Economic Watch

China | Currency Outlook in 2H 2021: Two-way fluctuation is the main theme

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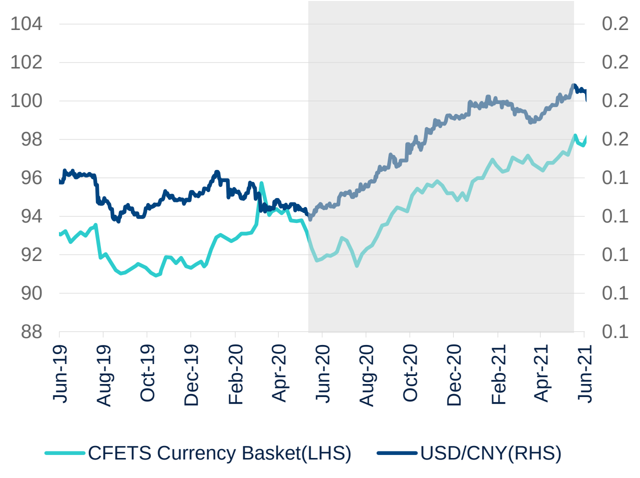
At end-May 2021, the RMB to USD exchange rate reached its three-year low since June 2018 at 6.368, stirring up market debates again. This round of strong currency appreciation went hand-in-hand with the surging global commodity prices, raising the market suspicion that the PBoC deliberately took use of RMB exchange rate appreciation to curtail the rocketing imports. However, the strong appreciation trend quickly reversed after the PBoC announced a rare hike of the foreign deposit reserve requirement ratio by 2% on May 31. The hike clearly signaled the PBoC's intention to limit the fast appreciation of the RMB exchange rate. At the same time, the USD DXY index, which historically has a strong correlation with the RMB exchange rate, also reversed its downward trend and picked up since end-May. As a result, the RMB to USD exchange rate quickly bounced back to 6.46 at end-June, around 1.44% depreciation from its previous low level at 6.368. (Figure 1)

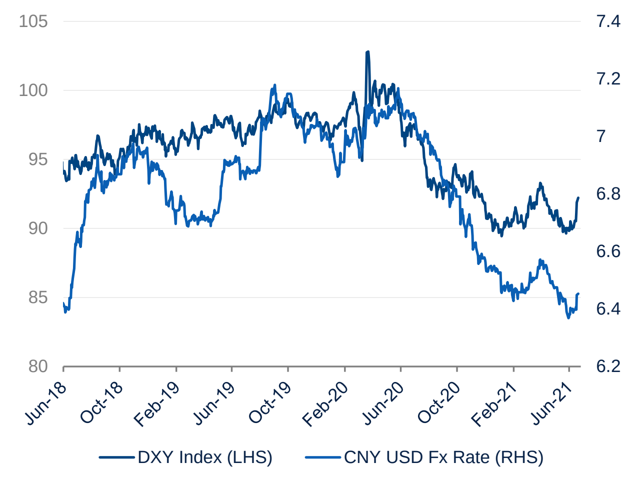
At the current stage, what intrinsically ignites the market's interests has been centering on three questions: What is the underlying logic of the RMB exchange rate appreciation trend from May 2020 to May 2021 and its sharp reversion since end-May 2021? Is the previous appreciation trend sustainable in 2H 2021 as the global economy gradually normalizes with vaccination advancement? And to which level will the RMB exchange rate go at end-2021, particularly will it break the historical low of 6.1 before the 2015 August 11 exchange rate reform or will it go back to the previous equilibrium around 6.4-6.5?

