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- Executive Summary -

China's Economy	Mid-term outlook for the Chinese economy

China's growth rate has stopped sliding and it is now rising at a gentle pace. However, this short-term phase of recovery is already coming to an end and the economy will continue to slow as China struggles with structural adjustment pressures related to overcapacity and excess debt. Though China is breaking away from a growth pattern that relied on the quantitative expansion of capital and labor inputs, the growth rate will continue to slide until 2020 due to overcapacity and excess debt. However, there is still ample room for more infrastructure investment, although growth is slowing, it will still be supported to a certain extent going forward. The key to mid-term growth lies in whether the government can boost productivity by promoting innovation and high-value-added industries. Mizuho Research Institute expects China to just about achieve its target of doubling incomes by 2020, with the subsequent slowdown likely to be mitigated by rising productivity.

News from the China Advisory Division	Examination Regarding the Change in the Fixing Rules for the People's Bank of China Central Parity Rate

In May 2017, the Chinese monetary authorities announced that they would add a "counter-cyclical factor" to the fixing rules of the People's Bank of China central parity rate. Regarding details, there is a lecture and a report prepared by a Chinese intellectual that held an important post in the international payments department until recently, under the government of Xi Jinping. This article will introduce the contents of the lecture and the report, in order to reveal the thoughts of the Chinese intellectual, while also examining the change in the fixing rules of the central parity rate announced this time, which can be seen as a regression of Chinese yuan reforms on the surface, from the point of view of the internationalization of the Chinese yuan.

Mid-term outlook for the Chinese economy
-The key lies in boosting productivity through innovation-

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1. Though the Chinese economy is undergoing a gentle economic recovery at present, it looks set to slow again going forward

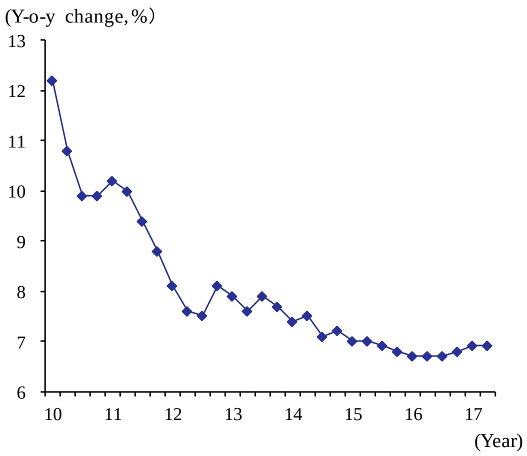
The Chinese economy last recorded double-digit growth in April–June 2011 (real GDP growth rate: +10.0% y-o-y). The economy subsequently slowed for a prolonged period, but the growth rate stopped sliding from the latter half of 2016 and it is now rising at a gentle pace (Fig. 1). Growth hit +6.9% y-o-y over January–March 2017 and it remained at this level in April–June. The economy was bolstered from the latter half of 2016 by fiscal spending on infrastructure investment, for instance, with exports also moving firmly on the improved global IT cycle. The output/inventory balance also improved on production curbs, mainly in materials sectors like iron and steel, with inventory rebuilding on the increase in the mining and manufacturing sectors (Fig.2). The employment and wages environment also recovered as corporate profits swung upwards on the improved supply and demand of finished goods, with consumer spending remaining firm. This also boosted the economy.

However, inventory increases seem to have played a major role in ensuring that growth remained strong over April–June 2017. Moreover, inventories of durable goods and so on were forced up by a slowdown in car sales after a tax break on small vehicles was reduced. There are also signs of a deteriorating output/inventory balance in sectors like mineral resources and materials. Based on this, the economy looks set to slow on inventory adjustment going forwards.

Furthermore, when cyclical movements are removed from the equation, the Chinese economy still faces structural adjustment pressures related to overcapacity, an accumulation of housing stock in small- to medium-sized cities, and excessive debt build-ups. This is also placing downward pressure on growth. Meanwhile, mounting local government debt means infrastructure investment is unlikely to increase in an unbridled fashion. In fact, real investment in fixed assets (Mizuho Research Institute estimate) continues to grow at a slower pace in sectors like manufacturing, which still face problems of overcapacity and excess debt. Fixed asset investment growth has dropped into the lower single digits entering 2017 on new rules to curb real estate speculation in major cities, for instance, and restrained infrastructure investment growth (though it remains at high levels).

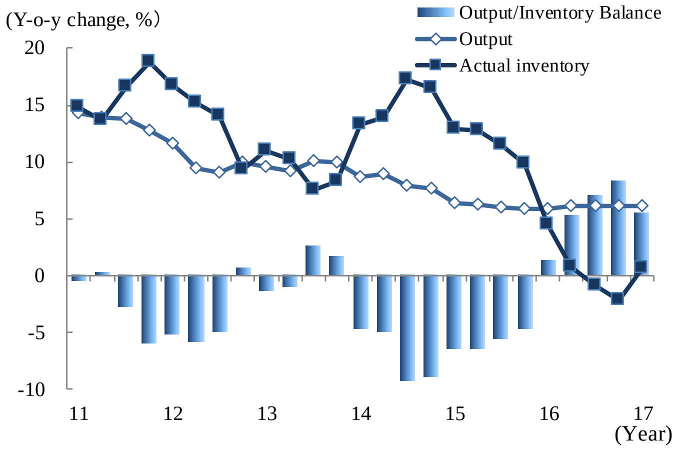
Furthermore, the rate of potential growth looks set to slide on the shrinking working age population. Under these circumstances, there are questions about whether the government can achieve its target of doubling incomes between 2010 and 2020. In fact, there are even questions about whether the government can achieve sustainable growth by boosting productivity through innovation and structural adjustment. This report will examine these questions and will give a mid-term forecast based on a consideration of the headwinds and tailwinds facing the Chinese economy.

