RMB Monthly: pressured by PBoC’s preemptive phase & fundamentals

- PBoC’s preemptive policy stance is yielding an accelerated transfer of risk premia from credit spreads to the RMB
- The shift in focus to a trade-weighted CNY Index highlights the diminishing appropriateness of China’s USD-peg
- PBoC is letting private sector flows impact the RMB in stages while limiting the pace of RMB depreciation
- The current level of CFETS’ CNY Index indicates PBoC will broadly maintain a weakening trend for the CNY

Key events and factors during the 1-month period ending in early December

Figure 1. USDCNH approximate timing of key events during the 1-month period ending today

Moderate CNY weakness overshadowed by a steeper CNH decline

Our trade-weighted CNY Index has declined by 1.4% thus far in December. A 1.2% appreciation of the USD and a 4.3% appreciation of the euro are primarily responsible. Higher US rates have provided support to the USD, while a smaller-than-expected loosening of ECB policy on December 3rd resulted in broad-based euro strength.

Although the decline in the CNY was modest, the decline in the offshore RMB (CNH) in November and December was more pronounced. USDCNH rallied by 1.6% in November and a further 1.7% by late-December, while a number of fundamental drivers moved in favour of the pair (Figure 1). The CNH discount to CNY therefore increased roughly 10-fold from 110 pips in early November to nearly 1,000 pips by mid-December.

The intensity of USDCNH appreciation in recent weeks reflects two key factors. First, after selling USDCNH aggressively in September and October, onshore banks stepped away in late November and early December. This unmasked strong, underlying demand for USDs from holders of CNH assets.

Second, CNH’s full convertibility is allowing for a bigger risk premium to become embedded in the currency relative to the CNY, in view of the current fundamental backdrop for the RMB. While we don’t expect the CNH or the CNY to continue weakening at the same pace in Q1 2016, the recent depreciation of the CNH has been appropriate on the basis of these fundamentals.
CFETS begins publishing a trade-weighted CNY Index in December

On December 11th, China Foreign Exchange Trading System (CFETS) began publishing a CNY Effective Exchange Rate Index (CNY Index) on its website. The Index will be updated regularly based on the bilateral movements between the CNY and the individual currencies of China's largest trading partners. This is basically a trade-weighted index, with small adjustments in the weights to account for re-export factors. PBoC also acknowledged the publication of the Index as being important.

The timing of the decision is of great importance, since it comes as the RMB has continued to depreciate and as China is moving towards greater CNY convertibility. If China is gradually allowing greater CNY convertibility under the capital account, it's doing so vs all major currencies, not just the USD. Since capital will flow more freely between the CNY and all currencies in the trade-weighted basket, it's the value of CNY vs the basket that matters, not just the value of CNY vs the USD.

We will now track two different CNY Indices. The first is the CNY Index published by CFETS. This Index is a trade-weighted mid-rate, rebased to the end of 2014. We have replicated this Index using the weights provided by CFETS. Since the end of 2014, the trade-weighted mid-rate has appreciated by 1.2%.

We refer to the second Index as the CNY Spot Index, which tracks the trade-weighted level for the CNY based off the daily closing spot levels of all 13 currencies traded on CFETS. This Index is also rebased to the end of 2014. Since then, the CNY Spot Index has appreciated just over 2.0%. Although both Indices are calculated in trade-weighted terms, the main difference between them is that one is based off the daily CNY mid-rate vs each currency in the basket (CNY Index), while the other is based off the daily CNY spot rates vs that same basket (CNY Spot Index).

Figure 2 shows the position of the CNY Spot Index relative to the trade-weighted mid-rate (CNY Index), while Figure 3 plots the trends in both Indices since the end of 2014. The important point highlighted in both charts below is that the CNY Spot Index has persistently traded above the mid-rate since the August mini-devaluation. This appreciation of the CNY Spot Index occurred because the devaluation triggered a risk-off phase that weakened the EM and commodity currencies within the CNY Spot index by more than CNY itself. After the August mini devaluation, the CNY tracked the USD higher vs many currencies because of the USD-peg.

