Economic Watch

China | 2022 RMB outlook: getting worse before it gets better

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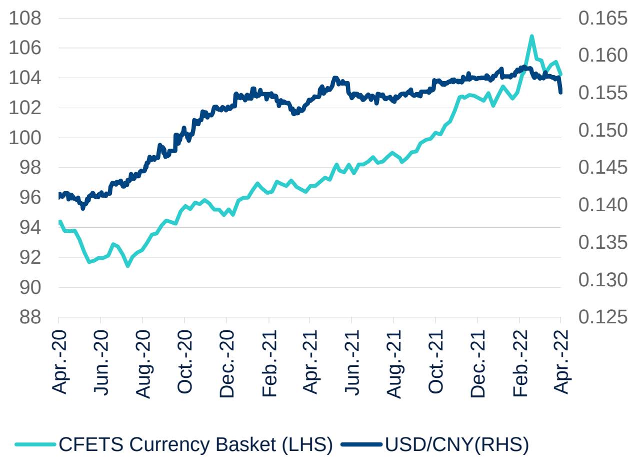
Sharp RMB depreciation has raised market concerns...

Recently, the RMB to USD exchange rate experienced a bout of fast depreciation from 6.367 to 6.8 just within a couple of weeks, which aggravated investors' concerns over the potential financial market turmoil in China's market. However, the recent sharp RMB depreciation is in line with our expectations at the beginning of the year amid the unsynchronized monetary policy cycle between China and the US. (Figure 1 and 2) A confluence of macroeconomic fundamentals are indeed behind this round of RMB sharp depreciation, including the diverging monetary policy between China and the US, the recent Omicron flare-ups and Shanghai lockdown, the shrinking China's current account and accelerating capital outflows, etc.

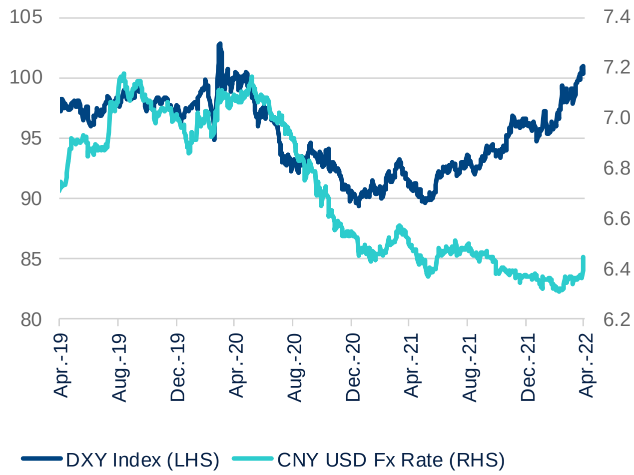
The currency depreciation is not a special case for China. By contrast, it is going hand-in-hand with the tumbling Japanese Yen which has depreciated accumulatively by 12.3% since the beginning of 2022 as both countries have diverging monetary policy against the US FED's aggressive interest rate hike and central bank balance sheet reduction. This round of RMB depreciation is also going hand-in-hand with the ongoing competitive currency depreciation among Asian economies including Philippines, Korea, Taiwan, Thailand and India etc. in a bid to sustain their export competitiveness amid FED's tightening cycle. (Figure 3 and 4)

Figure 1. **RMB EXCHANGE RATE HAS DEPRECIATED ACCUMULATIVELY BY 3.7% TOGETHER WITH CFETS BASKET**



Source: CEIC and BBVA Research

Figure 2. **HISTORICALLY, A STRONGER USD DXY INDEX IMPLIES A COMPARATIVELY WEAKER RMB**



Source: CEIC and BBVA Research

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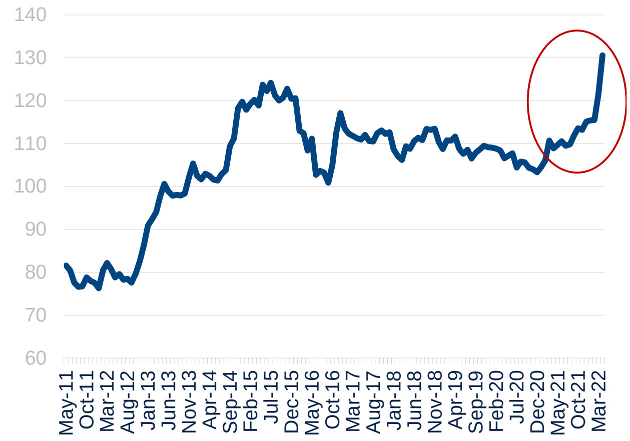
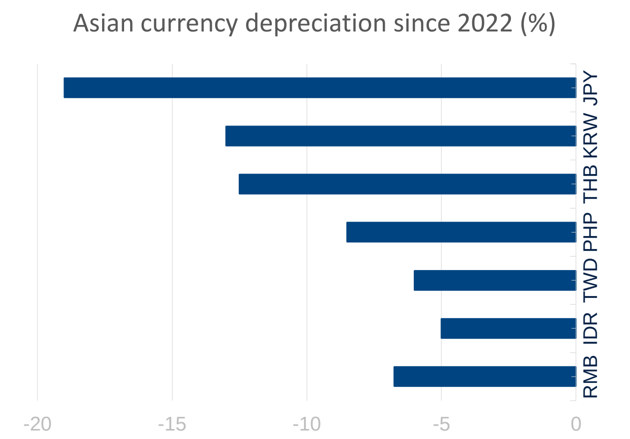
Figure 3. **RMB DEPRECIATION IS GOING HAND-IN-HAND WITH JAPANESE YEN DEPRECIATION…**



