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- Executive Summary -

China's Economy	2018 National People's Congress and China's Policy Outlook

At the 2018 National People's Congress, China's real GDP growth rate target was unchanged at "around 6.5%," and China presented its stance to accept economic slowdown and put more effort into supply-side structural reforms and forestalling financial risks. The fiscal deficit-to-GDP ratio target was lowered from the previous year, but the issuance of local government special bonds, which is not counted as a deficit, increased. China will continue to increase spending to prop up the economy, will maintain a prudent and neutral monetary policy, and will supply necessary funds for the real economy. China aims to achieve the forestalling and defusing of financial risks and various reforms by 2020. With the deadline approaching, all eyes will be on whether China can implement reforms speedily and skillfully under the strong leadership of the Xi Jinping administration.

News from the China Advisory Division	The Past and Future of the Chinese Yuan Exchange Market as Examined Through the Currency Options Market

The ban on Chinese yuan currency options transactions was lifted in April 2011. Thereafter, many events occurred in the foreign exchange market, including the expansion of the fluctuation band of the Chinese yuan exchange rate in 2012 and 2014, the significant devaluation of the Chinese yuan base exchange rate against the U.S. dollar in 2015, the sharp appreciation of the U.S. dollar in 2016 after the establishment of the U.S. Presidency under Donald Trump, and the rapid appreciation of the Chinese yuan with the introduction of the countercyclical factor in 2017. This article will review these events from the point of view of the currency options market, while examining the future outlook of the Chinese yuan exchange market.

2018 National People's Congress and China's Policy Outlook

China accepts economic slowdown and puts effort into reforms, such as forestalling financial risks, etc.

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1. National People's Congress held for the first time after Xi Jinping began his second term

The National People's Congress (equivalent to the Japanese Diet, hereinafter referred to as the "NPC") was held from March 5 to 20, 2018. The second Xi Jinping administration was launched after the 19th National Congress of the Communist Party of China in October last year, which marked China's entry into a "new era." The latest NPC was the first under Xi Jinping's second term. At the NPC, based on the understanding that many structural reforms are still underway, China expressed that it would accept economic slowdown and put more effort into supply-side structural reform and measures to forestall financial risks in order to achieve "high-quality development"—the concept laid out at the Central Economic Work Conference held in December last year (Figure 1). The article will explore the detailed points of China's economic policy positions for 2018 based on the "Government Work Report" and the budget bill, etc.

Fig. 1: Overview of Premier Li Keqiang's "Government Work Report"

Category	Overview
Understanding of current situations	◆ Outside China: The global economy is expected to continue to recover. Meanwhile, there are many unstable and uncertain factors, such as the effects of (monetary) policy adjustment and a rise in protectionism. ◆ In China: It is time to tackle the difficult challenge of structural transformation. However, many issues remain, and it is necessary to deal with risks that can be predicted and those that are difficult to predict. Prominent issues remain unresolved, such as economic structural transformation, issues of poverty and disparity, safety, well-being, administrative reforms, and corruption, etc.
Basic policy	◆ Based on the general principle of thoroughly implementing the "Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era" and of pursuing progress while ensuring stability, China regards stability and progress as being indivisible and works on the following challenges. 1) Strongly advancing high-quality development 2) Stepping up measures for reform and opening-up 3) Winning three critical battles to finish building a moderately prosperous society in all aspects
Economic growth	◆ The GDP growth target was set at around 6.5%, taking into account such factors as the goal of doubling the GDP by 2020, the fact that China is transitioning into a stage of high-quality development from its past rapid growth phase, and the creation of sufficient jobs. ○ Fiscal policy: The proactive fiscal policy will remain unchanged, and efforts are concentrated to increase efficiency. The fiscal deficit target was lowered to 2.6% of the GDP for 2018. ○ Monetary policy: The prudent, neutral monetary policy will continue in 2018, and the money supply will be well controlled. A smooth transmission mechanism of monetary policy will be established.

Source: Compiled by Mizuho Research Institute based on Premier Li Keqiang's "Government Work Report" on March 5, 2018

2. Points of economic policy management for 2018

(1) Numerical targets

a. Real GDP growth rate target remaining at "around 6.5%" but effectively revised downward

China's real GDP growth rate target for 2018 was unchanged at "around 6.5%" (Figure 2). However, given that the wording "or higher if possible in practice" that was included in the 2017 "Government Work Report" was removed, it can be said that the growth target was actually revised downward.

As for the growth target, the "Government Work Report" explained that the target level is sufficient for achieving a goal of doubling the GDP from 2010 levels by 2020,[1] saying, "The above targets take into consideration the need to secure a decisive victory in building a moderately prosperous society in all respects." At the same time, the report says that the targets "are fitting given the fact that China's economy is transitioning from a phase of rapid growth to a stage of high-quality development," suggesting that the target level will not hinder structural reforms for improving quality and efficiency.

In addition, in the National Development and Reform Commission's Report on the Implementation of the 2017 Plan for National Economic and Social Development and on the 2018 Draft Plan for National Economic and Social Development, it is pointed out that the growth target of around 6.5% is largely consistent with China's current potential growth rate. Given this, the growth target is apparently at a level that is acceptable for the Chinese government.[2]

Given these, it is highly likely that the Chinese economy will actually slow down to the level of around 6.5% in 2018.

b. Employment and income targets unchanged, with China indicating that it will give further consideration for employment by introducing a new unemployment rate target

The Chinese government focuses on employment from the perspective of maintaining stability in society. It set a goal of generating a minimum of 11 million new urban jobs, the same level as in the previous year, while saying that the target can be achieved if economic growth of around 6.5% is achieved.

Meanwhile, the registered urban jobless rate target was set at 4.5% or less—the same level as in the previous year. In addition to this, a new unemployment rate, called the "surveyed urban unemployment rate," was introduced this year. The surveyed urban unemployment rate covers a wide range of situations such as the unemployment situations of rural migrant workers (farmers migrating to cities for work), and it is said that it reflects actual unemployment situations more correctly than the registered urban jobless rate. Thus, the introduction of this indicator suggests the government's stance to pay broader attention to employment situations.