We draw three conclusions from CFETS’ new CNY Index and the behaviour of the CNY Spot Index since mid-August:

1) PBoC will continue to resist CNY appreciation. Although the CNY has continued to depreciate vs the USD since the August mini-devaluation, it has not done so in trade weighted terms because of China’s USD peg

2) with the CNY Spot Index trading above the mid-rate for most of H2 2015, PBoC will broadly maintain a weakening profile for the RMB
3) the current level of the CNY Spot Index relative to the mid-rate does not indicate PBoC is will force the CNY sharply lower

In a separate note dated December 14th, CFETS noted that although market supply and demand is an “important reference” for the CNY Index, China & PBoC still believe market forces of supply and demand should be “combined with necessary management” of the exchange rate.

We think these remarks indicate that China still has a large preference to maintain a managed float system for the RMB. Given that supply & demand fundamentals are currently RMB negative, China’s management of the RMB is likely to slow those forces down somewhat, not speed them up.

**China is split between market forces & a managed CNY float**

One explanation for the widening of the CNH discount from late November was a notable decline in USDCNH sell interest from local banks. In combination with tighter capital controls, these USDCNH offers from local banks prevented a widening of the aforementioned discount in September and October. However, the more recent absence of those offers allowed the CNH to weaken as the broad USD continued to rally and the euro rebounded.

The decline in USDCNH sell interest from local banks roughly coincided with the IMF’s November 30th decision to add the RMB to the SDR basket in late 2016. We have continually viewed the RMB’s ability to respond to a degree of private sector capital flow as a prerequisite for SDR inclusion. We still don’t expect China to fully allow market forces to influence the RMB at this stage. However, the recent decline in USDCNH sell interest as the USD and the euro have strengthened indicates that China is willing to let private sector forces play an important role from time to time.

In mid-August, China changed its methodology for setting the USDCNY mid-rate by allowing it to track the previous day’s close in spot USDCNY. As demonstrated in Figure 4, the USDCNY-mid-rate has broadly tracked the previous close since mid-August. However, Figure 4 also highlights PBoC’s tendency of setting the USDCNY mid-rate below the previous day’s close in spot USDCNY. This tendency was particularly notable on December 4th, when PBoC set the mid-rate 130 pips below the previous close. This was widest amount of divergence between the USDCNY mid-rate and the previous close since mid-August.

China is still using the USDCNY mid-rate to control the pace of RMB depreciation. In view of the exchange rate tensions policy makers in more developed economies are experiencing, PBoC will probably maintain a very cautious approach to increased CNY convertibility over the short-run by regulating the pace of CNY outflows.

China also made at least one additional change in early December, which likely caused a widening of the CNH discount to CNY. On December 9th, some newswires reported that PBoC had suspended new applications for the Renminbi Qualified Domestic Institutional Investor (RQDII) investment scheme. The scheme, which was approved just over a year ago, has been designed to allow certain domestic institutional investors to buy offshore renminbi products (i.e. capital outflows).
SAFE intervention is unlikely to halt RMB weakness

By our calculations, China’s FX reserves (adjusted for FX and bond valuation effects) saw a net inflow of $75 billion in the three months through October, indicating that tighter capital controls and direct support of the RMB succeeded in slowing the pace capital outflows. Indeed, our calculations show a $120 billion improvement in the flow of private sector capital in October (i.e. a net outflow of $60 billion in October vs a net outflow of $180 billion in September).

However, China’s FX reserves recorded a net bleed of $60 billion in November. Additionally, November also saw an $8 billion decline in China’s nominal trade surplus. In volume terms, total trade denominated in USDs declined by a cumulative 7% in the three months ending in October. These factors are fundamentally negative for the RMB.

We therefore view Chinese officials as being split over the appropriate pace of the move lower in the CNY, but not the underlying direction. As a result, China has allowed private sector capital flows and fundamentals to weigh on the RMB in stages, while periodically slowing the pace of that RMB weakness down.