Fig. 1 Real GDP Growth Rate



Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China.

Fig. 2 Output/Inventory Balance



Note: 1. Output/inventory balance = (y-o-y output growth) – (y-o-y inventory growth)
Note 2. The inventories data has been indexed using the PPI.
Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China and CEIC.

2. Economic headwinds

(1) The rate of potential growth looks set to slide on the shrinking working age population

The first step is to examine the factors that have driven economic growth in China so far. The Asian Productivity Organization (APO) conducted a growth accounting analysis that examined the contribution of capital, labor and total-factor productivity (TFP; growth factors besides capital and labor) to the growth rate these past 20 years. This shows that the input of capital mainly grew at a faster pace until the late 2000s, with the growth rate also pushed up by a higher contribution of TFP via the ingestion of technology from abroad (Fig. 3). However, investment expanded after the financial crisis as the government pumped over RMB 4 trillion into the economy. This led to financial risk via overcapacity and excess debt, with the growth rate being pushed down as capital input growth slowed from 2010 and the TFP rate of increase contracted on declining investment efficiency. Labor input growth slowed sharply from the late 2000s onwards.

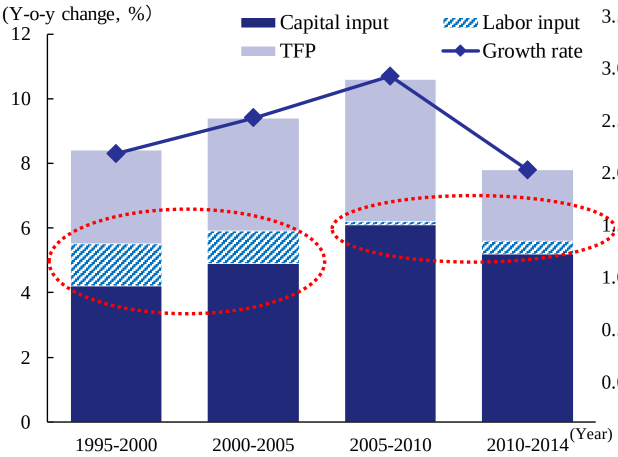
Capital input growth is likely to continuing slowing from here on, with the contribution of labor set to push the growth rate lower as the working age population declines on the rapid ageing of the Chinese population. The government is planning to sustain the working age population by raising the retirement age (currently 60 for men and 50 for women), with details of this plan set for release some time this year. If this goes ahead, it will temporarily stop the decline in the working age population, but even if the system is changed and new retirement ages come into effect, the working age population will eventually begin sliding again.

It is hard to imagine capital and labor input growth expanding, so the government will mainly have to rely on TFP improvements if it wants to maintain a certain level of growth. In fact, a major theme of the 13th five-year plan (2016–2020) is how to transit from a growth pattern that relies on the quantitative expansion of capital and labor inputs to an efficient growth model based on improved productivity[1].

(2) Moves to eliminate overcapacity could continue to place downward pressure on investment until around 2020

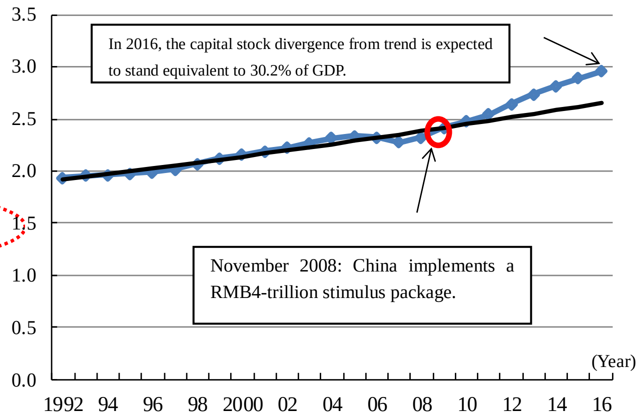
As we mentioned above, excess capital stock surged after the government pumped RMB 4 trillion into the economy in November 2008. A glance at the capital coefficient (real capital stock ÷ real GDP; a Mizuho Research Institute estimate) shows excess capital stock rising above previous trend lines after the introduction of the aforementioned economic stimulus (Fig. 4). This divergence from trend line finally stopped in 2016, but China is now estimated to have excess stock equivalent to 30% of GDP.