Figure 1. **RMB TO USD EXCHANGE RATE APPRECIATED ACCUMULATIVELY BY 10% FROM MAY 2020 TO MAY 2021**



Source: CEIC and BBVA Research

Figure 2. **HISTORICALLY, RMB TO USD EXCHANGE RATE HAS A STRONG CORRELATION WITH THE USD DXY**



Source: CEIC and BBVA Research

This note provides a macro analytical framework to understand the underlying logic of the recent RMB appreciation and its reversion recently. Under this framework, we forecast RMB to USD exchange rate trend in 2H 2021. The exchange rate forecasting is always deemed to be a challenging task. As in the literature of international finance, the macro-theory-based empirical models always fail to beat even the naïve random-walk model to forecast currency exchange rate, although macroeconomic models are able to provide a good framework to understand the exchange rate in the medium to long term. However, this certainly cannot prevent market participants from trying to understand the drivers behind the currency movement, or from forecasting forecast exchange rates from the short to long run.

Are the strong fundamentals that supported RMB appreciation in May 2020 to May 2021 sustainable in 2H 2021?

In retrospect to the Covid-19 pandemic period in China, the RMB to USD exchange rate dipped significantly in the first five months of 2020 to a historical trough in May 2020, as China bore the brunt of the unprecedented pandemic, together with the escalating China-US tensions. However, since May 2020, stunningly and mesmerizingly, the RMB exchange rate came roaring back from May 2020 all the way to May 2021. However, we believe that the macro fundamentals which used to support RMB exchange rate are not expected to be sustainable in the 2H 2021.

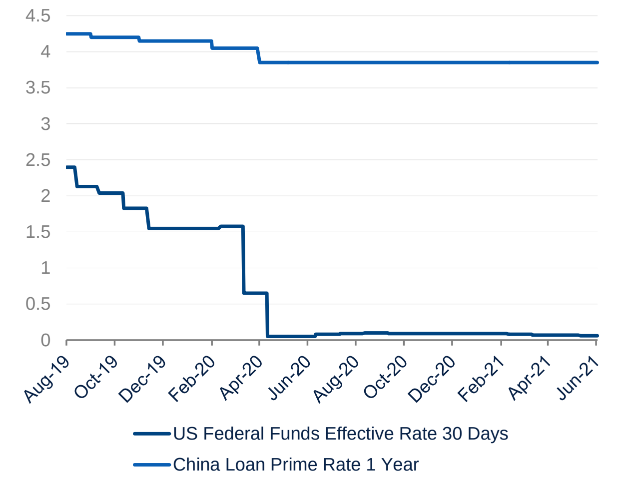
First, the growth divergence after China's "first-in, first-out" of the pandemic provides a sound economic fundamental for underpinning RMB exchange rate in the past year, but the divergence will gradually close amid global economic recovery. Although theoretically, growth differential is a long-term factor in determining the exchange rate, a short-term staggering change of growth by the pandemic shock should not be ignored. When other countries are still grappling with the coronavirus in 2H 2020, China's economy managed to engineer a positive growth among the main economies in the world. However, the growth gap will gradually narrow as the US recovery is gaining momentum this year.

Second, USD DXY index, another important factor leading to a strong RMB exchange rate in the past year, will reverse amid a higher US inflation expectation and potential FED QE Tapering. Historically, there has been a very tight relationship between RMB to USD exchange rate and the USD DXY index, as the USD takes up the largest share (around 26%) of the currency basket anchoring the RMB exchange rate. Namely, a stronger USD DXY Index indicates a weaker RMB to USD exchange rate and vice versa. Particularly, this correlation has become even stronger since October 2019. (Figure 2) From the regional peak in March 2020 till end-May, USD DXY has plunged significantly from 102.8 to 90.14, accumulatively around 12% 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.

However, starting from end-May 2021, the USD DXY index reversed its depreciation trend due to the recent strong inflation expectation, rising long-term bond yield and the FED's initially tentative QE Tapering talk. That means, given the high correlation between RMB to USD exchange rate and USD DXY, a USD DXY reversion is definitely leading the RMB exchange rate reversion.

