fastFT People's Bank of China

China's central bank gives itself more leeway on setting exchange rate

Move comes amid concerns that renminbi could fall rapidly as economy slows

Tom Mitchell 4 HOURS AGO

China's central bank has given itself greater leeway to determine the renminbi's exchange rate, reflecting Beijing's concerns that the currency could fall rapidly as economic growth slows and the US escalates its trade war with the world's second-largest economy.

In an announcement on its website, the People's Bank of China said it was reintroducing a "counter cyclical factor" to guard against what Chinese authorities have sometimes criticised as irrational market moves.

The decision should help the PBoC stabilise the renminbi without selling down too much of its foreign exchange reserves, which rose slightly in July to $3.12tn. This month a central bank adviser said the renminbi would break "a psychological barrier" if it fell below seven to the dollar, while Chinese officials have also worried that investor confidence would be damaged if forex reserves dropped below $3tn.

"This move is an attempt to stave off two risks related to rapid currency depreciation: speculative capital outflows and rising trade tensions with Washington," said Eswar Prasad, an expert on China's financial system at Cornell University. "Unfortunately, it also represents a step back from China's longer-term objective of moving to a more market-determined exchange rate."

The PBoC's tool against unwanted moves was introduced in 2017 to counter a long period of renminbi weakness, after the central bank moved to give market forces a greater role in determining the value of the currency. A botched announcement of the market-oriented reform in August 2015 had caused panic on international and domestic markets — as well as capital flight from China — in the second half of 2015 and early 2016, forcing the government to introduce strict capital controls.

The counter cyclical factor was criticised by some reformers, who saw it as a backwards step in former PBoC governor Zhou Xiaochuan's long campaign to internationalise the renminbi, and use of the mechanism was in effect suspended in January 2018.

After US President Donald Trump imposed punitive tariffs on Chinese industrial exports worth $34bn annually on July 6, the renminbi fell almost 7 per cent against the dollar to a low of Rmb6.93 on August 15, a sharp fall for the carefully managed currency.

The PBoC sets a daily dollar "reference rate" from which the renminbi is allowed to move only 2 per cent, in either direction, during onshore trading.

Under the August 2015 reform, the central bank committed itself to setting the daily reference rate in line with the currency's previous day's close against the dollar as well as dollar movements in overnight trading in Europe and the US.

The renminbi strengthened slightly after it was confirmed that Chinese and US trade negotiators would hold a fourth round of negotiations to halt a trade war that has so far affected more than $100bn worth of bilateral trade. But after those negotiations ended without progress on Thursday, the currency began to weaken again.

In its announcement, the PBoC said it had begun "actively adjusting" the counter cyclical factor earlier this month. "Due to factors including dollar strength and trade friction, the foreign exchange market has experienced some procyclical behaviour," it said, adding that it had acted in order to "moderately hedge" the renminbi's recent moves.

In its latest quarterly report on August 18 the PBoC noted the danger of "herd effects which intensify market fluctuations".

In an interview with Reuters this week, Mr Trump accused China of manipulating the renminbi. Some US officials suspect that Beijing has welcomed the currency's fall against the dollar because it relieves some of the pressure building on Chinese exporters because of US tariffs.

The renminbi's weakness was one of the subjects discussed at this week's trade negotiations, according to people briefed on the discussions. Chinese officials had earlier said that they would not use devaluation as a tool to offset trade frictions

As part of its efforts to bolster the economy, the PBoC has been injecting liquidity into the banking system. The government has also recently instructed banks to boost lending to infrastructure projects and exporters.

"It's clear that [the PBoC] is uncomfortable with the both the pace and magnitude of renminbi depreciation," said Andrew Polk at Trivium, a Beijing consultancy. "We expect the full complement of the PBoC's intervention tools to be exercised in the next few months."

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