Fig. 3 China growth accounting



Source: Prepared by Mizuho Research Institute based on the APO Productivity Database 2016

Fig. 4 Excess capital stock (capital coefficient)



Note: Real figure. The figure is estimated using the benchmark year method, with 1952 as the base year and the retirement rate set at a uniform 5%.
The figure is delayed, with 1992–2008 set as the standard trend line.
Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China

The elimination of overcapacity was positioned as one of the most important economic policy priorities in the 13th five-year plan (2016–2020) and it was also raised as a key task in the National People's Congress 'Report on the Work of the Government' in both 2016 and 2017. Specifically, in 2016 the authorities placed curbs on new investment in the iron & steel and coal sectors (by clamping down on lending for the purpose of building up capacity in violation of government regulations). They also promoted corporate restructuring and offered support to workers who lost their jobs due to restructuring ('*Opinions on eliminating overcapacity, moves to resolve problems and realizing development in the steel and coal industries,' April 2016*[2], etc.).

Furthermore, in 2017 the government announced plans to strengthen the weeding-out of facilities that do not meet environmental or quality standards. This was an even more painful adjustment than the moves to curb new investments ('*Opinions on accelerating elimination of backward capacity via*

[1] 三浦祐介「中国・新五カ年計画の骨子と特徴～小康社会の全面的完成に向けた習政権の政策課題」（みずほ総合研究所『みずほインサイト』November 13, 2015）

[2] 劉家敏「鉄鋼・石炭業の過剰生産能力解消・苦境脱出・発展実現への政策支援に関する意見」（みずほ総合研究所『みずほ中国政策ブリーフィング』June 1, 2016）

comprehensive standards and regulations,' March 2017[3]).

How long will these moves to eliminate overcapacity continue? Iron & steel is a representative example of a sector plagued with overcapacity. The capacity utilization rate in this sector moved in the lower-70% range from 2012 to 2015, though it recovered to 76% in 2016 (Fig. 5). This was the result of moves to weed-out outdated facilities. However, with demand for iron and steel set to fall from here on, this weeding-out process will need to continue. A stable capacity utilization rate of around 80% is an appropriate level for productive capacity. If the government's forecast for future iron & steel demand is correct and the government also manages to implement its weeding-out policy, this will see the capacity utilization rate hitting 80% in 2020. Extrapolating from the iron & steel sector, it seems that moves to eliminate overcapacity will continue to place downward pressure on investment until around 2020.

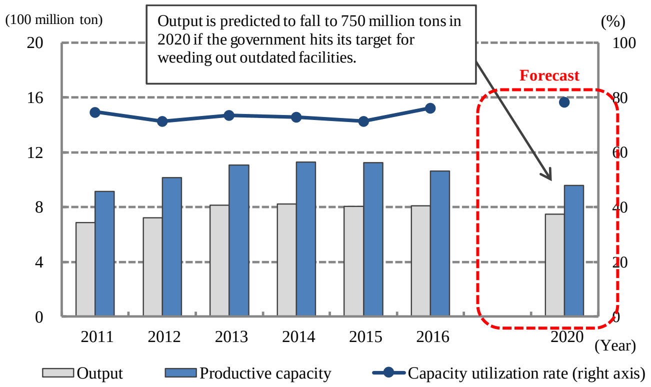
(3) Excess debt will keep ballooning until at least 2020

Corporate debt surged in the wake of the RMB 4-trillion stimulus package. This has also pushed investment lower. Chinese debt (as a proportion of GDP) moved stably around 150% until 2008, though it leaped to around 180% from 2009. This figure had expanded to 257% as of the end of 2016. Debt ballooned in the corporate sector in particular, with corporate debt hitting 166.3% of GDP (Fig. 6). The non-performing loan (NPL) ratio has been rising since 2011, when the economic slowdown grew more pronounced. If the problem of excess debt is not dealt with appropriately, this could destabilize the financial markets through an increase in bond defaults, for instance.

This ballooning corporate debt has prompted strong concerns both within and without China. December 2015's Central Economic Working Conference set deleveraging as one of its five main tasks and deleveraging has been positioned as a priority task in 2017 too. However, the government is trying to achieve average annual growth of around +6.5% in order to hit its target of doubling incomes by 2020, so it will try to avoid clamping down too much on fundraising for investment purposes. As such, in October 2016 the Chinese government promulgated the '*Opinions on reducing the corporate leverage actively and steadily*.[4]' In this, the government announced it would use gradual steps to achieve deleveraging, by promoting corporate mergers/restructuring, for instance, or equity finance and debt/equity swaps. This gradual approach suggests corporate debt as a proportion of GDP will not stop rising until at least 2020 (Mizuho Research Institute estimate). The IMF has released a forecast for corporate debt as a proportion of GDP, based on the scenario of the government temporarily sacrificing growth to aggressively promote reforms like corporate restructuring. This forecast also predicts that corporate debt will peak in 2020[5].

[3] 劉家敏「総合的標準・法規による遅れた生産能力の退出推進に関する指導意見」（みずほ総合研究所『みずほ中国政策ブリーフィング』April 21, 2017）
[4] 劉家敏「企業のレバレッジ比率の積極的かつ安定的な引き下げに関する意見」（みずほ総合研究所『みずほ中国政策ブリーフィング』November 15, 2016）
[5] IMF, *THE PEOPLE'S REPUBLIC OF CHINA: 2016 ARTICLE IV CONSULTATION*, August 12, 2016.

