Economic Watch

China | Understanding RMB exchange rate cycle

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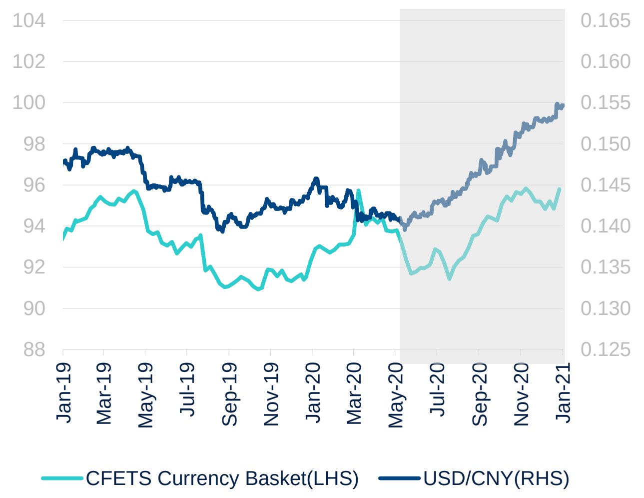
From the regional peak of 7.167 in May 2020 till now around 6.477, RMB to USD exchange rate seems to have been entering into a one-way appreciation trend with its accumulative appreciation for around 9.6%, gaining most of lost ground of the previous depreciation triggered by China-US trade war since 2018. Not only the RMB to USD spot rate, but also the RMB CFETS basket has displayed quite a similar pattern from 91.39 to around 96, accumulatively 5%. That means, CNY has not only outperformed USD, but also against a broader basket of currencies. (Figure 1) Currently, what ignites market's interest has been centering around three questions: What is the underlying logic of the ongoing RMB exchange rate appreciation trend? Is the trend sustainable as the global economy normalizes with vaccination advancement? And where will the RMB exchange rate go at end-2021, particularly will it break the psychological level of 6?

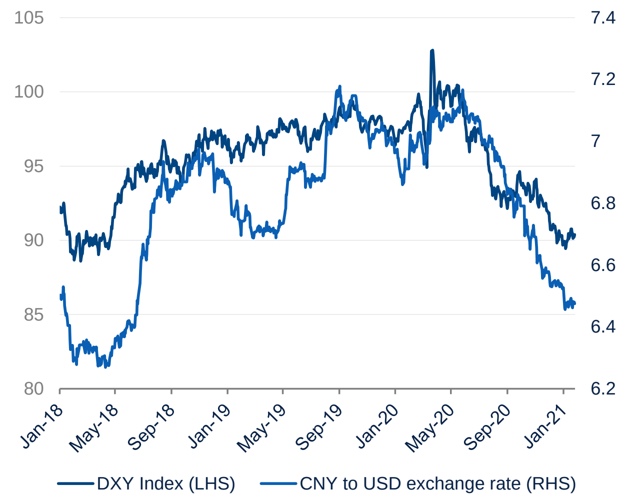
Notwithstanding, forecasting exchange rate in an academic sense is always deemed to be quite a challenging job, as in the international finance literature, the macro-theory-based empirical models always fail to beat even the naïve random-walk model to forecast currency. Nevertheless, macroeconomic models are always providing a good foundation to understand the exchange rate in the long term. However, this certainly cannot dispel the market interests of trying to understand the reasons behind the exchange rate movement, or to forecast exchange rate, for most of the time, in the short-term.

