THEME

China | On the way to the floating regime: RMB is set to depreciate

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Summary

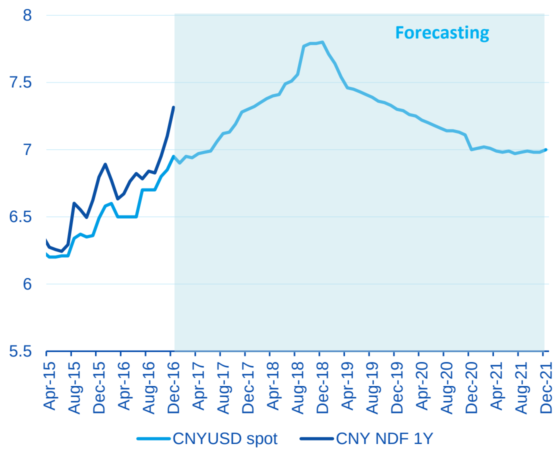
- The RMB exchange rate has witnessed violent movements since the US president election. Despite the recent rebound, we project that the RMB exchange rate will depreciate another 4-5% against the USD in the new year, bringing CNYUSD to around 7.2 by end-2017.
- Persistent pressure of RMB depreciation stems from the capital rather than current account. Enormous demand of Chinese residents' for international investment diversification has been unleashed since the devaluation in August 2015. Moreover, international comparison demonstrates that such a rebalancing process is set to continue in future.
- It is a daunting task for the authorities to navigate the ongoing external rebalancing. China's central bank has implemented a number of policy initiatives to stem capital outflows and engineer a soft-landing of the exchange rate. They have more available policy tools in their toolkit to help them achieve the goal.
- We believe that the exchange rate regime of the RMB will ultimately shift to a floating one as other major economies in the world. The floating of the RMB could come in the second half of 2018. Although certain degree of currency overshooting is inevitable, the final floating will help China's economy restore its external balance and push up the exchange rate in the long run.

Gradual depreciation is set to continue

The external balance of Chinese economy was in limbo through the entire 2016, partly thanks to the "Black Swans" to the global economy ranging from market turmoil at the beginning of the year to the mid-year "Brexit"; from the US president-election to the Italian "constitution" referendum. The RMB exchange rate had depreciated by another 7.0% in 2016, extending the cumulative depreciation of the currency to 12% since the one-off devaluation of August 2015. (Figure 1) Meanwhile, China's foreign reserves continued to diminish at an annual pace of USD 320 billion in 2016, as a consequence of the authorities' efforts to defend the exchange rate to avert a textbook currency crisis of emerging markets featuring the vicious spiral of currency depreciation and capital flight. (Figure 2)

Figure 1

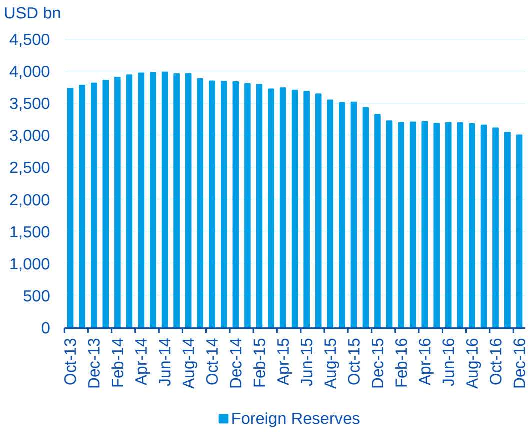
RMB went to the depreciation trend since August 2015 RMB fixing price reform



Source: BBVA Research and CEIC

Figure 2

Foreign reserve has diminished by around 1 trillion USD since Q3 2014



Source: BBVA Research and CEIC

Despite the recent rebound of the RMB, we expect the woes of China's external balance to persist in this new year. As such, the RMB exchange rate is likely to continue its weakening trend with a moderated pace of depreciation due to the authorities' beefed-up intervening efforts. A mild depreciation of 4-5% against the USD envisaged in our base scenario will bring CNYUSD to around 7.2 by end-2017. As the depreciation is primarily driven by domestic forces rather than external shocks, our 2017 projection of the exchange rate is, to a certain extent, immune to the performance of the USD. That being said, a stronger-than-expected USD can introduce more volatility to the RMB exchange rate, accelerate the depletion of foreign reserves and prompt China's authorities to implement more restrictive measures on capital flows. Nevertheless, the authorities will be reluctant to allow the depreciation to exceed 5% to guard against market panic.