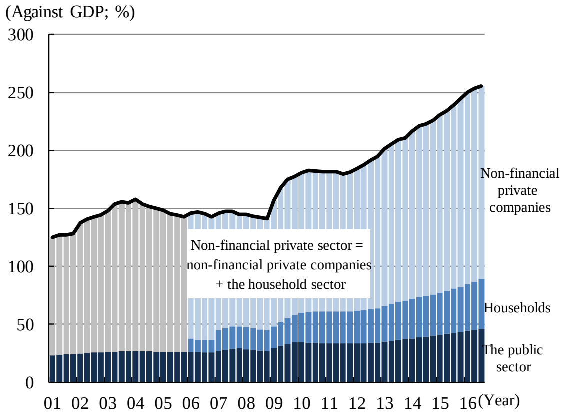
Fig. 5 Output, productive capacity, and the capacity utilization rate in the iron & steel sector



Note: 170 million tons of outdated capacity look set to be eliminated (the government's target of 150 million tons + an extra 20 million tons in 2016). The 2020 output figure uses forecasts from government materials (750–800 million tons).

Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China, 鋼鉄工業調整昇級規画(2016~2020) and CEIC Data.

Fig. 6 Debt as a proportion of GDP



Source: Prepared by Mizuho Research Institute based on BIS.

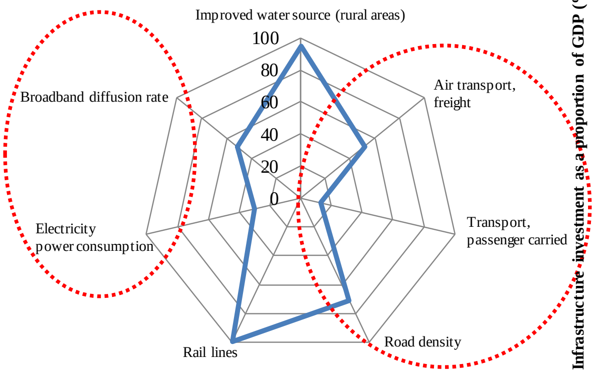
3. Economic tailwinds

(1) Though infrastructure investment is pushing ahead, particularly in priority regions, growth is expected to slow

Investment in fixed assets began sliding from 2013, particularly when it came to manufacturing, though infrastructure investment has continued to grow by around 20% y-o-y, so investment as a whole has remained firm. There is likely to be ongoing demand for infrastructure investment in China from here on. The Asian Development Bank (ADB) predicts infrastructure investment demand in China will be $940 billion a year, or around 5.9% of GDP, from 2016 to 2030 (premised on a forecast for low annual average growth of +4.6%)[6]. Furthermore, a comparison with infrastructure development in the U.S. (a country with similar territorial conditions to China), based on U.N. World Development Indicators, reveals that China lags behind when it comes to aviation infrastructure, roads, electricity and broadband, for instance. This suggests there is still ample room for expansion going forward (Fig. 7).

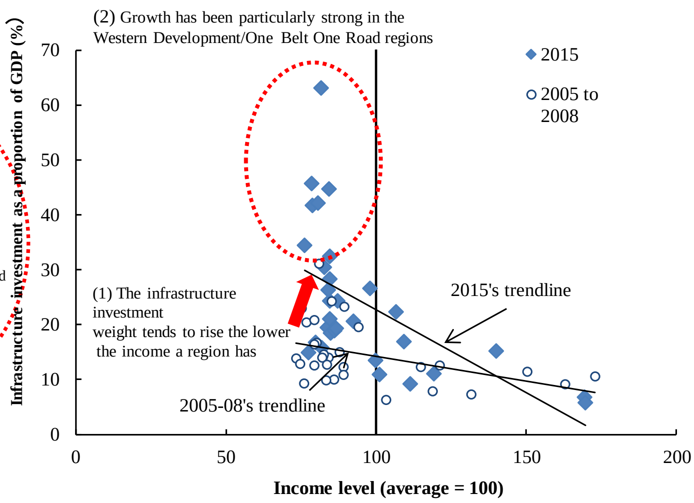
[6] Asian Development Bank, *Meeting Asia's Infrastructure Needs*, February 2017.

Fig. 7 Infrastructure development in China



Note: The data is indexed with the U.S. as 100 (any figures above 100 are set at 100). The details for each indicator are as follows.
Improved water source (rural areas): The percentage of people in rural areas with access to safe water supplies
Transport, passenger carried: Passenger numbers/population
Air transport, freight: Cargo transportation volume (ton, km)/land area
Road density: Roads (km) per 100 km^2.
Rail lines: Line length/population
Electricity power consumption: Kwh per person
Broadband diffusion rate: No. of contracts per 100 people
Source: Prepared by Mizuho Research Institute based on the material from World Bank, World Development Indicators 2017, Broadband commission, the National Bureau of Statistics of China, and the US Department of Transportation

Fig. 8 Infrastructure investment income levels per region



Note: Income: Per capita disposable income
Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China

However, there is a growing sense of saturation in some sectors, with China's rail system as developed as the system in the U.S., for instance. Furthermore, infrastructure demand is concentrating even more in regions with small economies. This also looks set to cap investment growth from here on. When plotting the relation between infrastructure investment and income levels in each region, we can see that, compared to before, (1) the lower an income a region has or (2) the further a region lies to the west in priority regions (One Belt One Road regions, for instance), the higher that region's infrastructure investment will be compared to GDP (Fig. 8). These regions have small economies, so overall Chinese infrastructure investment looks set to grow more slowly than before.