Third, the large interest rate difference, resulting from the central banks' sharply contrast behaviors during the pandemic time between China and the advanced economies, is not sustainable in 2H 2021 amid as the FED is gearing up to start QE Tapering . Main advanced economies' central banks maintained the ultra-easing monetary measures during the pandemic time. By contrast, in China, monetary policy normalization started quite early after the pandemic fully controlled in May 2020. The monetary policy normalization step in China was almost one year earlier than the US, while the latter has just started the tentative QE Tapering talk recently. (Figure 3) Although the benchmark interest rate divergence in two countries remained the same, the ten-year bond yield difference has already shrank significantly in the recent month, reflecting the market has already priced in the FED's QE Tapering in the bond market. (Figure 4) Again, it indicates the interest rate difference is set to narrow in 2H 2021.

Figure 3. **INTEREST RATE DIVERGENCE ALSO CONTRIBUTES TO A STRONG RMB EXCHANGE RATE, BUT IT IS NOT SUSTAINABLE**



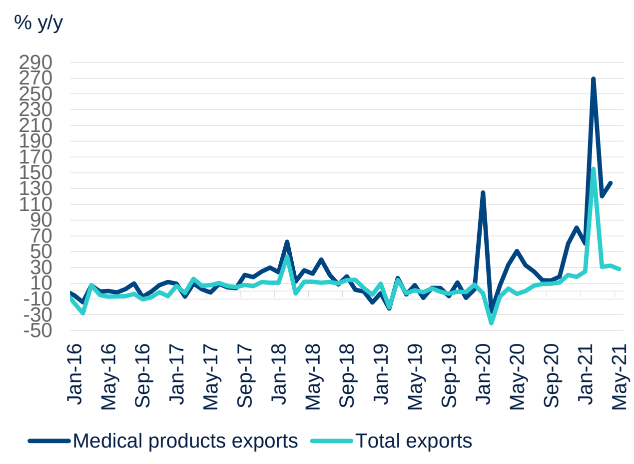
Source: CEIC and BBVA Research

Figure 4. **A GRADUAL CLOSING GAP BETWEEN THE US AND CHINA'S 10-YEAR BOND YIELD**

Source: CEIC and BBVA Research

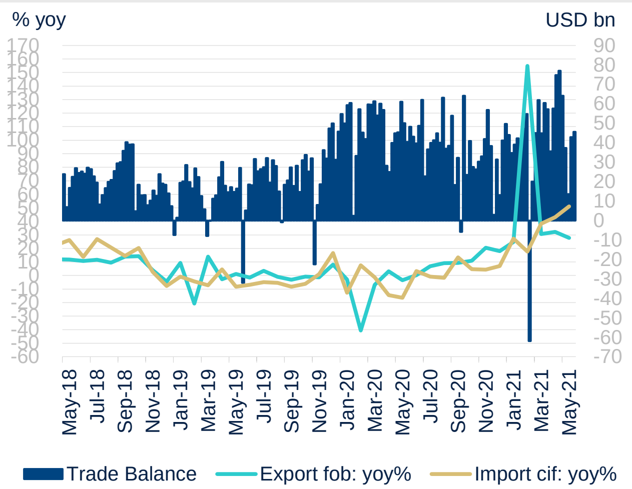
Finally, the gradual shrinking of trade balance and current account surplus will soften the RMB exchange rate momentum. There are two main factors leading to the trade balance shrinking from the perspectives of both exports and imports. First, the surprisingly resilient China's exports which added further impetus to RMB exchange rate in the past year cannot be sustainable amid global normalization. For the past months when Chinese exports broke the records from month to month, the market has been worried that its momentum may fade as the world economy normalizes. It will take some time for this scenario to materialize but it will come eventually. In addition, the vast shrinking of service trade deficit due to almost zero outbound tourism etc. in the past year will also gradually rev up as more and more countries started to open their borders for stimulating their tourism sector. (Figure 5)