Meanwhile, as for an income target, the conventional wording of "Basic parity in personal income growth and economic growth" was applied.

[1] Based on GDP growth rates until 2017, the goal is expected to be achieved if China maintains an average real GDP growth rate of 6.3% from 2018 to 2020.
[2] In the OECD's *Economic Outlook*, China's potential growth rate is expected to gradually slow down to slightly below 6.5%, at 6.4% in 2017 and 6.3% in 2018. (OECD [2017] *Economic Outlook*, November)

Fig. 2: Main numerical targets for 2018

	2018		2017	
Category	Numerical target	Comparison with last year's target	Numerical target	Result
Real GDP growth rate	Around +6.5%	(→)	Around +6.5% (+α)	+6.9%
Fixed-asset investment (nominal)	(Not clearly stated)	—	Around +9.0%	+7.2%
Total retail sales of consumer goods (nominal)	Around +10.0%	(→)	Around +10.0%	+10.2%
Consumer Price Index (CPI)	Around +3.0%	(→)	Around +3.0%	+1.6%
Money supply (M2)	(* Maintaining last year's real growth rate)	—	Around +12.0%	+8.2%
Aggregate financing		—	Around +12.0%	+12.0%
No. of new urban jobs	Over 11 million	(→)	Over 11 million	13.51 million
Registered urban jobless rate	4.5% or less	(→)	4.5% or less	3.9%
Surveyed urban unemployment rate (*New)	5.5% or less	—	—	4.98%
Fiscal deficit-to-GDP ratio	2.6% (RMB 2.38 trillion)	(→)	3.0% (RMB 2.38 trillion)	2.9% (RMB 2.38trillion)
Reduction of overcapacity	Coal: Approx. 150 mil. tons Steel: Approx. 30 mil. tons Coal-fired thermal power: Facilities not meeting standards	(↓) (↓) —	Coal: Over 150 mil. tons Steel: Around 50 mil. tons Coal-fired thermal power: 50 million KW	250 mil. tons 50 mil. tons 65 mil. tons

Source: Compiled by Mizuho Research Institute based on Premier Li Keqiang's "Government Work Report" on March 5, 2018, on the National Development and Reform Commission's Report on the Implementation of the 2017 Plan for National Economic and Social Development, and on the 2018 Draft Plan for National Economic and Social Development on March 5, 2018, along with materials from the National Bureau of Statistics of China and CEIC Data

c. No investment targets set, toward a shift from investment-led growth to consumption-led growth

As for numerical targets related to the real economy, the growth rate target for the total retail sales of consumer goods (on a nominal basis) remains unchanged from last year, at around +10%, while a fixed-asset investment growth target (on a nominal basis) was not presented this year. Against the background of a reduction of overcapacity and with measures to stabilize the housing market, etc., there has been strong downward pressure on investment in recent years, and actual fixed-asset investment has fallen below the target for the past few years. This year, a fixed-asset investment target was not presented, which clearly suggests the Chinese government's stance to accept the slowdown of investment.

However, the Chinese government plans to continue to put effort into increasing the contribution of total factory productivity toward growth by raising the ratio of R&D spending to GDP (increasing the target from 2.13% in 2017 to 2.16% in 2018), etc., and optimizing and improving the efficiency of investment by developing investment environments through support for private investors, standardization of PPP, etc.

Meanwhile, for consumption, the Chinese government announced that it will pursue higher-quality and healthy development through the implementation of the "*Ten Initiatives for Boosting Consumer Spending*" (established in April 2016) and the development of new consumption areas such as new-energy vehicles, standardization of the sharing economy, etc., along with scale expansion.

(2) Fiscal and monetary policy

a. Fiscal deficit-to-GDP target lowered, but with the general principle for proactive fiscal policy remaining unchanged

In 2018, China's fiscal deficit target is set at RMB 2.38 trillion, unchanged from 2017, and this year's deficit target as a percentage of GDP was lowered to 2.6% from 3% in the 2017 budget. As for reasons for the reduction, the "Government Work Report" explains that the reduction in the deficit-to-GDP ratio is mainly due to China's economic growth being steady and the foundation being there for an increase in revenue; it also keeps policy options open for macro regulation. However, the planned issuance of local government special bonds,[3] which are not regarded as part of the fiscal deficit in budgetary terms, substantially increased from RMB 0.8 trillion in 2017 to RMB 1.35 trillion in 2018. If a fiscal deficit-to-GDP ratio is calculated by including the amount of the bond, it will be 4% both for 2017 and 2018 (both on a budgetary basis). Given this, the general principle of a proactive fiscal policy is likely to remain basically unchanged.

A look at a breakdown of fiscal spending reveals the Chinese government policy position to focus on: innovation-driven development, agriculture, rural areas, and rural residents, and the improvement of living standards, etc., strengthening local government finance mainly in the midwestern region through fiscal transfer, and optimizing the spending structure. In addition, the budget for infrastructure investment was increased by RMB 30 billion to RMB 537.6 billion.

b. Prudent and neutral monetary policy to be maintained

When it comes to monetary policy, the government suggests that it will maintain a prudent and neutral monetary policy while pointing out the necessity to achieve an adequate balance between monetary easing and tightening. It is reconfirmed that China will not lean toward either of easing or tightening.

The reason behind the position seems to be the Chinese government's judgment that policy management focusing on easing is not desirable for measures against financial risks, such as shadow banking, which have been fully implemented since last year, while at the same time, excessive tightening is also not desirable, in order to avoid the destabilization of the financial market, the shortage of money in the real economy, and an increase in costs. In fact, concrete monetary policies include; adequately controlling the money supply, maintaining reasonable stability in flexibility, and expanding financing for small and micro businesses, three agriculture-related sectors, and deprived areas through fund reserves and lending policy. This represents the government's intention to supply necessary funds in an appropriate manner.