The current regime of the exchange rate, namely the currency value being linked to a currency basket, is in nature a transitory arrangement. That being said, the authorities will finally achieve the "clean float" as they intended, but failed, to do in the first place when they devalued the "redback" in August 2015. The floating of the RMB could happen in the second half of 2018. Although certain degree of currency overshooting is inevitable (we estimated that the CNYUSD could touch the level of 7.8 sometime late 2018), the final floating will help China's economy restore its external balance and push up the exchange rate in the long run.

The enemy inside the gates

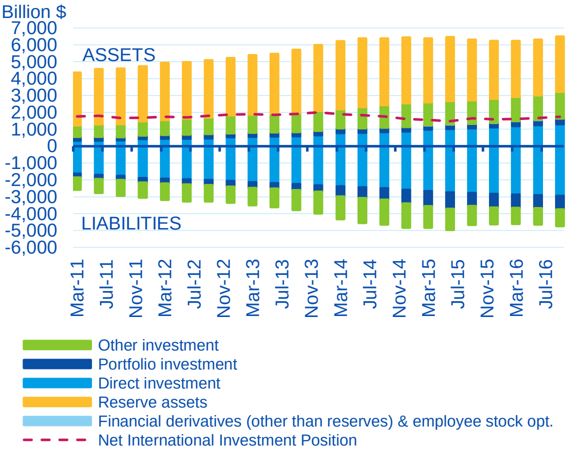
Several factors lurked behind the RMB depreciation since the one-off devaluation in August 2015: continuing growth deceleration, dampened domestic confidence, the on-going normalization of US monetary policy and associated USD strength etc. However, we believe that the root is Chinese residents' increasing demand for diversifying their portfolios in the wake of the devaluation in August 2015. Indeed, the devaluation has made people aware of the unsustainability in the previous regime of exchange rate under which the authorities artificially maintained one-side appreciation against other major currencies regardless of the dynamics in external environment. As a consequence, Chinese residents, including both enterprises and households, scrambled to acquire international assets so as to diversify their portfolios and mitigate the exchange rate risk stemming from the prospective floating of the RMB.

China's capital outflows since August 2015 were dominated by its own residents' portfolio adjustment rather than foreign investors' capital flight. One important observation in this respect is that China's international investment position hasn't changed much compared to its level in Q3 2014, (Figure 3) although foreign reserves has lost almost 1 trillion since then. It means that through the course a considerable size of foreign reserves flowed from the central bank to Chinese residents and then became their international assets. To a certain extent, it can be perceived as a rebalancing of China's external position, a reallocation of China's aggregate international investment between the public and private sectors. However, the rebalancing can also lead to market turmoil and weigh on the exchange rate as we have seen when domestic firms and individuals scrambled to exchange for foreign reserves with local currency.

We expect that the rebalancing is not going to end soon. International comparison (figure 4) demonstrates that the composition of China's international investment, even after the violent adjustment since August 2015, is still tilting toward the public sector (in the form of foreign reserves) relative to the private sector disproportionately. It means that the authorities will continually face the pressure of capital outflows and currency depreciation. As such, the authorities must ensure a gradual and smooth proceed of the rebalancing process and guard against the associated risks.