Figure 1. **RMB TO USD EXCHANGE RATE APPRECIATED ACCUMULATIVELY BY 9.6% SINCE MAY 2020**



Source: CEIC and BBVA Research

Figure 2. **A WEAK USD DXY INDEX IMPLIES A COMPARATIVELY STRONG RMB EXCHANGE RATE**



Source: CEIC and BBVA Research

Abundant reasons to explain the RMB trend in the past year…

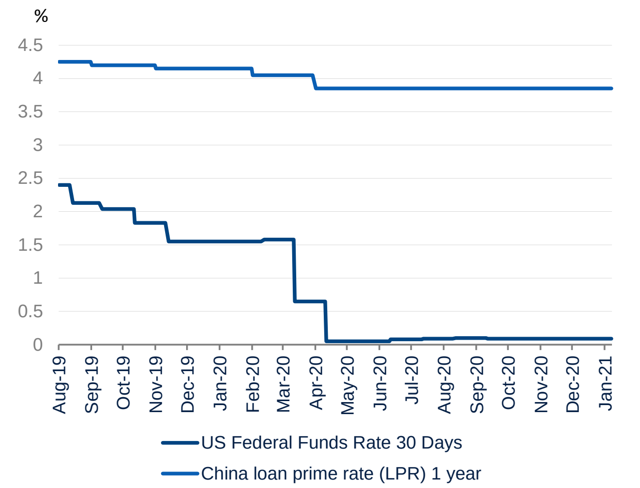
Actually, RMB to USD exchange rate has been dipped significantly in the first five months of 2020 to a historical low in May 2020, as China was to bear brunt of the unprecedented pandemic at the beginning of the year, together with the escalating and lingering China-US tensions. However, after its historical trough, stunningly and mesmerizingly, the RMB exchange rate started to rev up and come roaring back. Backward looking, the reasons seem to be straightforward and multi-faceted:

First, the growth divergence after China's "first-in, first-out" of the pandemic provides a sound economic fundamental for underpinning RMB exchange rate. Although theoretically, growth differential is a long-term factor in determining exchange rate, a short-term staggering change of growth by the pandemic shock should not be ignored. While other countries are still grappling with the coronavirus, China's growth seems to be the only silver lining and the only positive growth among the main economies in the world, achieving a complete V-shape recovery in 2020 Q4 and is anticipated to further bounce back from 2020 slump at 2.2% to 7.5% in 2021.

Second, USD DXY index, another important factor led to a buoyant RMB. From the regional peak in March 2020 till now, USD DXY has plunged significantly from 102.8 to 90, accumulatively around 12.5% depreciation. The underlying logic is quite straightforward: domestic political uncertainties before Biden's inauguration, economic blow by the pandemic flare-up, unprecedented ultra-easing monetary policy measures with over-expansion of central bank balance sheet and the ballooning fiscal deficit and public debt, all seem to be able to explain the reasons behind. That means, as USD has a large proportion in RMB basket, instead of saying how strong RMB is, we probably would rather say how weak the USD is. (Figure 2)

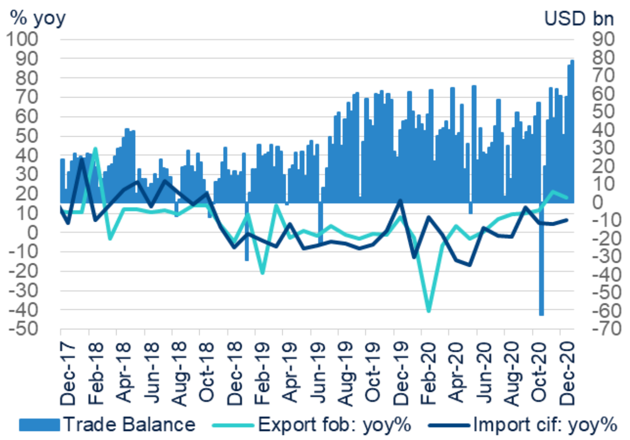
Third, interest rate divergence due to the central banks' sharp contrast behaviors during the pandemic time between China and the advanced economies also played a vital role. Main advanced economies' central banks continue to maintain the ultra-easing monetary measures until the global economy truly stabilizes. In particular, ECB expanded the PEPP program and recalibrated the terms on the TLTROs last December, preparing for economic recession. FED is expected to remain zero interest rate while officials recently downplayed the previous talk of QE Tapering. By contrast, in China, monetary policy normalization is the main stance of 2021 amid better-than-expected growth recovery, although without "a sharp turnaround". A neutral but accommodative monetary policy is anticipated this year, thus, the interest rate differential with advanced economies reached historical high. (Figure 3)