Source: CEIC and BBVA Research

Figure 4. **…ALSO, TOGETHER WITH CURRENCY COMPETITIVE DEPRECIATION AMONG ASIAN ECONOMIES**



Source: CEIC and BBVA Research

… while its driving factors include both global and domestic ones

Global and domestic economic fundamentals are able to sufficiently explain this round of RMB depreciation:

First, the unsynchronized monetary policy between China and the US is the prime reason for this round RMB depreciation. In face of the record high inflation, the US FED is speeding up their steps more aggressively on interest rate hike and central bank balance sheet reduction to compensate their previous underestimation of the US inflation outlook. In the FED FOMC meeting on May 3-4, FED hiked interest rate by 50 bps, the largest hike for the past decade and they will continue 50 bps hikes in the following two FED FOMC meetings. By sharp contrast, in China, the main monetary policy stance in 2022 forcefully remains expansionary amid a series of Omicron flare-ups and followed lockdowns in a number of major cities including Shanghai. The PBoC has already conducted 2 LPR cuts and 3 RRR cuts recently. The unsynchronized monetary policy cycles between China and the US has led to a reversal of their 10-year treasury bond yields, adding pressure on the RMB value. (Figure 5 and 6)

Second, China's growth slowdown also contributes to the recent RMB sharp depreciation. Although theoretically, growth is a long-term factor in determining exchange rate, a short-term staggering change of growth by the recent pandemic shock and Shanghai lockdown in China should not be ignored. Unlike the previous two years, in 2022, when the US economy has already normalized from the pandemic with a good-shape labor market, China is still grappling with the coronavirus with lockdown measures imposed in Shanghai and other infected cities. Taking into account the adverse spillover effects of Shanghai lockdown and the supply chain disruptions, we lowered our China GDP forecast from 5.2% to 4.5% in 2022.

Third, China's shrinking current account and dipping exports growth in 2022 also led to RMB exchange rate depreciation. For the past two years, when Chinese exports growth broke the records month after month, the market worried that its momentum may fade as the world economy normalizes. This concern seems to be materialized recently based on the March exports data outturns which tumbled from two-digit growth to 3.9% y/y. (Figure 7 and 8)

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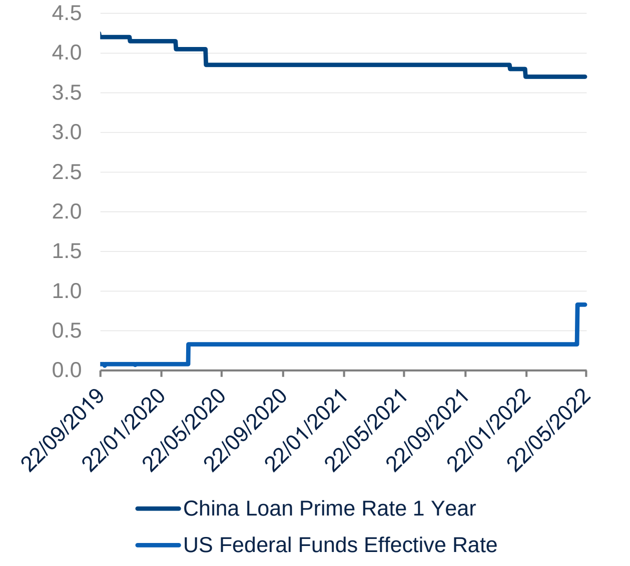
Figure 5. **SHRINKING INTEREST RATE DIVERGENCE ALSO CONTRIBUTES TO A STRONG RMB EXCHANGE RATE (%)**

