



We are not sure, though, that this transitional regime of managing the currency with reference to a basket will last for long. It is one thing for a very small very open economy like Singapore to target a certain trajectory for its trade-weighted exchange rate. But having a view on the exchange rate implies some level of constraint on interest rate policy. A rigid peg like that of the HKD implies complete surrender of independent interest rate policy unless capital controls are equally rigid. It is one thing for the PBOC to monitor the value of the RMB with respect to its trade-weighted value. But if they try to use that index as a basis for managing the currency's value against other currencies then they are not gaining much more independence of policy than they had before August.

Ultimately, the intention appears still to be to move over a reasonable time frame to a more flexible exchange rate against all currencies and we think the CFETS basket will just be one way to think a little more broadly about the value of the currency.

In the near-term, a narrowing interest rate differential versus the USD and continuing debt repayment flows will likely continue to pressure the RMB's external value. The PBOC has more than enough foreign exchange reserves, we think, to make this a stable process. The paramount risk, though, which motivates the more bearish among the investment community, is that any further weakening of the RMB encourages Chinese households to redenominate their RMB assets into foreign currencies.

To reduce that risk, the authorities need to do everything they can to reassure investors that they will earn an attractive return on their capital if they invest it in China. That requires more than just stabilizing growth. It requires delivering on commitments to reform across a number of dimensions – closing down chronically unprofitable SOEs and privatizing others, opening up state-dominated sectors to private investment, improving the pricing of capital to facilitate capital flows to private rather than SOE firms, strengthening corporate governance so as to improve the returns to investment in listed companies, and so on. March's National People's Congress and the promulgation of the next five year plan would be a good place to start doing that.

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*If the PBOC manages the RMB with reference to a basket similar to how Singapore does, they will give up policy flexibility.*

*Ultimately, we think the goal is genuine currency flexibility.*

*Once the overhang of external debt is reduced, it will be easier to manage the further transition to flexibility.*

*It will be important, though, that investors gain confidence in their ability to earn a competitive rate of return in China. For that, delivery on reform pledges is needed.*