(2) China will probably boost productivity by promoting investment in innovation

With infrastructure investment demand gently sliding, the key to mid- to long-term growth lies in boosting productivity by promoting innovation and high-value-added industries. Specifically, the 'Made in China 2025' plan aims to break away from an over-reliance on heavy industry by 2025 by nurturing ten high-growth industries, including hi-tech. Furthermore, the 'Internet Plus Action Plan' intends to vitalize innovation by promoting internet usage across a wide area, including the service sector. Though overall investment continues to slow, investment in these priority areas will remain high thanks in part to government support.

In fact, the hi-tech products sector is steadily gaining a stronger presence in China. A glance at the competitiveness of products in the electronics and telecommunications sector, based on trade specialization coefficients, reveals that high-value-added products like lithium ion batteries are steadily growing more competitive. The Chinese government is pouring most of its efforts into developing a national semiconductor (integrated circuit) industry. In 2017 (January–June), 34.3% of the semiconductors used in China were made in China, up sharply on 24.9% in 2014 (Fig. 9).

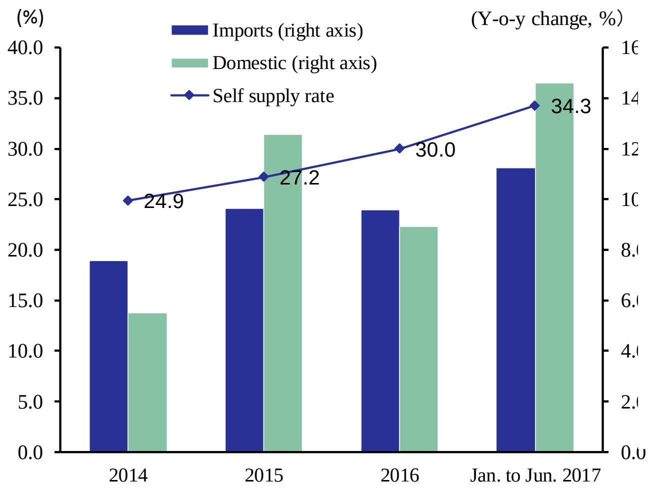
The Global Competitiveness Report 2016-2017 assesses the status of growth drivers in each country. It says China's advantage lies in its macro-economic situation, with its huge market and high rate of savings, for example. It also notes that China has made improvements in a number of areas, by widening access to higher education, making business more sophisticated (industrial density, etc.), and promoting innovation (R&D investment, etc.). By building up its human capital and technology on the back of these competitive advantages, China will probably be able to boost productivity.

4. By 2020, China will achieve growth somewhat higher than the rate of potential growth, with incomes also doubling

Based on the above, though the Chinese economy will face headwinds up until 2020 from adjustment pressure related to overcapacity and excess debt, infrastructure investment looks set to continue to a certain extent, so China's real GDP will probably hit RMB 94.4 trillion by 2020, double 2010's figure of RMB 47.2 trillion (Fig. 10). Though the growth rate will hit +6.3% in 2020 and just under 6% from 2021 onwards, average annual growth over the early 2020s will probably come in at +5.3%, only a slight slowdown on the +6.5% average for 2015–2020. Though growth is unlikely to accelerate, China's economy looks set to overtake the U.S. economy in terms of scale sometime around 2030 and will take first place in the world. China's global political clout also looks set to grow from here on.

Of course, this scenario depends on the avoidance of geopolitical risk or on trade not being impacted negatively by rising protectionism. Furthermore, if the reforms are too painful, the Chinese government may waver in its efforts to tackle structural problems like overcapacity and excess debt. If so, China may face low growth as productivity declines. At the 19th National Congress, scheduled for this autumn, general secretary Xi Jinping looks set to shore up his authority and retain his position at the center of the Chinese Communist Party. The question now is whether the Xi administration can tackle its internal and external problems in an appropriate manner. The situation will require monitoring from here on too.

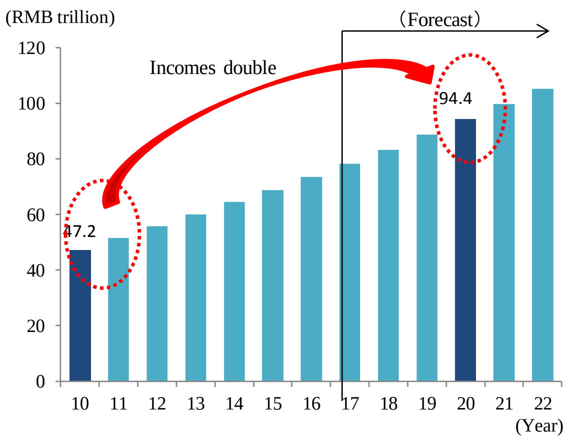
Fig. 9 Self supply of integrated circuits



Note: Self supply (%) = Production÷(production + imports – exports); volume basis.

Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China, and the General Administration of Customs

Fig. 10 China's real GDP forecast



Source: Prepared by Mizuho Research Institute based on the materials from the National Bureau of Statistics of China

Examination Regarding the Change in the Fixing Rules for the People's Bank of China Central Parity Rate

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1. Introduction

On May 26, 2017, the Chinese monetary authorities announced that they would add a "counter-cyclical factor" to the fixing rules of the "People's Bank of China central parity rate." Even though detailed information about the "counter-cyclical factor" has not yet been revealed, market participants see this as a message that the government authorities will strengthen their control over the foreign exchange market in order to stabilize the exchange rate.

This article will re-organize the discussion points, introduce a lecture and a report by a Chinese intellectual discussing the "counter-cyclical factor," and examine the future of the Chinese yuan exchange market. With regard to the "counter-cyclical factor," the information released by the Chinese monetary authorities itself has been limited, causing some confusion in the market. However, this article is expected to deepen understanding regarding local opinions in China that are not often obtainable in domestic media reports in Japan.

The lecture introduced in this article is that of Mr. Tao Guan, the former head of the Balance of Payments Department of the State Administration of Foreign Exchange (SAFE), currently serving as a member of the Chinese Economists 50 Forum, as well as a senior research fellow at the China Finance 40 Forum. The contents of the lecture are discussed in this article with the approval of Mr. Guan. However, it should be noted that the translation is based on the understanding of the author of this article.

2. Fixing rules for the People's Bank of China central parity rate

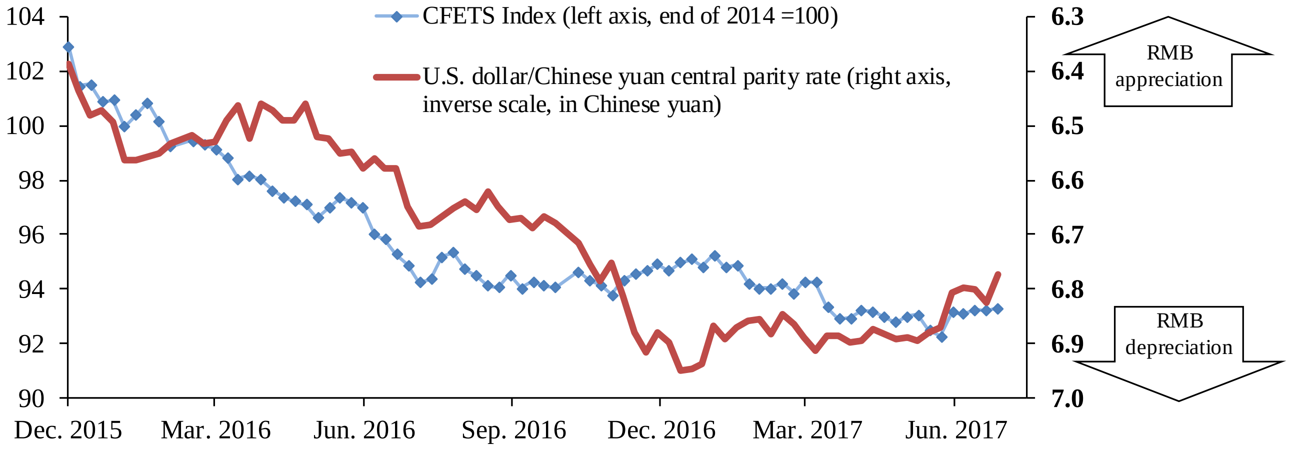
The People's Bank of China (PBOC) central parity rate (hereinafter referred to as the "central parity rate") refers to the Chinese yuan central rate against other major currencies announced every business day at 9:15 a.m. by the China Foreign Exchange Trade System (CFETS), an institution directly managed by the PBOC. This rate was previously fixed based on "the closing rate of the previous trading day and on the CFETS Index."* However, the "counter-cyclical factor" was newly added this time.

* The CFETS Index is an index calculated using the currency composition based on the trade-weighted average introduced in order to measure the accurate value of the Chinese yuan. The CFETS started to release the index in December 2015.

Change made this time

Before the change	The central parity rate was fixed based on the closing rate of the previous trading day and on the CFETS Index.
After the change	The central parity rate is fixed based on the closing rate of the previous trading day, the CFETS Index, and the "counter-cyclical factor."

Previously, the U.S. dollar/Chinese yuan central parity rate generally followed the trend of the CFETS Index.



Source:Bloomberg

3. Impact of the "counter-cyclical factor"

Strengthened control for the stability of the foreign exchange rate

First of all, what is the "counter-cyclical factor" and how does it impact the foreign exchange market? The summary of the announcement by the Chinese monetary authorities is shown below.

- The objective is to counter the one-sided move of the exchange rate based on biased market sentiment, as well as to mitigate crowd behavior in the market.
- In the times ahead, it will be easier to reflect changes in the fundamentals of the domestic economy.