Figure 3

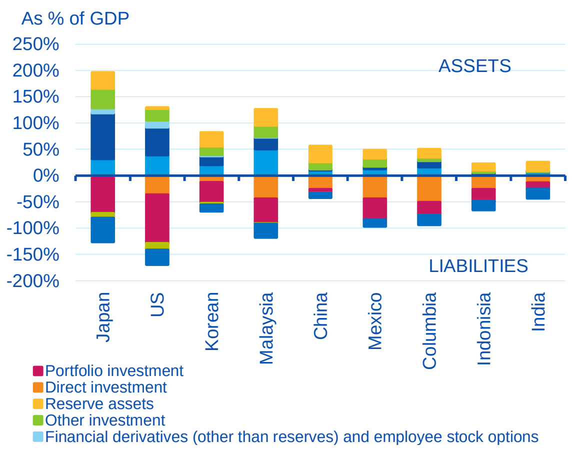
The capital outflow trend has not reversed since mid-2014



Source: BBVA Research and CEIC

Figure 4

Cross-Country comparison of international investment positions



Source: BBVA Research and CEIC

Strategies to engineer a currency soft-landing

To the authorities, it is a daunting task to navigate the rebalancing of China's international investment position. In particular, the rebalancing itself requires for more foreign reserves controlled by the public sector to flow to the hands of the private sector. On the other hand, the depletion of foreign reserves could aggravate people's concerns about the authorities' capacity and capability of FX market intervention and therefore add more depreciating pressure on the currency value. Nevertheless, we deem that the authorities have enough levers to engineer a soft-landing of the exchange rate and avoid disruptions through the course.

To date, the PBoC has implemented a number of policy initiatives in this respect:

First, the PBoC have restricted capital outflows by enforcing the existing regulations and attempted to attract more capital inflows by opening domestic markets to potential foreign investors. For instance, the PBoC, at the beginning of 2017, enhanced the monitoring of the FX usage by individual investors so as to prevent individuals' overseas investment in property, securities, life insurance etc. They have also tightened approval procedures of outward FDI by domestic firms. In the meantime, the authorities have opened the domestic bond market in a bid to allure more fund inflows from international investors. (Table 1)

Table 1

Selected measures to "encourage inflows and restrict outflows"

Time	Measures
February, 2016	The PBoC further opened the domestic bond market by allowing more qualified foreign investors to invest inter-bank bond market, in order to allure more fund inflows from international investors
October, 2016	The PBoC required that it is forbidden for Chinese residency to use UnionPay to buy insurance except for the tourism-related insurance. Moreover, each transaction of UnionPay cannot be excessed 50,000 USD.
November , 2016	The SAFE tightened the approval procedures of outward FDI by domestic firms, for instance, domestic firms, which want to move more than 5 million USD outside for OFDI, must report to SAFE and accept the authorities' censorship, compared with 50 million USD threshold previously.
January, 2017	Starting from January 1, 2017, the PBoC requires that individuals to reveal their usage when exchanging FX, although the USD 50,000 quota per year remains unchanged.
January , 2017	Starting from July 2017, banks and other financial institutions in China are required to report all domestic and overseas cash transactions of above RMB 50,000 (around USD 7,201), compared with RMB 200,000 previously. In addition, banks need to report any overseas transfers by individuals of USD 10,000 or more.
January, 2017	The State Council promulgated a series of policies to encourage foreign investment to China, including to create an environment for fair competition to foreign investors, to allow the local government to formulate attracting FDI measures, to protect the IPR of foreign firms, etc.

Source: BBVA Research and the website news

Second, the authorities changed the composition of the CFETS currency basket, to which the value of the RMB is referred. The new currency basket includes more currencies (such as the Korean won, the South African rand, the Mexican peso etc.) and has accordingly lowered the weights of USD. Now the CFETS currency basket includes 24 currencies compared to 13 previously. (Table 1) In doing so, the authorities increase the transparency and credibility of its current regime of the exchange rate. (Figure 5)

Table 2

The updated currencies and their weights in the new CFETS currency basket												
Currencies	**USD**	**EUR**	**JPY**	**HKD**	**GBP**	**AUD**	**NZD**	**SGD**	**CHF**	**CAD**	**MYR**	**RUB**
Current share (%)	22.4	16.34	11.53	4.28	3.16	4.4	0.44	3.21	1.71	2.15	3.75	2.63
Previous share (%)	26.4	21.39	14.68	6.55	3.86	6.27	0.65	3.82	1.51	2.53	4.67	4.36
Currencies	**THB**	**ZAR**	**KRW**	**AED**	**SAR**	**HUF**	**PLN**	**DKK**	**SEK**	**NOK**	**TRY**	**MXN**
Current share (%)	2.91	1.78	10.77	1.87	1.99	0.31	0.66	0.4	0.52	0.27	0.83	1.69
Previous share (%)	3.33	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