Figure 3. **A LARGE INTEREST RATE DIVERGENCE ALSO CONTRIBUTES TO A STRONG RMB EXCHANGE RATE**



Source: CEIC and BBVA Research

Figure 4. **CHINA'S EXPORTS REACHED RECORD-HIGH IN PANDEMIC TIME DUE TO THE SUBSTITUTION EFFECT**



Source: CEIC and BBVA Research

Fourth, the surprisingly resilient China's exports added further impetus to RMB exchange rate. For the past months, the market has been worried that exports momentum may fade as the world economy normalizes that will need fewer of goods from China it demanded when factories were shut elsewhere. Yet, the worry seems to be still a long way to materialize, as the world is grappling with the pandemic. Again, China's December trade data pointed to a continuing surge in exports, as the supply-side substitution effect persists coupled with the holiday demand, pushing the trade balance once again surged to a record high at USD 78.17 billion. In addition, the stunningly high trade balance, combined with the vast shrinking of service trade deficit due to almost zero outbound tourism etc., revs up the current account balance to another historical high since 2008, with Q2 and Q3 2020 reaching USD 110.2 billion and USD 92.2 billion, supporting a strong RMB exchange rate (Figure 4)

Will RMB to USD break the level of 6 at end-2021? Cautiousness and conservativeness are needed

Amid the ongoing ever-increasing RMB exchange rate, the market starts to talk about the possibility of "breaking 6" this year end. As we discussed at the beginning, due to the different model settings based on different understanding of the market, there is no "true" model, whether it is macro-based or technical analysis based, to forecast spot exchange rate or the equilibrium exchange rate; what we could have is only the "comparatively better" models in terms of producing a smaller forecasting error. Under this circumstance, instead of dwelling on the accurate number for RMB exchange rate at end-2021, an analysis of the possible changes of the above four factors in 2021 which used to support a strong RMB in 2020 might be more meaningful and promising. In addition, policy intentions of Chinese authorities could be also carefully considered.

Generally speaking, except for the factor 3 (historical high interest rate differentials) which might last for a longer period of time, other factors will be normalized as the global economy recovers with the vaccine roll-out, thus will not become a reason to support the RMB exchange rate any longer.

First, the economic fundamentals to support RMB in the past year such as growth divergence and exceedingly strong exports will sooner or later normalize together with the global economy recovery, although the timing is not certain yet. The continuing Covid-19 pandemic remains the prime risk to the global economy which is fraught of uncertainties of vaccine effectiveness and distribution. That means, the strong RMB momentum might only remain before the global economy normalizes.

Second, the USD softness should continue, but we do not expect straight-line depreciation or a collapse in the current uncertain world. Historically, the global recovery is indeed accompanied by a weakening USD. The USD tends to be soft when global trade improves as transactions between countries increase the velocity of USD outside the US, improving global liquidity conditions, which usually becomes a drag on the greenback. On the other hand, we have to also notice that the Fed's ultra-easing policies will continue in 2021, but with a smaller scale than that of 2020, which could support USD DXY to a certain degree. Recently, the FED officials even started to talk about QE Tapering, raising the market concern of an early exit of monetary support. If the tapering realizes with economic recovery, USD trend will have a large turnaround.

Third, the PBoC's intensions in maintaining a stable RMB exchange rate are important for the future RMB exchange rate prediction. China's monetary authorities are likely to stick to their pledge of keeping the CNY stable on a trade-weighted basis. They do not appear willing to let the CNY appreciate to the same extent as in 2020, as this could weigh on exports and destabilize capital flows, disparaging the ongoing growth recovery and financial stability in China.

In summary, instead of dwelling on the accurate figure of RMB to USD exchange rate at end-2021, we provide a framework with various factors to investigate what have determined and what will determine the RMB exchange rate trend based on economic fundamentals, central bank policy and global normalization etc. Altogether, we are cautious and conservative about “breaking 6” as most of dominant factors are not sustainable when the global economy normalizes. But a continuing soft appreciation trend before the global economy and advanced economy’s central bank policy normalization is indeed anticipated. Thus, a range of 6.3-6.4 probably is more promising than “breaking the psychological level of 6” at end-2021.

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