In addition, what should be noted here is that the government only predicted that the growth rates of the money supply (M2) and total social financing for this year would be basically the same as their respective real growth rates in 2017, while not setting specific numerical targets, just like the above-mentioned investment target. The reasons for this could

[3] The bond is a local government bond issued for public works projects that generate a specific type of revenue.

include: (1) that the government plans to continue the standardization of shadow banking this year and to accept the slowdown of M2 growth; and (2) that the government, which currently promotes a shift toward a modern monetary policy framework modelled on advanced countries, will put more focus on short-term money market rates as an interim goal than on the money supply.

Meanwhile, as for the RMB exchange rates, the government says that they will remain basically stable at an adaptive and balanced level, and China is expected to try to stabilize exchange rates while preventing the excessive depreciation or appreciation of the RMB.

(3) Key tasks

The key tasks for 2018 are outlined in Figure 3 on the next page. Of them, the main measures will be explored in the following section.

a. Stepping up supply-side structural reform: New drive for economic growth to be developed

On top of the "key tasks for 2018" comes the stepping up of supply-side structural reform, which is said to be a pillar of economic policy since 2016.

The first two issues mentioned in the section—the development and expansion of a new drive forward for economic growth and the acceleration of building China into a manufacturing power—particularly represent the government's direction toward deepening reform. Since 2016, supply-side structural reform has mainly focused on measures to address the after-effects of the stimulus package amounting to RMB 4 trillion carried out in the past, such as cutting overcapacity, under the policy of "five priority tasks through reform[4]" (three cuttings, one lowering, and one strengthening). However, this year, the government apparently shifted the focus of the reform to the developing industries that drive future economic growth. More specifically, the government-listed policy directions are: strengthening the development of emerging industries through the utilization of big data, R&D, and the commercialization of artificial intelligence (AI), etc.; developing smart industries; developing manufacturing sectors such as integrated circuits, fifth-generation mobile communications (5G), aircraft engines, and new-energy vehicles; and improving quality management for industrial products.

On the other hand, the government also showed the intention to continue to work on the "five priority tasks through reform," which has steadily progressed so far. For example, as for cutting overcapacity, China will cut steel capacity of about 30 million tons and coal capacity of about 150 million tons in 2018. In addition, coal-fired power generating units with a capacity of less than 300,000 kilowatts that fail to meet standards will be closed.[5] Meanwhile, based on experiences in the steel and coal industries, China suggests that it is possible to further cut the overcapacity of the other industries that are said to have serious overcapacity, such as cement, flat glass, and electrolysis aluminum,[6] under the initiative of

[4] "Five priority tasks through reform" is a core measure for the "supply-side structural reform" that was announced at the end of 2015. More specifically, it refers to cutting overcapacity (去産能), cutting excess real estate inventory (去庫存), cutting excess debt (去杠杆), lowering corporate costs (降成本), and strengthening areas of weakness in the economy and in society (補短板).

[5] China aims to cut steel production capacity by 100 to 150 million tons in the five years from 2016 and cut coal production capacity by 500 million tons in the three to five years from 2016, through restructuring. Compared to these, steel production capacity was cut by a total of 120 million tons and coal production capacity by 540 million tons in the two years from 2016 to 2017.

[6] 发展改革委就创新和完善宏观调控等答问 (Xinhua. March 6, 2018)

industry organizations and companies. Furthermore, the government also announced a plan to strengthen work on zombie enterprise bankruptcy liquidations and reorganization and to continue to deal with debt by promoting debt-equity swaps based on market mechanisms, etc.

b. Forestalling and defusing financial risks: Issues piling up, such as those regarding financial holdings companies and local government debt

At present, the largest risk factor for the Chinese economy involves financial risks such as shadow banking—one of the key areas to be worked on over the next three years.

To address the issue, the "Government Work Report" listed a wide range of measures including: carrying out crackdowns on unlawful financial activities; promoting market- and law-based debt equity swaps and restructuring; strengthening the risk control of financial institutions; improving regulations on shadow banking, internet finance, financial holding companies, etc.; and forestalling and defusing local government debt risk.

Of these, as for financial holding companies, the financial stability and development committee that was launched in November last year said that regulations for such companies is an important issue, and since then, China has accelerated measures to address this. In February this year, financial authorities, including the China Banking Regulatory Commission, jointly sent their regulators to seize control of Anbang Insurance Group, a financial holding company representing China. This is a direct measure that has not been seen so far, and it indicates the government's concern regarding financial holdings companies as a risk factor. In the future, the government is expected to put effort into developing relevant laws and regulations.[7] In addition, as for local government debt, there are many concrete statements, such as that "All forms of borrowing and debt underwriting that violate the law and regulations are strictly prohibited" and "Provincial-level governments should assume overall responsibility for debts incurred by local governments within their jurisdictions; and governments below the provincial level should live up to their own responsibilities." All of these are policy positions that have already been presented. However, given that their standardization has not been thoroughly implemented, all eyes will be on how much progress will be made in the disposal of existing debt, to be led by provincial and other local governments.

c. Implementation of anti-pollution measures: China to continue to work on effective measures

Environmental pollution is another issue that the government places emphasis on, and the government has stepped up measures to address the issue. This issue is also designated as one of the key areas to be worked on over the next three years. While the Chinese government has been implementing environmental measures for many years, it has toughened measures since around 2016. For example, China conducted inspections on the state of compliance with the *Environmental Protection Law* (environmental inspections) in various parts of the country from 2016 to 2017. Moreover, as 2017 was the year of the end of the first phase of the Action Plan on Prevention and Control of Air Pollution (10 measures to improve air quality), which began in 2013, the government conducted a tough crackdown so as to achieve

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[7] The People's Bank of China released China Monetary Policy Report Quarter Three, 2017 (第三季度中国货币政策执行报告) on November 17, 2017. In the report, the bank commented on the direction of strengthening regulations, saying that they should: accelerate the creation of rules to regulate financial holdings companies; establish supervision, controls, and requirements for market entry, financing, corporate governance, capital adequacy ratios, and transactions with affiliated parties, etc.; strictly restrict and make standards for investment in financial institutions by non-financial companies; separate the financial sector and other business sectors in terms of regulations; and strengthen weakness in regulatory mechanisms.

the targets in the action plan. For this, some companies not meeting environmental and other standards were forced to suspend production.