Figure 5. **CHINA'S EXPORTS REACHED RECORD-HIGH IN PANDEMIC TIME BUT WILL GRADUALLY NORMALIZE**



Source: CEIC and BBVA Research

Figure 6. **SOARING COMMODITY PRICE LED TO A HIGH IMPORTS, SHRINKING THE TRADE BALANCE**



Source: CEIC and BBVA Research

The second factor is from the import side. The recently soaring commodity price, together with the deteriorating terms of trade and shrinking trade balance, will add more depreciation pressure on RMB exchange rate. The recent high global commodity price largely pushed up China's imports value. For instance, China's May imports growth again broke the record of the previous month's reading of 43.1% y/y to 51.1% y/y, constituting the fastest year-on-year growth since 2011 January. It was driven by the surging global commodity prices rather than by domestic pent-up demand, as the import volume has not been increased at all. (Figure 6) It is anticipated that a continuing surge of imports will shrink China's trade balance thus current account in 2H 2021, and exacerbate China's terms of trade, adding depreciation pressure on RMB exchange rate.

Where will RMB exchange rate go at end-2021? Cautiousness are needed

To predict the RMB to USD exchange rate at end-2021, instead of dwelling on the accurate number for RMB exchange rate at the year end, a macro analytical framework is more relevant to understand the underlying logic and make the forecasting. Beyond the macro fundamentals we mentioned in the above section, China-US relations, global capital flows and most importantly policy intentions of Chinese central banks on exchange rate also need to be carefully considered and evaluated.

As we mentioned above, the macro fundamentals which used to support a strong RMB exchange rate from May 2020 to May 2021 will get reversed and gradually normalized in the 2H 2021. To briefly summarize here, China's growth divergence with the advanced economies will be narrowed amid global recovery; the USD DXY index which goes hand-in-hand with RMB exchange rate will reverse its depreciation trend as the FED tapering gradually materializes; large interest rate divergence due to the central banks' sharp contrast behaviors between China and the advanced economies is also not sustainable, neither will be China's stunningly increasing exports, current account balance and portfolio inflows in 2020; and finally, the recent soaring commodity price, together with the deteriorating terms of trade, will add more depreciation pressure on RMB exchange rate.

Beyond the above macro fundamentals reversion, what we should take into consideration in predicting the RMB to USD exchange rate in 2H 2021 also includes at least three more perspectives: China-US relation, global capital flows and most importantly the PBoC's policy stance on the RMB exchange rate.

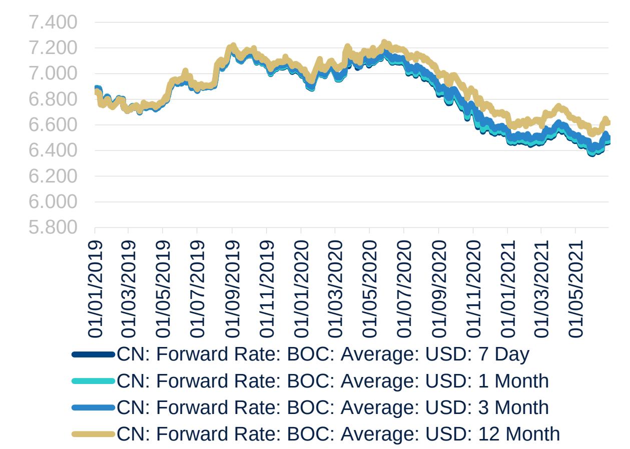
First, the uncertainties of China-US relationship will add more fluctuations to the RMB exchange rate. The confrontations between China and the US in the past months escalated, on a number of issues including Xinjiang's human rights, Hong Kong and Taiwan issue, technology war etc. On the other hand, there might also be some improvements of the bilateral relationship which might add impetus of the RMB exchange rate in the future. For instance, the US might reduce the tariff on China imposed in the Trump's time as the US is experiencing high inflation expectation, labor shortage and supply bottleneck. Reducing the tariff will indeed help the US to moderate its inflationary pressure.