The details of the effects and problems anticipated will be discussed later. As was mentioned at the beginning of this article, many market participants see that the control by the Chinese monetary authorities has been strengthened in order to stabilize the exchange rate.

Is this a regression of the internationalization of the Chinese yuan?

Taking the above characteristics literally, the central parity rate is likely to be fixed in the times ahead in order to put a brake on one-sided movement in the foreign exchange market, taking the fundamentals of the domestic economy into consideration.

If so, the question is: would the internationalization of the Chinese yuan, which has been in progress so far, regress as a result of the strengthened control by the Chinese monetary authorities? Regarding the "counter-cyclical factor," Mr. Guan has discussed that the following points need to be improved on.

1. First of all, the contents of the "counter-cyclical factor" have been unclear, resulting in the impression that the fixing rules of the central parity rate itself are unclear.
2. There are various views in assessing whether an economic index is at a proper level or not; and therefore, there will be cases in which there is no consensus on how the issues should be evaluated.
3. Even if the index is considered to be good, it is difficult to quantitatively measure how much the result should be reflected in the foreign exchange rate.
4. Whether the exchange rate rises or falls, it is possible that negative impact on the supply & demand balance will occur if everyone has the same estimate.

What is the true intention of this?

With the above points in mind, many market participants seem to have a negative opinion about the strengthening control by the Chinese monetary authorities. On the other hand, having recognized such concerns, Mr. Guan considers this change as a phenomenon in a larger flow of the internationalization of the Chinese yuan and supposes the intentions of the Chinese monetary authorities from a broader point of view, as below.

- It will solve the current problem such that domestic economic fundamentals are not easily reflected in the foreign exchange market.
- It will to some extent prevent overshooting, i.e., the violent fluctuations of the foreign exchange market, which are significantly different from the actual situation.
- The announcement of the methods for fixing the central parity rate is a temporary measure in the transitional period for the market to mature. This will also increase communication with the market.
- It will lead market participants to observe not only the U.S. dollar and the Chinese yuan but also various other foreign exchange rates, as well as changes in domestic economic fundamentals. It is possible for other new factors to be added in the times ahead.

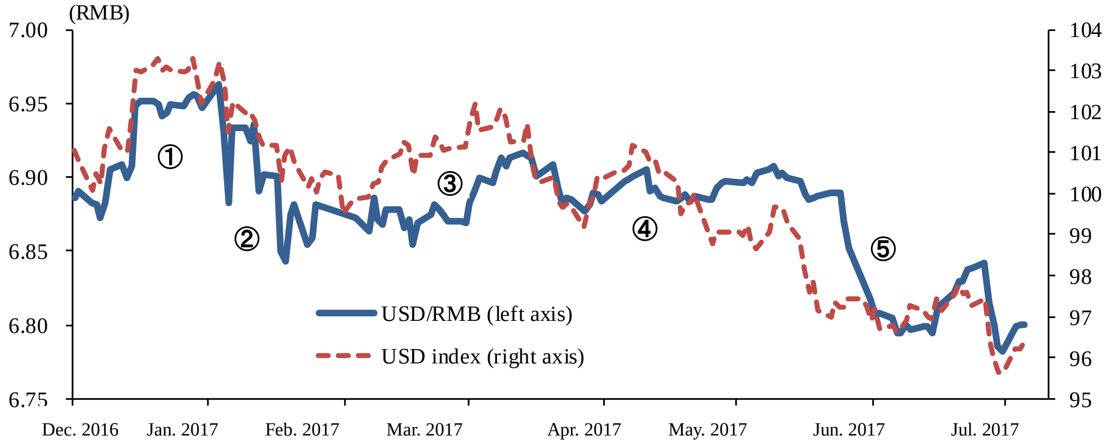
Mr. Guan has always maintained the idea that a strong domestic economy will lead to a strong Chinese yuan. It seems reasonable to think that the economy should be strengthened first of all while stabilizing the foreign exchange market, in order to make progress in the internationalization of the Chinese yuan.

Furthermore, Mr. Guan has also been emphasizing the importance of communication between the Chinese monetary authorities and the market. He has thus relatively highly evaluated the attitude of the Chinese monetary authorities to reveal the fixing method of the central parity rate (albeit not in detail).

4. Future outlook

Summary of the recent trends in the foreign exchange market

It is now useful to summarize the recent trends in the foreign exchange market. Mr. Guan analyzes the trends in the U.S. dollar/Chinese yuan exchange market in relation to the strength of the U.S. dollar shown in the U.S. dollar index. The below is the U.S. dollar/Chinese yuan exchange rate (in the actual trading market) and the U.S. dollar index.