Fig. 3: Overview of key tasks for 2018

1. Stepping up supply-side structural reform	
(1)	Developing powerful new growth drivers
(2)	Speeding up work to build China into a leader in manufacturing
(3)	Continuing cutting ineffective supply
(4)	Deepening the reforms designed to delegate powers, improve regulation, and strengthen services
(5)	Further lightening the tax burden on businesses
(6)	Slashing non-tax burdens on businesses
2. Moving faster to make China a country of innovators	
(1)	Improving national innovation systems
(2)	Acting on and improving policies that stimulate innovation
(3)	Taking the nationwide business startup and innovation initiative to the next level
3. Deepening reforms in fundamental and key areas	
(1)	Advancing reforms of state capital and state-owned enterprises
(2)	Supporting the development of private enterprises
(3)	Improving property rights systems and mechanisms for the market-based allocation of the factors of production
(4)	Continuing structural fiscal and tax reforms
(5)	Speeding up reforms in the financial sector
(6)	Advancing institutional social reforms
(7)	Building a more robust system for developing an "ecological civilization"
4. Fighting three critical battles	
(1)	Striving for notable progress in forestalling and defusing major risks
(2)	Stepping up targeted poverty alleviation
(3)	Working to make greater progress in addressing pollution
5. Making strong moves in the rural revitalization strategy	
(1)	Advancing supply-side structural reform in agriculture
(2)	Deepening all rural reforms
(3)	Promoting the full development of all programs in rural areas
6. Making solid progress in the coordinated regional development strategy	
(1)	Creating a new landscape in regional development
(2)	Pursuing better-quality new urbanization
7. Actively increasing consumption and promoting effective investment	
(1)	Strengthening the fundamental role of consumption in driving economic growth
(2)	Enabling investment to play a pivotal role in improving the supply structure
8. Creating a new landscape in comprehensive opening-up	
(1)	Advancing international cooperation under the Belt and Road Initiative
(2)	Promoting a steady growth in foreign investment
(3)	Consolidating the healthy trend toward stable growth in foreign trade
(4)	Promoting trade & investment liberalization and facilitation
9. Doing more to ensure and improve people's well-being	
(1)	Focusing on boosting employment and business startups
(2)	Steadily increasing people's incomes
(3)	Developing fair, high-quality education
(4)	Implementing the Healthy China strategy
(5)	Better addressing people's housing needs
(6)	Strengthening efforts to meet people's basic living needs
(7)	Developing a new model of social governance based on collaboration, co-governance, and common gains
(8)	Providing rich cultural nourishment to help people live better lives

Source: Compiled by Mizuho Research Institute from Premier Li Keqiang's "Government Work Report" issued on March 5, 2018

As mentioned above, the government's anti-pollution measures have caused such problems, while the "Government Work Report" states the numerical targets that must be achieved for major forms of pollution[8], such as air, water, and soil

[8] For example, China set goals of cutting sulfur dioxide and nitrogen oxide emissions (NOx) by 3%, continuing to reduce PM 2.5 density in key areas, and cutting chemical oxygen demand and ammonia nitrogen emissions by 2%.

pollution, emphasizing a stance to continue to implement practical measures this year. In addition, it was confirmed that the import ban on foreign solid waste, which was imposed in 2017, will be maintained. Out of regret over an excessive crackdown last year, China is likely to strengthen regulations according to each situation, while it is also rumored that China will conduct a review of environmental inspections this year. Furthermore, there is also a plan to create a three-year plan to fight for cleaner air this year,[9] which follows the "10 measures to improve air quality." Close attention should be paid to the trends in China's environment policy and its impact on economic activities.

d. Addressing housing issues: Housing safety net to be strengthened

Policies concerning housing issues are mentioned in the section regarding "Doing more to ensure and improve people's well-being."

More specifically, first of all, based on the policy of building a housing system that "ensures supply through multiple sources, provides support through multiple channels, and encourages both housing purchase and renting," which was laid out at the Central Economic Work Conference, China plans to strengthen the housing safety net for various people struggling with housing. For example, in order to improve poor housing conditions, China released a three-year plan on the renovation of shanty towns, which includes the construction of 5.8 million dwellings in 2018. In addition, it announced a plan to supply public-rental housing for low-income families, houseless first-time workers, and rural migrant workers. It also announced a plan to foster a rental housing market and to develop homes with joint property rights shared between the government and buyers according to their investment ratios. China is likely to encourage a shift from home purchasing to renting by continuing to increase the ratio of land supplied for rental homes in 2018.

In addition, the principle that "houses are for living in, not for speculation," which was presented at the Central Economic Work Conference, was again confirmed, indicating that China will continue to implement control according to situations in respective cities and to build long-term, effective mechanisms for real estate regulation so as to achieve the stable and healthy development of the real estate market.

Meanwhile, as for the real estate tax system,[10] which is said to be one of the above-mentioned long-term, effective mechanisms, this year's "Government Work Report" mentioned that China will prudently advance legislation on real estate tax. China had not clearly shown a plan to establish real estate tax legislation, while a policy of this kind was officially provided in the report.[11] However, in the course of establishing legislation, processes requiring relatively long times could be included,[12] such as making coordination with other tax items. Therefore, China will simply begin preparation for establishing legislation this year.

e. Expansion of opening-up: China to further ease foreign investment regulations mainly for service sectors

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[9] "全国环境保护工作会议在京召开" ("中华人民共和国环境保护部网站" February 3, 2018)

[10] In addition, real estate tax is said to have a proactive function to increase fiscal revenue, adjust income distribution, and promote social fairness. (Vice Minister of Finance Shi Yaobin). (财政部就"财税改革和财政工作"答问) (*Xinhua*, March 7, 2018)

[11] Last year, Minister of Finance Xiao Jie wrote in his article that the establishment and implementation of legislation on real estate tax will be accelerated, thus the issue attracted attention. (Xiao Jie, 2017) "加快建立现代财政制度" (《党的十九大报告辅导读本》编写组 "党的十九大报告学习辅导读本")

[12] Deputy Minister of Finance Shi Yaobin said that coordination with existing relevant tax items will be made and that tax burdens in real estate construction and transactions and other burdens will be reduced in a rational way. His statement indicates that China plans to establish a new real estate tax system. (财政部就"财税改革和财政工作"答问 [*Xinhua*, March 7, 2018]) .