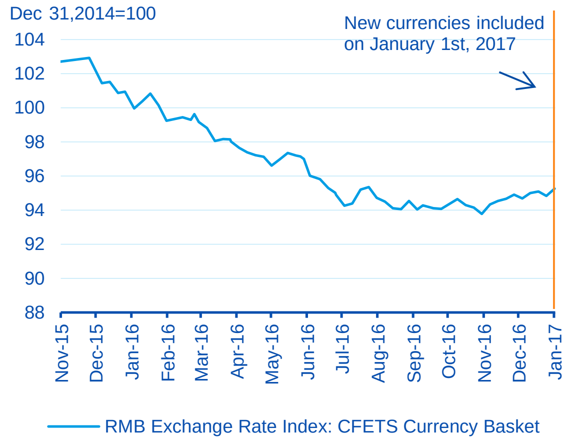
Source: BBVA Research and the PBoC announcement

Last but not least, the PBoC frequently intervened in the offshore CNH market by withdrawing liquidity from the market. As a result, the CNH interest rate in the offshore market surged to an extremely high level and gave a boost to the exchange rate. The PBoC has successfully implemented this strategy at the beginning of this year, which resulted in a strong rebound in the offshore CNH market. (Figure 6)

Apart from the abovementioned measures in place, the authorities could implement extra initiatives had the financial tension escalated. For example, the authorities can: (i) further tighten regulations under the capital account; (ii) guide market interest rates to a high level; and/or (iii) force exporters to sell their USD to the central bank. All in all, the risk of RMB depreciation is still manageable in the short-medium term.

Figure 5

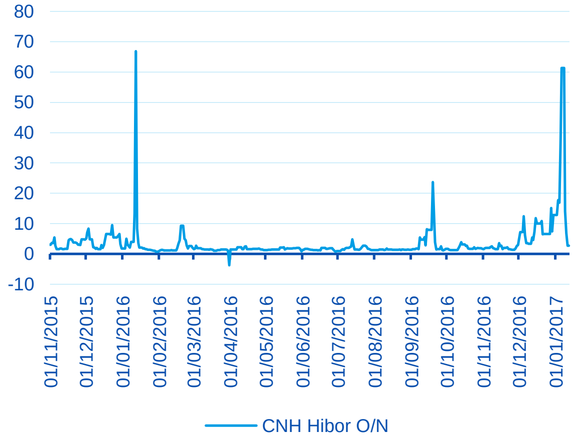
CFETS index seems to be stable after the PBoC included more currencies into the basket



Source: BBVA Research and Bloomberg

Figure 6

CNH overnight HIBOR hiked in January 2017, due to PBoC's intervention in offshore market



Source: BBVA Research and CEIC

"Clean Float" is the final destination of the RMB exchange rate regime

We expect that the regime of the RMB exchange rate will finally shift to a "clean float" as the authorities intended to do in August 2015. Financial turmoil following the unsuccessful reform could slow the pace of the transition but can't change the final destination. For a giant economy like China, a floating exchange rate regime is imperative because it enables the authorities to retain the independence of monetary policy and to cushion external shocks.

Moreover, a floating exchange rate regime can also constitute a solution to the increasing demands of Chinese residents' international diversification. With a flexible exchange rate, the currency value could adjust quickly to a level to attract capital inflows to balance the outflows. It means that the residents' demand for FX could be automatically met by new FX inflows rather than the depletion of foreign reserves.

In view of the advantages of the clean float, we expect that the authorities will attempt to let go the exchange rate as early as in the second half of 2018. The floating of the RMB will unavoidably accompany with the over-shooting of exchange rate while in the long run, the exchange rate will ultimately go back to the level warranted by the economic fundamentals.

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