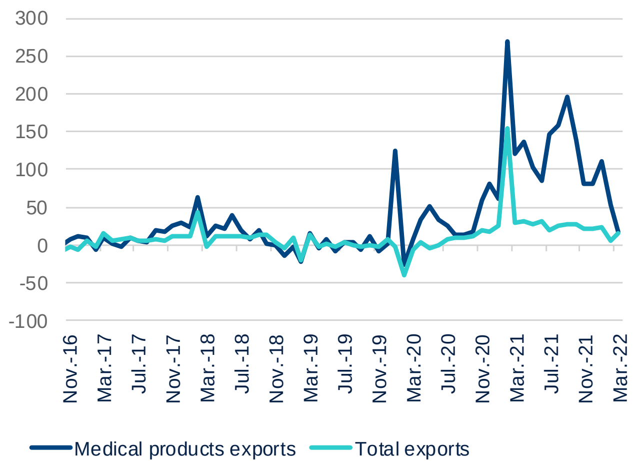


Source: CEIC and BBVA Research

Figure 6. **A REVERSION OF THE US AND CHINA'S 10-YEAR BOND YIELD HAPPENED IN APRIL**

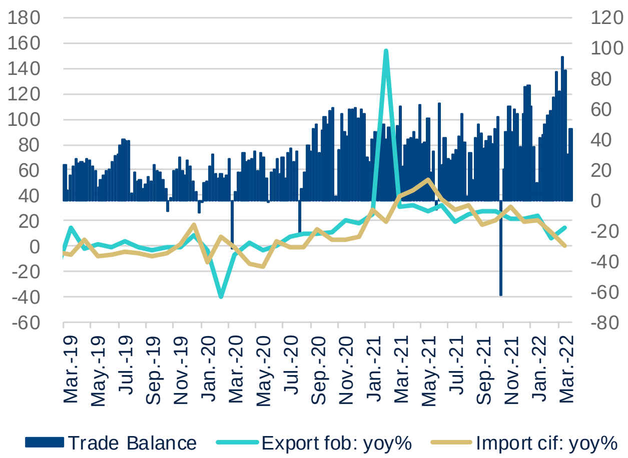
Source: CEIC and BBVA Research

Figure 7. **CHINA'S EXPORTS REACHED RECORD-HIGH IN PANDEMIC TIME BUT GRADUALLY NORMALIZES (%)**



Source: CEIC and BBVA Research

Figure 8. **SHRINKING THE TRADE BALANCE ALSO CONTRIBUTE TO RMB DEPRECIATION**



Source: CEIC and BBVA Research

Finally, the Ukraine-Russia war and the continuous China-US financial and tech war dampen global investors' sentiment and the perception of China, leading to capital flights and stock market sell-off, weighing on exchange rate. The Ukraine-Russia war, together with the threat from the US if China helps Russia militarily or economically, the sanctions will extent to China, is part of the reason, but it cannot explain the massive capital flights completely. The more direct reason is the recent two moves of the regulatory storms from the US so that China's stocks listed in the US face delist risk. In particular, the US PCAOB wanted Chinese listed stocks in US to hand over the audit documents to the US which is forbidden according to China's regulation. In addition, the US HFCAA also requires Chinese companies to disclose sensitive data and information to be listed in the US stock market while Chinese

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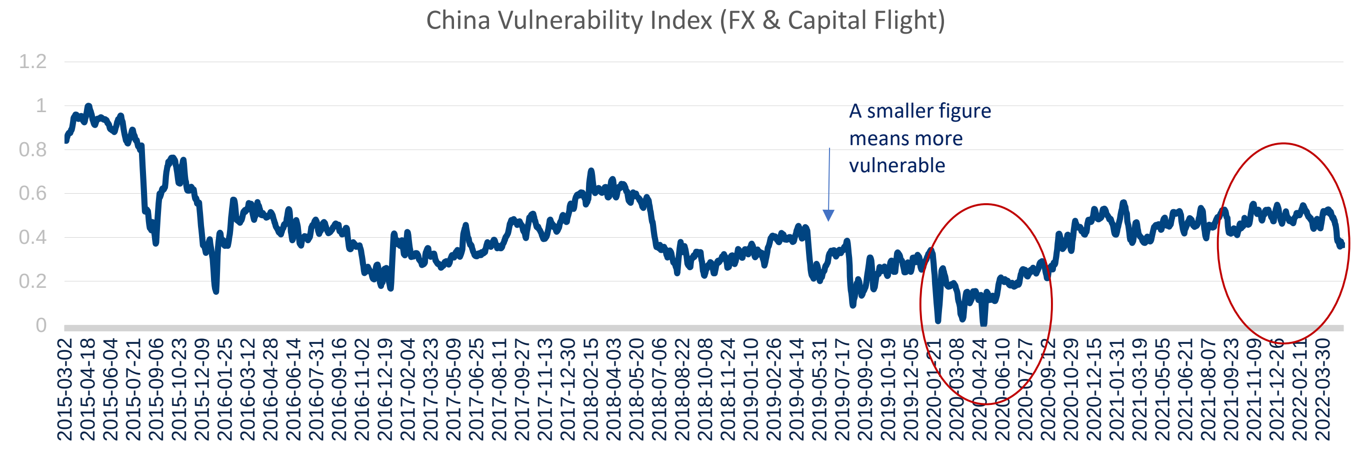
authorities never agree on this. These two moves directly triggered sell-off of China-related stocks not only in US and HK market, but also in the onshore market, leading to large-scale portfolio outflows and RMB depreciation.