As 2018 is the 40th anniversary of reform and opening-up, the report stressed that "reform and opening was a game-changing move in making China what it is today; it now remains a game-changing move for us to achieve China's two centenary goals." Moreover, based on the policy to step up reform and opening-up, China plans to open its doors wider to foreign investors.

More specifically, while the level of opening-up is different depending on the sector, the "Government Work Report" says that China will open up the general manufacturing and new-energy vehicle manufacturing sectors in the manufacturing industry as well as the sectors of telecommunications, medical services, education, elderly care, and finance (banking card payment clearing, insurance agent companies, banking, securities, fund management, futures, financial asset management companies) in the service industry.

However, of these, the schedules and roadmaps for the deregulation of the new energy vehicle manufacturing sector and the financial sector have been already released.[13] Therefore, attention should be paid to progress in sectors where deregulation policies have not been specified, such as telecommunications, medical care, education, and elderly care, in 2018. Since the 2010s, China has made clear its stance to actively invite foreign capital investment mainly for high-added-value industries that contribute to the growth of China and Chinese companies, in order to sophisticate its economic structure. Given this, China is likely to ease foreign investment regulations mainly for industries that match the policy going forward.[14]

Meanwhile, keeping in mind U.S. protectionism, which has been smoldering since the launch of the administration of U.S. President Donald Trump two years ago, the report says that China must stand for the settlement of trade disputes through discussion as equals, must oppose trade protectionism, and must resolutely safeguard its lawful rights. China again emphasized its opposition against trade protectionism much like it did in 2017. Since the beginning of this year, the Trump administration has successively announced the imposition of safeguard tariffs on imported solar panels and large residential-use washing machines and the introduction of additional tariffs on steel and aluminum imports. While these initiatives are not limited to imports from China, amid such a situation, there is a sign of trade tensions surfacing. We need to pay close attention to how China, which says it will resolutely defend its lawful rights, deals with economic policies toward the United States.

3. Economic policy management: Will not be easy in the future

At this year's NPC, the major national leadership positions were decided, such as for the president, vice president, government ministers, and governor of the People's Bank of China, while the government structure was reformed (reorganization of government ministries).[15] With these, the second Xi Jinping administration was established, and policy

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[13] 国务院关于促进外资增长若干措施的通知 ("中国政府网" August 16, 2017, 国新办举行中美元首北京会晤经济成果相关情况吹风会) ("中华人民共和国国务院新闻办公室网站" November 10, 2017)

[14] For example, Politburo Standing Committee member Wang Yang wrote in his article in the *People's Daily* in November 2017 that the proactive and effective use of foreign capital should not be an expedient measure but a strategic policy to be maintained for the long term, and that what is important is not simply acquiring funds from overseas but incorporating Chinese companies into global supply chains, value chains, etc., via the introduction of advanced technologies, management philosophies, management experience, and market opportunities, etc., owned by foreign capital. ("推动形成全面开放新格局" [*People's Daily*, November 20, 2017])

[15] Existing ministries and agencies were restructured, and new ministries and agencies were launched, such as the "Ministry of Land and Resources," "Ministry of Ecology and Environment," "Ministry of Agriculture and Rural Affairs," "Ministry of Culture and Tourism," "Ministry of Veterans Affairs," "Ministry of Emergency Management," "National Supervisory Commission," "National Health Commission" "Banking and Insurance Regulatory Commission," and "International Development and Cooperation Office." ("一目了然！九张图读懂国务院组成部门调整" ["财经网"

management will begin in full swing from here onward. However, as shown in the "Government Work Report," China is only halfway through the sophistication of its economic structure, while difficult domestic issues are piling up, such that quite a few people complain about environmental issues and their day-to-day lives.

In particular, achieving a balance between market-oriented economic reforms in the financial and other sectors and economic stability will continue to be highly difficult going forward. During Xi Jinping's first term, China has given priority to ensuring stability, and some reforms appear to have been stalled after the stock market became volatile and after the RMB sharply declined. For example, the reform on China's initial public offering (IPO) system,[16] which is one of the important initiatives for developing the capital market, became stalled following the stock market turmoil in 2015, and in February this year, China decided to shelve the reform until February 2020. Other measures seem to be insufficient, such as the further acceptance of defaults in securities, wealth management products, etc., and the marketization of the RMB exchange rate.

Furthermore, as indicated in the "Government Work Report," external uncertain factors exist as well, such as monetary policy normalization in advanced countries and regions, a rise in protectionism (with the United States in mind), and increasing geopolitical risks.

On the other hand, China aims to complete major initiatives such as forestalling and defusing financial risks and various reforms by 2020. Three years remain until the deadline, and the time limit is steadily approaching. Under such circumstances, it is difficult for China to further delay reforms and other initiatives. Will General Secretary Xi Jinping be able to implement reforms skillfully and speedily by exercising stronger leadership? All eyes will be on future developments. It should be noted that, if reforms are implemented at a fast pace, there is the possibility of economic and financial situations temporarily becoming unstable, such as sudden turmoil in the financial markets triggered by financial reform measures such as allowing an increase in defaults.

March 13, 2018])

[16] This is one of the measures for capital market reform that are included in the reform plan adopted at the Third Plenary Session of the Central Committee of the Communist Party of China. It aims to shift from the current IPO system under which the Securities Regulatory Commission examines the financial and other conditions of the companies concerned and gives approval for individual IPOs to one in which stock exchanges play a central role in screening the information disclosure of companies concerned. The government aims to achieve the goal by the end of February 2018.