Second, global capital flow is also an important factor to determine RMB exchange rate in the post-crisis QE Tapering period. Theoretically, in the discussion and announcement period of the FED QE Tapering, taking the historical lessons of post Global Financial Crisis time, emerging markets' currencies will depreciate while the capital flows out from the emerging markets to the advanced economies to pursue the higher yields. However, at the current stage, the pace and the timing of the capital outflows from EMs still highly depends on the FED's QE Tapering decisions which is still full of uncertainties. On the other hand, due to China's tightly controlled capital account, China's bond yield is not synchronized with the emerging markets and the advanced economies empirically. That means, China's stunning economic performance and opening-up policies might still reverse the theoretical capital movement pattern in the post-crisis time.

Third, the PBoC's intention to maintain a stable RMB exchange rate with two-way fluctuation around its equilibrium level is important for the future RMB exchange rate prediction. At end-May 2021, the historical low RMB to USD exchange rate raised a lot of concerns of Chinese central bank. In order to lead the market expectation of a two-way fluctuation of RMB exchange rate, the central bank governor and other high level government officials have communicated with the market intensively on their policy stance on the currency. On May 23, the deputy Governor of the PBoC Guoqiang Liu announced the RMB exchange rate will depend on the supply-demand of the foreign exchange market and the international financial markets, and will display a two-way fluctuation pattern in the future. On May 27, in the 7th meeting of China's Foreign Exchange Market Self-discipline Mechanism Commission, the PBoC again pointed out that the PBoC will not take use of RMB exchange rate as the tool to counter the impact of global commodity price soaring (appreciation) or to stimulate the exports (depreciation).

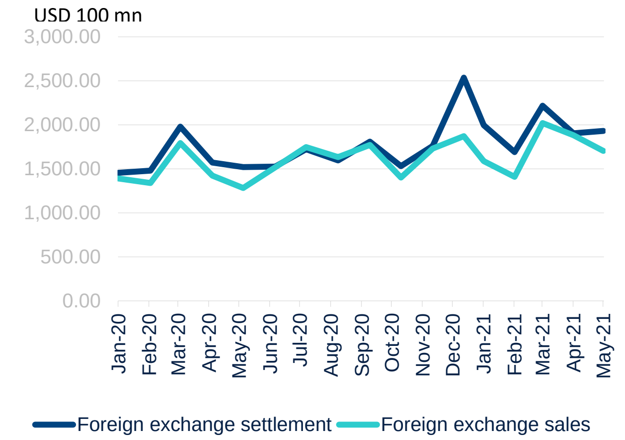
Based on the above signals from the PBoC, we could conclude that the PBoC is willing to see the RMB exchange rate display some two-way fluctuation around its equilibrium level, and they will certainly intervene into the FX market if the RMB exchange rate displays some one-way trending, either one-way appreciation or depreciation. That means, 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, stall the ongoing growth recovery and cause financial instability in China.

Figure 7. **RMB TO USD FORWARD RATE PRICED IN OUR PREDICTION ALREADY**



Source: CEIC and BBVA Research

Figure 8. **CHINA'S FOREIGN EXCHANGE SETTLEMENTS ARE HIGHER THAN THE FX SALES IN RECENT MONTHS**



Source: CEIC and BBVA Research

In summary, instead of dwelling on the accurate prediction figure of RMB to USD exchange rate at end-2021, we provide a macro analytical framework to investigate what have determined and what will determine the RMB exchange rate trend based on economic fundamentals and central bank policy movements. Altogether, we believe that RMB to USD exchange rate will go back to the 6.4 to 6.5 range at end-2021 and will display more two-way fluctuations. A soft depreciation trend in 2H 2021 is indeed anticipated. Some forward-looking indicators such as RMB to USD forward rate and the FX settlement and sales figures seem to have priced in this kind of trend already. (Figure 7 and 8) More importantly, the PBoC will maintain the two-way fluctuation of the RMB exchange rate around its equilibrium level to sustain financial market stability in the future, and will certainly intervene in the FX market if the one-way appreciation or depreciation trend materializes.

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