Chi Time

FOR WHOLESALE INVESTORS – 17 July 2018

QUESTIONS ABOUT THE RENMINBI'S STRESS

Too often we... enjoy the comfort of opinion without the discomfort of thought.

John F. Kennedy

The rapid pace of correction of the renminbi exchange rate recently has surprised the market (Chart 1). What have changed to trigger the slide? Is China finally shifting to a devaluation policy? Will it surprise the market again by rebounding later?

Concerns about escalating Sino-US trade tensions have rattled the renminbi, which has given back all its 1H 2018 gains against the USD within just a few weeks recently. Its sharp fall has also raised the suspicion that Beijing might have shifted to a devaluation policy to fight the trade war. I beg to disagree. In addition to other reasons, Beijing will not want to repeat the experience in August 2015 when the PBoC reformed the renminbi fixing mechanism but the market misread it as a devaluation move, causing massive capital outflows and wreaking havoc the renminbi and the global markets. It took Beijing almost two years to stabilise capital flows with capital controls.

Is the PBoC devaluing the renminbi?

I have long argued[1] that devaluation would not be effective in boosting Chinese growth, and that the renminbi would have to be devalued by 20% and 40% against the USD if it were to yield any material impact for China. This would be unacceptable for everyone. So the four-percent decline in the CNY-USD cross rate since June is meaningless from a policy perspective.

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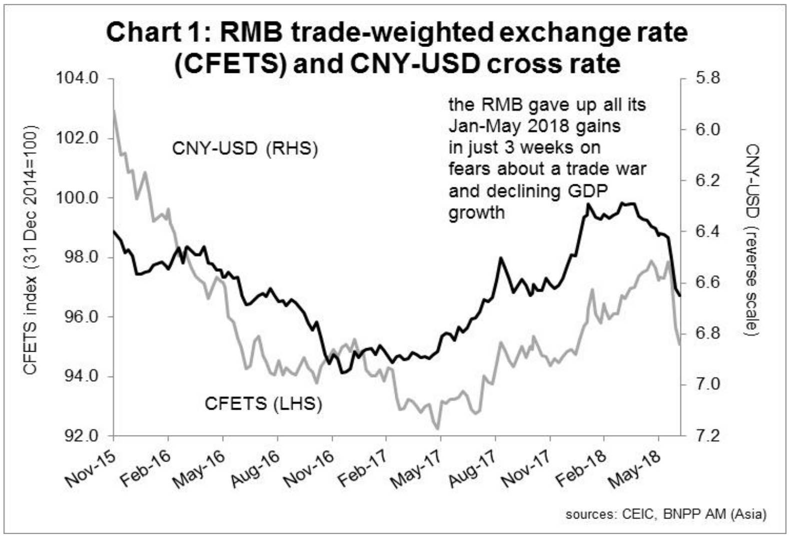


Crucially, evidence from the PBoC's usage of the "countercyclical factor" in the fixing mechanism[1] shows that it has actually been leaning against, but not pushing for, the renminbi's decline. The calculation of this factor showing the PBoC using "brute force" to set the CNY-USD fixing against market direction is unknown. But a market study[2] estimates that the PBoC had been using the countercyclical factor to set the fixing to counter a falling renminbi recently. The purpose was to prevent disorderly renminbi depreciation but not to encourage it.

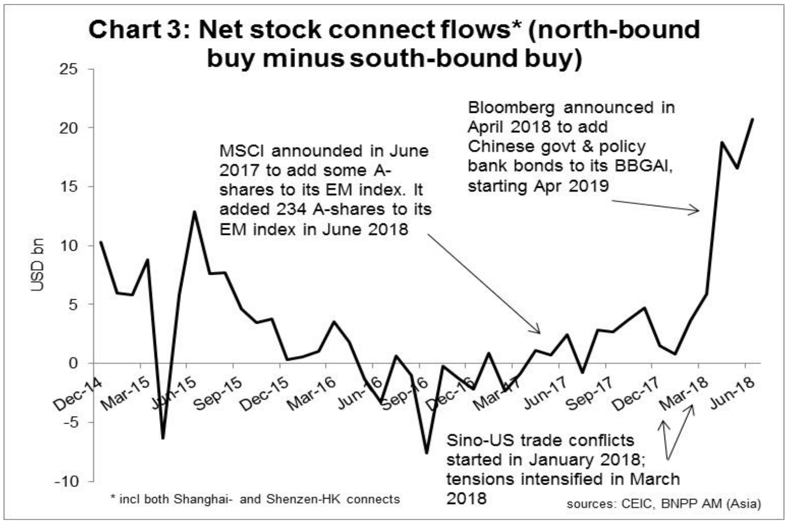
Why the sharp fall?

In my view, it is not the China-US monetary policy divergence that is driving down the renminbi, as most observers have casually argued. That policy divergence has emerged since 3Q 2017 when the PBoC started cutting the bank reserve requirement ratio (i.e. easing liquidity) while the US Fed embarked on normalising US interest rates. But the CNY was appreciating against the USD all the way until this June.