The Past and Future of the Chinese Yuan Exchange Market as Examined Through the Currency Options Market

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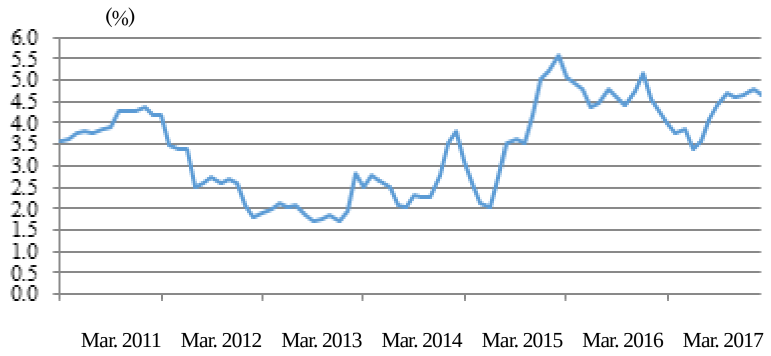
1. Introduction

In April 2011, the State Administration of Foreign Exchange of China lifted the ban on currency option transactions as a means to avert foreign exchange risks in its project to reinforce the flexibility of the Chinese yuan exchange rate. Thereafter, the Chinese monetary authorities have taken various measures to internationalize the Chinese yuan, such as in the expansion of the exchange rate fluctuation band as well as entry into the SDR. This article will examine the past Chinese yuan exchange market from the point of view of the currency options market, while forecasting the future prospects of the Chinese yuan exchange market.

2. What are currency options?

Currency options involve a transaction to sell or buy the right to buy (call) or sell (put) a particular currency at a pre-fixed price by a pre-fixed date. Those who purchase these options can decide whether they will exercise or give up the right, while paying the option's premium in exchange for the right to the seller. Currency options were first traded in the international financial market for the first time in the 1980s and have since become an extremely effective instrument for companies to hedge foreign exchange risks, along with forward contracts. Furthermore, in general, the Black Scholes model is used to calculate an option's premium in which the implied volatility is an essential element. The implied volatility can be used to understand how market participants are judging the future fluctuations of the underlying asset.

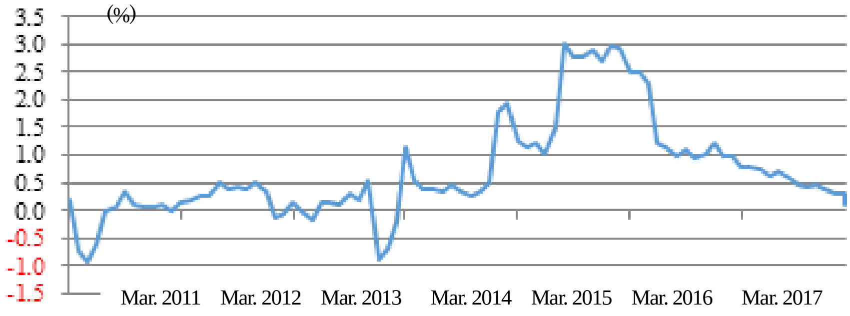
Fig. 1: One-year U.S. dollar/Chinese yuan ATM ("At The Money") option



Source: Bloomberg

Figure 1 shows the price chart for the one-year U.S. dollar/Chinese yuan ATM ("At The Money") currency option. An ATM option refers to an option in which the price of the underlying asset price (in the case above, the one-year U.S. dollar/Chinese yuan outright forward rate) equals the premium to exercise the right, the transaction volume of which is the largest in the inter-bank market. The price of such an option is also used to calculate the premium to exercise various types of options for the same duration. The vertical axis of the above chart shows the implied volatility that tends to rise when the future uncertainty of the underlying asset price grows.

Fig. 2: One-year U.S. dollar/Chinese yuan 25 delta risk reversal



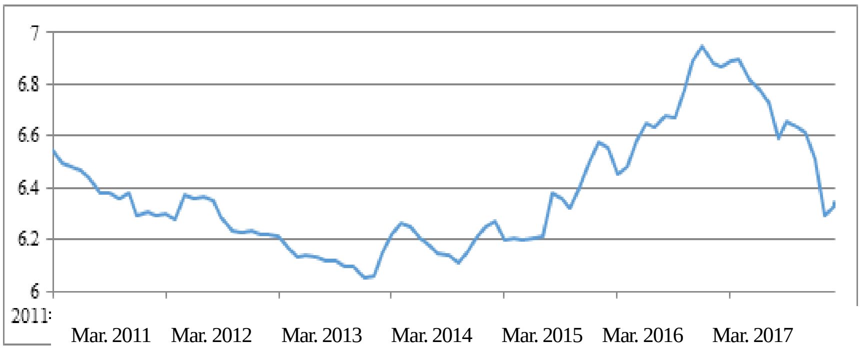
Source: Bloomberg

Figure 2 shows a chart of the one-year U.S. dollar/Chinese yuan 25 delta risk reversal. The delta is, in general, an index to show the change of the option premium in relation to the underlying asset price. The above chart shows changes in the option premium in terms of the depreciation of the Chinese yuan, the appreciation of the Chinese yuan, and the exchange rate remaining at the same level. In theory, the risk reversal should be 0, as the probability of the depreciation and the appreciation of the Chinese yuan is 50% each. However, either the call option or the put option becomes more expensive, reflecting the supply & demand in the market, as well as the fears in the market. In other words, it can be seen as an index to show which risk between the depreciation of the Chinese yuan or the appreciation of the Chinese yuan in the times ahead is seen more probable by market participants. In the above chart, the U.S. dollar call option (the right to buy the U.S. dollar) is more expensive when the figure is positive, while the U.S. dollar put option (the right to sell the U.S. dollar) is more expensive when the figure is negative. The next section will review the history of the currency options market in China, using the ATM and risk reversal charts.

3. History of the Chinese yuan currency options market

In China, Chinese yuan currency options transactions started with the circular issued on February 14, 2011 by the State Administration of Foreign Exchange. Prior to 2011, transactions of currency options were permitted in China for currencies other than the Chinese yuan. With the circular, transactions of Chinese yuan currency options were permitted, only in the case of the purchase of an option by clients. Thereafter, the sale of an option by a client was also permitted from December 2011. It has thus become possible for clients to hedge foreign exchange risks by cutting costs by combining the purchase and sales of currency options. The following section will review the history of the Chinese yuan currency options market. Please refer to Figure 3 with regard to the U.S. dollar/Chinese yuan spot exchange rate.