Referring back to Figure 4, market forces have gradually caused the USDCNY mid-rate to drift higher in line with the trend in spot USDCNY. By allowing USDCNY to periodically respond to market forces, China has created a release valve for private sector capital outflows and prevented USDCNY from trading close to its upper 2.0% limit. At the same time, additional easing from PBoC has prevented a rush of scared capital from exiting the CNY.

PBoC’s monetary policy stance is in a preemptive phase

Recent central bank data indicate a further loosening of onshore monetary conditions in November. Although there has been some deceleration since Q2, the growth rate of PBoC’s balance sheet has contributed to a steady decline in onshore rates. As demonstrated in Figure 5, China’s 10yr government bond yield has declined by 60bps this year as a result of PBoC policy.

PBoC added an additional CNY100 billion of liquidity through its Medium-term Lending Facility (MLF) in November at a rate of 3.25%. PBoC also provided an additional CNY52 billion of liquidity through its Pledged Supplementary Lending Facility (PSLF). Both injections of liquidity were conducted at interest rates below the ones observed in October.

For 2015 as a whole, the average monthly growth rate of PBoC’s balance sheet (excluding foreign assets) has exceeded the average monthly decline in SAFE’s FX reserves by a healthy amount. More recently, the two series have converged as the growth rate of PBoC’s balance sheet has decelerated somewhat (Figure 5). This partially explains why the pace of CNY weakness hasn’t been more aggressive.

However, as the external and industrial sectors of the economy have slowed (Figure 6), PBoC has acted to support total social financing, including bank lending and corporate bond issuance. PBoC is using its monetary policy stance to preempt debt rollover risks and slow the growth rate of non-performing loans. Therefore, we expect PBoC to engage in a continued expansion of its balance sheet in the months ahead.
This dynamic has a number of implications for the RMB, and all of them are short-term negatives. First, a rising total debt stock will support the growth rate of financial intermediation. As a share of GDP, financial intermediation rose to approximately 10% for the first time in 2015. This creates new risks for the domestic economy at a time when economic growth is still slowing. As a result, we expect foreign investors to treat their RMB exposures with a high degree of caution, even with 2016 SDR inclusion being a done deal.

Second, PBoC is acting to mitigate debt rollover risks and prevent financial contagion. As a result, PBoC’s ability to generate enough policy traction for an acceleration of economic growth is very limited in the short-run. Monetary policy divergence is therefore unlikely to favour the RMB for the foreseeable future.

Third, onshore debt dynamics and the trend in credit spreads indicate that support from PBoC is leading to declining risk premia (Figure 7). However, balance sheet risks in the domestic economy are arguably higher as a result of weakening fundamentals. They are not lower, as onshore credit spreads suggest. Therefore, RMB strength will be heavily constrained by the transfer of these risk premia from credit spreads to the currency.

Our view

We expect a continuation of RMB weakness over the short and medium-term horizons, and we look for USDCNY to trade at 6.52 in 3M and 6.55 in 9M. We expect PBoC and Fed policies to continue diverging over that timeframe, as the Fed delivers the next rate hike of the cycle in March. We expect additional support in USDCNY to come from further PBoC easing, onshore debt dynamics and net capital outflows as the capital account is further liberalised. At the 12M horizon, we expect a small appreciation of the RMB as the USD reaches its peak for the current cycle and as RMB inclusion in the SDR becomes effective in late 2016.

Rather than lean against market forces, PBoC has allowed the USDCNY mid-rate to climb by a total of 120 pips since the Fed’s rate hike on December 16th, given the broad based strength of the USD (Figure 4). Over that same period, Bloomberg’s Liquidity-weighted USD Index has appreciated by 0.2-0.5% since the close on December 16th.

We take this as an indication that PBoC’s preference is for the CNY to continue tracking a basket of currencies rather than the USD if the USD strengthens further from present levels. It also indicates PBoC’s preference to let the trade-weighted CNY weaken to where it is in line with the trade-weighted mid-rate (Figure 2).

Current FX Strategy views for onshore spot USDCNY and other key variables

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