Crucially, the two key assumptions behind the interest rate parity theorem – namely an open capital account and perfect substitution between USD and RMB assets – which observers often use to bet on renminbi movement (mostly devaluation), have limited relevance to the CNY market! It may apply to the CNH market which is not subject to direct PBoC control. But still, the CNH market is not totally free from intervention, as the PBoC can still intervene in the offshore (Hong Kong) renminbi interbank market to affect CNH liquidity, as it did in 2016[3].

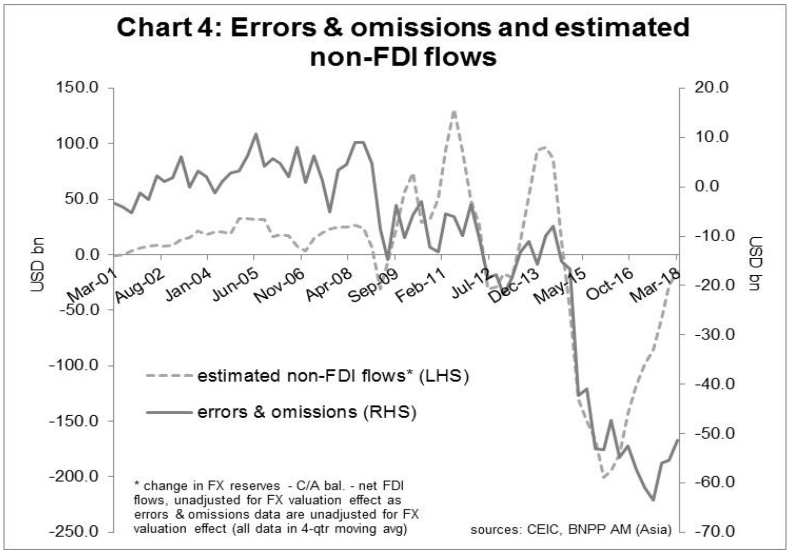
The renminbi's recent decline is an overdue correction of its excessive strength between mid-2017 and May 2018 when strong portfolio inflows (Charts 2 and 3) overwhelmed the drag on the currency from a small current account deficit in 1Q. The USD's weakness early this year also exacerbated the renminbi's strength. But the escalation of Sino-US trade tensions has shaken the market's complacency about China's risks[4]. When weakening economic data started flowing in May, the renminbi's fortune also turned.

[1] For a discussion on the "countercyclical factor" in the fixing mechanism, see "*Chi Time: Why Does the PBoC Fiddle Around With the Yuan Fixing Again?*" 1 March 2017.
[2] "*Reluctant RMB Depreciation Will Continue But Remain Moderate*", Natixis, 6 July 2018.
[3] See "*Chi on China: RMB Internationalisation (part 1 of 2) – Short-term Tactics May Have Changed*", 24 February 2016.
[4] See "*Chi Time: A-Shares Tanked. What's Next?"* 11 July 2018.



The next big question

Will the renminbi fall significantly further to trigger a crisis and force the PBoC to burn FX reserves to defend it? I do not think so. Firstly, there is no massive capital outflow pressure on the renminbi today as there was in 2015 and 2016. Portfolio inflows have been robust (see Charts 2 and 3) and the current account remains in surplus despite a small seasonal deficit in 1Q 2018. Our estimates for non-FDI flows and the BoP's errors and omissions, both are proxies for hot money/illegal capital outflows, have rebounded from their huge deficits in 2015/16 (Chart 4). Today's economic and corporate fundamentals are better, macroeconomic policy coordination is better and structural reform and debt-reduction drives are stronger. So a collapse in public confidence causing massive capital outflows wreaking havoc the renminbi is unlikely.



What's PBoC's FX policy stance?

The PBoC has never announced its official policy stance. But its policy moves over the past two years have underscored my long-held argument that it is targeting a stable CFETS index using the CNY-USD cross-rate as an adjusting factor – i.e. when there is too much upward/downward pressure on the trade-weighted exchange rate, it will allow CNY to depreciate/appreciate against the USD to stabilise the CFETS. But during volatile market conditions, it will shift back towards stabilising the CNY-USD cross-rate and allow the CFETS to fluctuate.

Trouble is that no one knows what the targeted CFETS level is. What seems to be clear is that the recent decline in the CNY-USD cross-rate is market-driven and consistent with the PBoC's preference for CFETS stability. CNY-USD is down about 2.4% from the beginning of this year while the CFETS index has unwound its gains and is now roughly flat relative to January 2018's level of 95 (i.e. CNY has depreciated against the USD to keep the CFETS stable).

Will the renminbi surprise the market again?

The CFETS's appreciation in 1H 2018 has ignited concerns about hurting China's growth on the back a trade war risk. So the PBoC should be happy to keep the CFETS stable by tolerating short-term weakness in the CNY-USD cross-rate when market forces warrant it.

How the CNY-USD moves from here will depend on three factors: 1) the direction of the USD, 2) the PBoC's desired path for the CFETS and 3) renminbi sentiment. Improvement in sentiment will depend on stabilisation in China's growth momentum and easing Sino-US trade tension. These may happen in 4Q 2018 when the domestic easing measures filter through the Chinese economy and the US mid-term elections are out of the way. Barring a full-scale trade war and deterioration in China's BoP, there is still a fair chance for the renminbi to pose a U-shape recovery and end the year up (3.0% YoY to 6.31) against the dollar, as I have been forecasting since the beginning of this year.

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