Fig. 3: U.S. dollar/Chinese yuan spot exchange rate

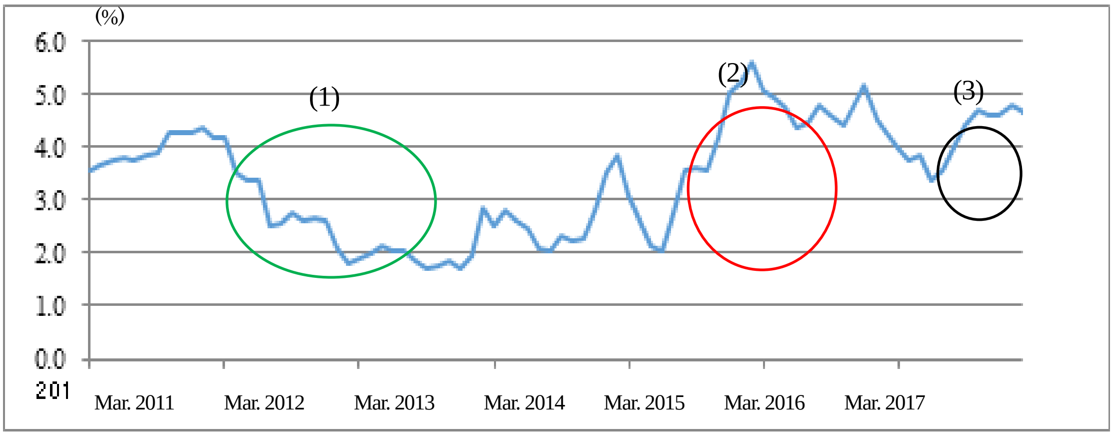


Source: Bloomberg

(1) 2011–2014: Moderate appreciation of the Chinese yuan under measures of quantitative monetary easing in the U.S.

The U.S. carried out QE3 in order to lead the economy to recover from the damage incurred during the financial crisis that started with the Lehman Brothers' bankruptcy. On the other hand, the Chinese monetary authorities shifted the U.S. dollar/Chinese yuan exchange rate, which used to be virtually fixed at CNY 6.83 to the U.S. dollar via Chinese yuan-selling interventions after the financial crisis, back to the floating exchange rate system from June 2010. In 2012, the accepted fluctuation range (from the previous day) for the U.S. dollar/Chinese yuan exchange rate during the day was expanded to 1.0%. As a result, the Chinese yuan continued gradually appreciating against the U.S. dollar until 2014. In the currency options market, the volatility started gradually falling as the risk sentiment was mitigated and the cautious feeling weakened in the market regarding possible changes in monetary policy by the Chinese authorities (see Figure 4: (1)).

Fig. 4: One-year U.S. dollar/Chinese yuan ATM ("At The Money") option

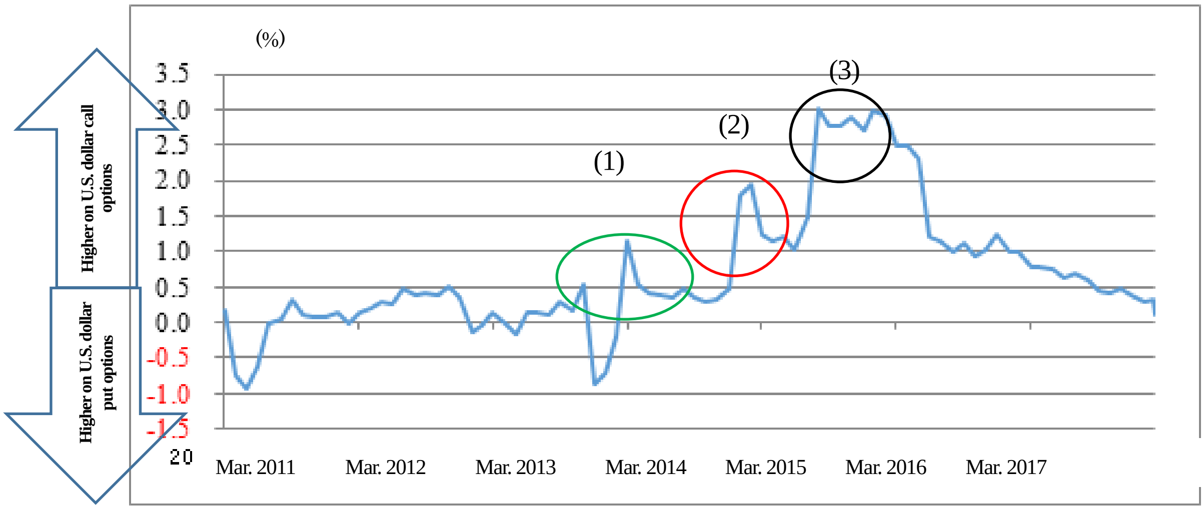


Source: Bloomberg

(2) 2014–2015: End of QE in the U.S. and the stock market crisis in China

Although the volatility remained low and stable, the trend of the gradual appreciation of the Chinese yuan was reversed when the U.S. started tapering QE3 from 2014, while the People's Bank of China cut the interest rate.

Fig. 5: One-year U.S. dollar/Chinese yuan 25 delta risk reversal



Source: Bloomberg

In the currency options market, the volatility level went up due to the growing sense of uncertainty, while in the risk reversal market, cautious sentiment was growing regarding the appreciation of the U.S. dollar, which encouraged market participants to buy U.S. dollar call options and Chinese yuan put options (to buy the U.S. dollar and sell the Chinese yuan) (see Figure 5: (1)).

On the other hand, Chinese stock prices appreciated significantly in 2014, thanks to the monetary easing carried out by the central bank. However, individual investors continued buying high-risk credit, which led stock prices in the Shanghai Stock Market to fall sharply by more than 30% from June to July 2015. In addition, in August, the People's Bank of China devaluated the Chinese yuan against the U.S. dollar in order to promote trade to protect stock prices. As a result, in the currency options market, the volatility level appreciated sharply (see Figure 4: (2)). Market participants grew cautious about the appreciation of the U.S. dollar, and in the risk reversal market, the demand for U.S. dollar call options reached an all-time high (see Figure 5: (2)). It should also be mentioned that the one-year U.S. dollar/Chinese yuan volatility was slightly below 2% before the stock market crisis in China, which makes it clear that the estimated volatility rate of 5% is extremely high.

