanghai onshore interbank market, i.e., CFETS, during last year. As these currencies comprised 21.1% of whole basket, the weights of the original 13 currencies were reduced proportionately. The share of the US dollar was also reduced from 26.4% to 22.4%, which may show RMB's exchange rate will be less related to or dependent on the US dollar.

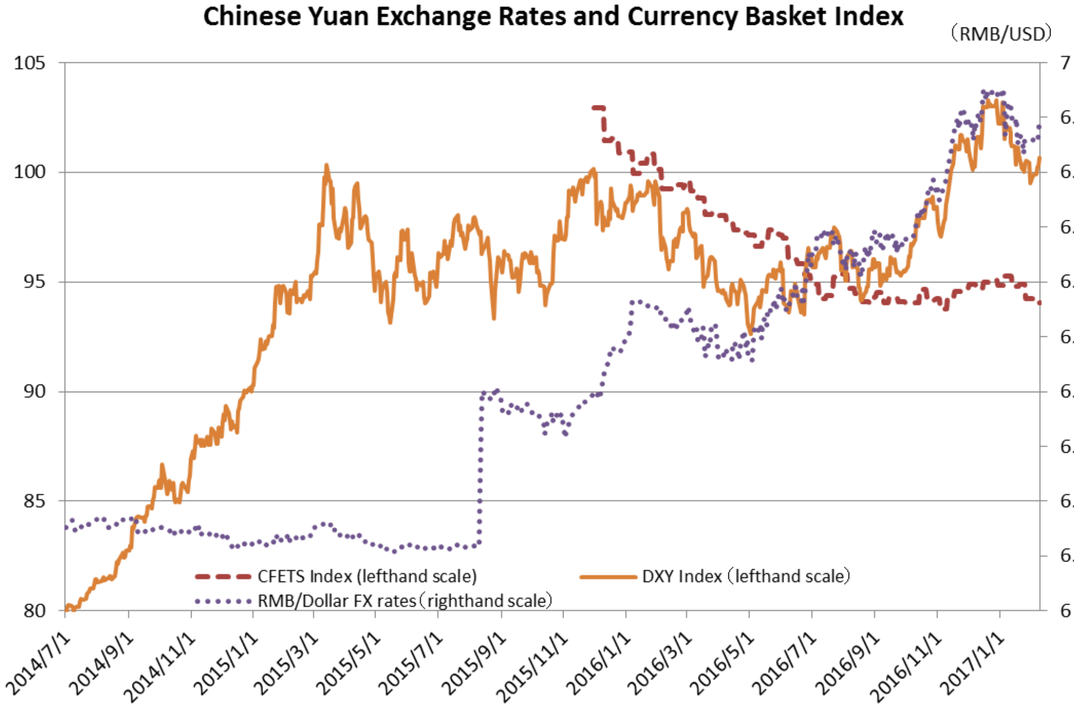
Back in 2015, the Chinese government actively promoted the negotiation with the IMF for including the RMB into the SDR basket, but on the other hand, it left a deep impression in the market through its aggressive supporting measures against plunging stock prices and sudden devaluation of the RMB. The inclusion of the RMB into the SDR currency basket was much important milestone for China on its road to raise the RMB to a status of major currencies and boost its national prestige, however, the IMF requested China to make necessary reforms before giving them the prize. It did not go further to request to adopt a free-floating exchange rate system immediately, but it then requested China to give up the crawling peg system, in which the RMB exchange rate was managed to follow the US dollar. In response to this request, Chinese authority implemented foreign exchange reforms in August 2015, and then introduced the CFETS index in December, which was further followed by this year's expansion of the

[1] Please see below URL link for details of the announcement of CFETS on December 29.
http://www.chinamoney.com.cn/english/svcnrl/20161229/2049.html
http://www.chinamoney.com.cn/english/svcnrl/20161229/2047.html

[2] Please see below URL link for the Eyes of IIMA, "A New Renminbi Index; the CFETS RMB Index"
https://www.iima.or.jp/Docs/column/2016/0112_e.pdf

number of currencies in the basket. If we go back further to July 2005, we can find China introduced a managed floating exchange rate system, in which the Chinese government clearly stated that it would refer to a currency basket. Nevertheless, after some more years, it took an easier way and did peg the currency to the US dollar, throwing aside the idea of reference to the basket at some point or another. In 2015 again, the rough and hasty implementation of exchange rate reform coupled with the devaluation of the RMB generated a formation of firm expectation of a medium-term depreciation of the RMB, which continues up to now. In the Hong Kong market that has got hot and raised its presence as the mother market of offshore RMB, not all has been smooth sailing and even cool winter monsoon may be observed.

Chinese Yuan Exchange Rates and Currency Basket Index



Source: Thomson Reuters Datastream

Note: Higher value for DXY Index indicates higher dollar, that for RMB/Dollar indicates higher dollar/cheaper yuan. Higher value for CFETS Index represents higher yuan.

Since 2016, the RMB watchers in and out of China have strengthened their attention on the US Dollar index (DXY)3, which is useful to understand the changing value of the US dollar. From the Chart above, we can see that in the period of solitary rise of the US dollar following the start of tapering of the US monetary easing in the latter half of 2014, the Chinese government continued its foreign exchange management of its currency nearly pegged to the US dollar. The rise of the dollar meant the RMB's rise against all the currencies except the dollar.

[3] Among many dollar indices available, the Chinese government pays attention to the DXY or USDX provided by Intercontinental Exchange (ICE). The index is calculated on a weighted average of six currencies including euro, yen, pound sterling, Canadian dollar, Swedish krona, and Swiss franc, with their respective weight of 57.6%, 13%, 11.9%, 11.9%, 9.1%, 4.2% and 3.6%. The high proportion of the euro is outstanding in the index. Other major indices include the FXCM of Dow-Jones Co, and the broad index (26 currencies) and the major currencies index (major 7 currencies) released by the FRB.

This triggered Chinese “big shopping spree” in Japan, breathing a warm wind into a sagging Japan-China relationship. The Chart above also shows that the energy for weaker RMB irrationally accumulated since 2014 under the control of the Chinese authority was released suddenly driven by the devaluation of the RMB in 2015 by Chinese authority. Further, what is interesting is that, although there was much effort of the authority to improve the CFETS Index, we can see that the co-relation between the RMB/USD exchange rate and the Dollar Index has been rising since the turn of the year. This may reflect the psychological tendency of the Chinese authority for dependency on the US dollar through the Dollar Index.

Since the turn of the year 2017, we can see that the Chinese government began their efforts to induce the expectations of the market. Currently there still is a strong sentiment in the market that the exchange rate moves in one direction for weaker RMB. Therefore, it might be a big bet to introduce floating exchange rate system in such an environment. The best way the Chinese government can take at present will be that they work on weakening the widespread expectation of the Chinese people for weaker RMB and gradually nurture the recognition that the exchange rates will move in both directions. If they succeed in this effort, it will be a good running step toward the transition to the free-floating exchange rate regime. The year 2017 is the year with full of political events to China, so big reforms will not be implemented, but it will still deserve attention how they will address the economic and political challenges, including reforms of foreign exchange market management.