Source: Bloomberg

- The pessimistic view on the Chinese yuan that was observed at the end of the last year (①) is no longer observable this year. On the contrary, the Chinese yuan has appreciated by 2–3%.
- In January, the U.S. dollar index declined significantly, and thus the Chinese yuan appreciated sharply against the U.S. dollar (②). In February, the trend was reversed, and the U.S. dollar index started to appreciate. However, the U.S. dollar/Chinese yuan exchange rate remained stable, with slight appreciation (③). In March and after, the U.S. dollar index has been declining, while the U.S. dollar/Chinese yuan exchange rate remains stable (④).
- Despite the fact that the U.S. dollar index started declining in March and after, the U.S. dollar/Chinese yuan exchange market stabilized for the following possible reasons. In short, the U.S. dollar-buying trend remained strong, while the pressure for capital outflow had been weakened to some extent. As a result, there has been a "cycle" in which the Chinese yuan weakens against the U.S. dollar, compared to the central parity rate during trading hours, leading to a weaker yuan to the U.S. dollar in the central parity rate fixed on the following day.
- As market participants are aware of this "cycle," the trend was reversed once the "counter-cyclical factor" was introduced, and the Chinese yuan continued appreciating against the U.S. dollar (⑤).

Using the expression of "cycle," Mr. Guan has pointed out that there tends to be a spiral from "the appreciation of the U.S. dollar during trading hours" to "a strong U.S. dollar reflected in the central parity rate fixed on the following day" and to "the further appreciation of the U.S. dollar in the actual trading market because of the central parity rate," as long as pressure to buy the U.S. dollar persists based on actual demand.

It seems that for this reason the "counter-cyclical factor" was introduced, and Mr. Guan implies that there should be more space for improvement for the fixing of the central parity rate itself in reforming the Chinese yuan exchange market.

Future outlook

In terms of the medium- to long-term future outlook, Mr. Guan has raised the following points, given the possible appreciation of the Chinese yuan based on the introduction of the “counter-cyclical factor.”

- The most likely scenario for the Chinese yuan exchange market in the times ahead would be sustained stability in the market, by controlling excessively violent fluctuations, as <u>market participants will be more aware of the intentions of the government regarding the stability of the foreign exchange market</u>.
- Furthermore, economic fundamentals are recovering both domestically and internationally, while the method used to fix the central parity rate has been improving. Thus, market sentiment is expected to become even better in the times ahead.
- Risk scenarios include the continued appreciation of the U.S. dollar without the recovery of the domestic economy. In such a case, the government will be obliged to consider involvement in the foreign exchange market or the consumption of foreign currency reserves. If the government chooses not to take either measure, there will be no other option but to further strengthen regulations.

Mr. Guan also mentions the possibility of unavoidable market intervention as a means to react to the unlikely scenario of the excessive appreciation of the U.S. dollar against the Chinese yuan, which is a realistic point of view, given the current situation in the market. Furthermore, here again, he mentions the stability of the foreign exchange market. Therefore, it is evident that he prioritizes the importance of the stability in the foreign exchange market in order to achieve the internationalization of the Chinese yuan.

5. Toward the internationalization of the Chinese yuan

Capital deregulation

In October 2016, the Chinese yuan was adopted as a basket currency for the IMF’s (International Monetary Fund) SDR (Special Drawing Rights). Since then, the movement toward the internationalization of the Chinese market has accelerated again. In June 2017, China A shares was included into the MSCI Emerging Market Index, which had long been awaited. In addition, in July of the same year, the “Bond Connect” scheme was launched, making it possible for overseas investors to buy and sell bonds in Mainland China through the Hong Kong market.

According to the plan announced by the State Council in April 2009, Shanghai is expected to become an international financial center by 2020, and the above market reforms are part of the process. It is believed that such capital deregulation is an essential part of the internationalization of the Chinese yuan. Mr. Guan has also been insisting on the necessity for the Chinese yuan to be internationalized.

- Including the reform introduced this time, there have been various measures taken for the stabilization of the foreign exchange market. However, <u>there has been the unchanged goal to internationalize the Chinese yuan and to let market principles lead the exchange rate</u>. As a result, it would be necessary to build up expertise in reacting to market fluctuations in both directions.
- In doing so, the most important thing is to be highly aware of monetary risks, to control speculative moves surrounding the appreciation and depreciation of the exchange rate, and to manage positions and risks using various monetary tools in an appropriate manner. If cross-border capital transfer is carried out via appropriate channels as a result of such efforts, it would be a desirable result not only for the market but also for the government.

Process of the internationalization of the Chinese yuan

This article has thus discussed the trends in the Chinese yuan exchange market focusing on the “counter-cyclical factor” based on the analysis by Mr. Guan. As market participants, it is easy to overreact to changes that can be seen as a strengthening of regulations, as there are many situations in which the true intentions of the Chinese monetary authorities are not made clear through their regulations and policy measures. The change announced this time has also clearly strengthened the control by the Chinese monetary authorities, and therefore, a large number of market participants saw it as a regression of the Chinese yuan reforms.

On the other hand, Mr. Guan, who was a key member in implementing policy measures related to foreign exchange and the international balance of payments under the government of Xi Jinping, considers many individual decisions in terms of the “internationalization of the Chinese yuan” from a broader perspective. This seems to imply important things. Mr. Guan does not consider the change announced this time as part of the regression of Chinese yuan reforms, insisting that the internationalization of the Chinese yuan and the market principals of the foreign exchange market would not change. Given his claim, it is possible to keep a broader perspective, believing that the current market is in the middle of the long process of achieving the internationalization of the Chinese yuan. In this way, we can deepen our understanding of individual regulations and policy measures, along with their concomitant change in market trends.