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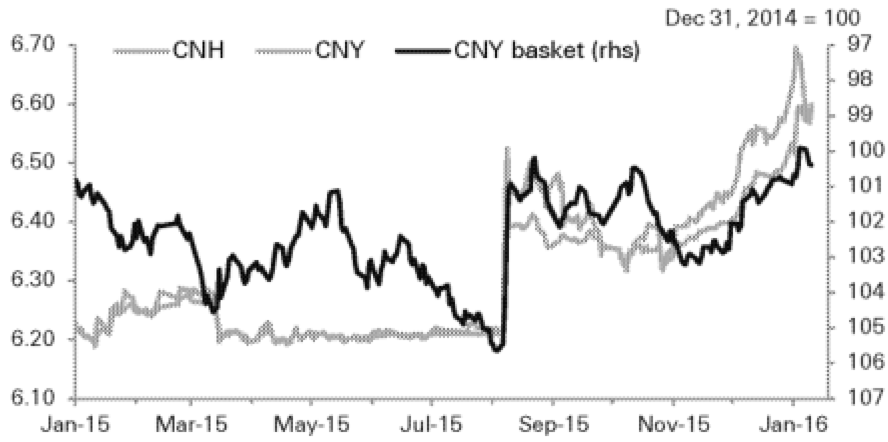
Global Economic Perspectives

China's evolving FX policy

- Our annual Access China conference this week was dominated by concern about the RMB as an unprecedented devaluation in August and rapid depreciation in recent weeks raised concerns that the authorities could not – or did not want to – restore stability to the currency's value.
- We see recent events as unanticipated (at least, to us) transitional stages in the progression to an eventual goal of having a freely floating exchange rate. Managing the value of the RMB against a basket of currencies, if that is what the PBOC is doing, implies a limitation on monetary policy independence that we think policymakers eventually will resolve by introducing further genuine flexibility.
- Most capital outflows over the past year appear to have gone towards repaying foreign debts. As those debt reducing flows taper off later this year, it will be safer to allow more flexibility. In the interim, a narrowing interest rate differential versus the USD will likely continue to pressure the currency and/or foreign exchange reserves.
- Ultimately, it will be important to reassure domestic investors that they will earn a competitive return on their investments in China rather than converting to dollars. That will require continuing to articulate and deliver on reforms that reward private capital. March's National People's Congress and the promulgation of a new Five Year Plan could be important in this respect.

Two steps in the transition to flexibility: a devaluation and a basket



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