Will this round of RMB depreciation lead to systematic financial instability risk?...

By applying Big Data methodology to construct China's Vulnerability Index (FX & Capital Flight), we try to answer this question that this round of RMB depreciation is different from that of 2020 or 2015.

Our China FX and Capital Flight Vulnerability Index include both hard data and media sentiment data. Although it declines recently but still better than the beginning of 2020 when the pandemic started in Wuhan and 2015 when August 11 RMB exchange rate reform was pressed ahead. The Index shows no panic so far because the RMB depreciation is quite synchronous with other currencies such as Euro and Yen and other emerging market currencies amid the US FED aggressive tightening measures. (Figure 9)

Figure 9. **BIG DATA CHINA VULNERABILITY INDEX (FX AND CAPITAL FLIGHT)** (%)



Source: GDELT and BBVA Research

…more importantly, Chinese authorities have a series of counter-cyclical tools to maintain RMB exchange rate stable

Policy intentions of Chinese central banks on exchange rate need to be carefully considered and evaluated as well. Indeed, we agree that the market-driven RMB exchange rate depreciation may help to stimulate China's exports growth which used to be a main growth engine during the pandemic time but dipped significantly recently due to a decelerating global demand. However, we have to, at the same time, realize that the PBoC does not want to see a fast-speed depreciation of RMB which may lead to financial market turmoil, a weakening sentiment and market sell-off.

As China has a comparatively closed capital account and strict capital control under managed floating exchange rate regime, the PBoC and SAFE has a series of policy weapons in its arsenal to lead the direction of RMB exchange rate and sustain RMB exchange rate stability.

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The central bank's first step recently to curb RMB dipping was on April 25th, when the PBoC announced to cut the reserve requirement rate for foreign currencies from 9% to 8% in mainland China, which helped to expand foreign currency liquidity thus support RMB exchange rate. It indicates a clear signal that the central bank is intervening in the RMB market to circumvent one-way depreciation.

Except for the RRR cuts for foreign currencies, the PBoC has many other policy tools to curb RMB depreciation going forward: (i) The PBoC may increase the reserve required rate for foreign currencies in the business of Forward Settlement and Sale of Foreign Exchange. Like what the PBoC did in 2018 August, by increasing this rate, it could curb the sell-off speculation behaviors in FX market; (ii) The PBoC could also increase the macro-prudential coefficient in cross-border financing business, which helps to increase the foreign currency supply in the cross-border financing business; (iii) The PBoC may re-start the counter-cyclical factor which they applied previously when the RMB exchange rate was in the downward trend. By applying counter-cyclical factor in the RMB mid-price setting, it could support RMB exchange rate; (iv) In the cross-border capital flow regulation, the PBoC could tighten the scrutiny on ODI and individual cross-border flows and control the quota of exchanging RMB to foreign currencies at the individual level. (v) The PBoC could also issue central bank notes in the offshore market in order to withdraw RMB liquidity, in a bid to support offshore and ultimately onshore RMB exchange rate.

Where will the RMB exchange rate go in the future?

Looking ahead, RMB depreciation is unavoidable in the short term amid the contrast monetary policy measures between China and the US. We believe there is a chance for the RMB to fall above 7 in the coming months because some of the negative factors stated above will continue and even deteriorate in the short run. However, these factors are likely to improve in the second half of the year.

For instance, the market might get used to the Ukraine-Russia war even if it won't stop soon, that means, the market has already priced in the effect of war into their RMB pricing model. In addition, in 2H, China may come out of Covid-19 situation and end the lockdown measures. Thus, the economic activities may bounce back which are supported by the easing monetary and fiscal measures that the authorities have conducted to boost growth, which will support RMB exchange rate. Under these circumstances, we predict the RMB to USD exchange rate at end-2022 to be 6.8. That means, there will be some bounce-back at end-2022 from the current RMB sharp depreciation.

In the medium-to-long term, the PBoC is willing the RMB exchange rate to display some two-way fluctuations around its equilibrium level, and they will certainly intervene in 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.

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