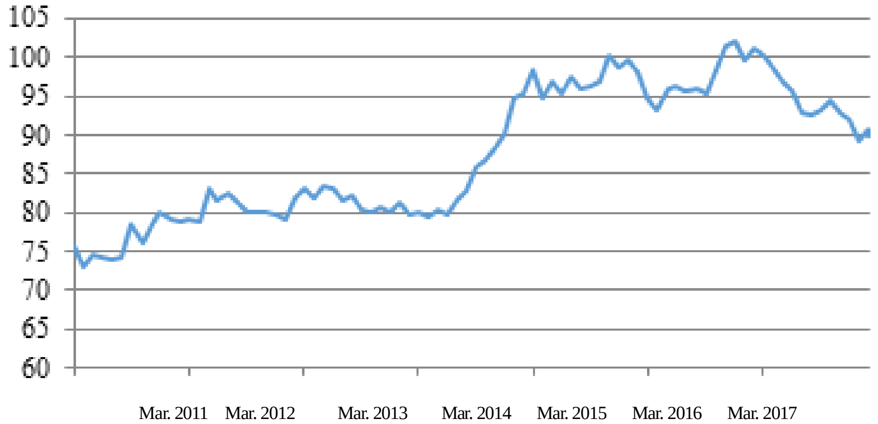
(3) 2015–2016: Persistent depreciation of the Chinese yuan and the reversed trend in the risk reversal market

In reaction to the sharp depreciation of stock prices, concerns grew over the significant slowdown in the Chinese economy that resulted from capital outflow. Despite various restrictions on foreign currency-buying as well as foreign exchange market interventions by the People's Bank of China (PBOC), the Chinese yuan continued depreciating against the U.S. dollar in the spot exchange market, and the exchange rate reached the CNY 6.60 level toward the middle of 2016. Furthermore, Donald Trump was elected in the U.S. Presidential election in November 2016, which led the U.S. dollar to appreciate. As a consequence, the Chinese yuan depreciated further against the U.S. dollar, and the U.S. dollar/Chinese yuan spot exchange rate reached the CNY 6.95 level toward the end of 2016. In the meantime, the volatility level in the ATM options market remained high, while, strangely, in the risk reversal market, demand for U.S. dollar call options started to decrease both against the offshore Chinese yuan and the onshore Chinese yuan, from around the time of the Brexit referendum in June 2016 (see Figure 5: (3)). Generally, this is considered to be a result of the precondition that the Chinese yuan exchange market is easily impacted by the intentions of the Chinese monetary authorities to a great extent, unlike the Japanese yen or the euro exchange markets. Based on this precondition, if one considers the overall conditions, including the strong Shanghai stock market, the level of the decline in foreign currency reserves in China, and the introduction of the Chinese yuan in the SDR basket, it would be possible for the Chinese monetary authorities to keep the Chinese yuan from depreciating further, leading market participants to judge that there would be higher risks when the Chinese yuan appreciates significantly as a result of a change in the monetary policy by the Chinese monetary authorities.

(4) 2017: Rapid appreciation of the Chinese yuan caused by the downgrading of China

In May 2017, U.S. ratings company Moody's announced its decision to downgrade China's rating. In reaction to this, the Chinese monetary authorities announced that they would introduce the "countercyclical factor" to the method for calculating the U.S. dollar/Chinese yuan base exchange rate. Even though the details of the countercyclical factor were not revealed, market participants saw that the Chinese monetary authorities showed their intention to lead the Chinese yuan to appreciate, as a result of which the Chinese yuan appreciated rapidly. In the currency options market, those that had bet on the depreciation of the Chinese yuan started to sell their options, which led to temporary depreciation. However, the U.S. dollar index also fell as a result of concerns over deflation in the U.S. Furthermore, various central banks in Europe are starting to introduce the Chinese yuan in their foreign currency reserves. As a result, some market participants started to bet on the appreciation of the Chinese yuan again along with the internationalization of the Chinese yuan, which led to the appreciation that is currently being observed.

Fig. 5: U.S. dollar index



Source: Bloomberg

4. Future prospects for the Chinese yuan exchange market from the point of view of the currency options market

Currently, the Chinese yuan has been strong in the foreign exchange market, while the volatility level remains high in the currency options market. As for the high volatility level, the current level is considered to be appropriate given that the Chinese monetary authorities wish for "fluctuation in both directions" in the foreign exchange market, in the process of the internationalization of the Chinese yuan. For example, the volatility levels of the currencies of developed countries, such as the U.S. dollar/Japanese yen pair and the euro/U.S. dollar pair, have currently been higher than that of the U.S. dollar/Chinese yuan pair. Even though it is impossible to compare them in a simplistic manner, the author of this article considers that the volatility level is still too low given the current fluctuation range in the spot exchange market.

With regard to the risk reversal market, the price difference between the call option and the put option has narrowed significantly from its largest figure observed in 2015, currently remaining around 0%. This shows that there has been no bias among option market participants in terms of the need to hedge the risks of appreciation and depreciation of the Chinese yuan. In general, the value of the U.S. dollar call option tends to be more expensive in the U.S. dollar/Asian currency pairs, due to cautious feelings about capital outflow at the time of risk-aversion. Given this fact, the above phenomenon seems to demonstrate the high level of trust in the market toward the Chinese yuan. In the times ahead, if the demand starts to lean toward U.S. dollar put options in the risk reversal market, we should be cautious about the further appreciation of the Chinese yuan.

5. Conclusion

This article has reviewed the Chinese yuan exchange market from the point of view of the currency options market. The Chinese yuan currency options market has been open only for slightly more than seven years. It is expected that needs for currency options will increase in the times ahead, as the Chinese yuan is internationalized. The currency options market can be a tool to foresee the future foreign exchange market, as it reflects the psychology of market participants.