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Economic Watch

China | RMB exchange rate sharp depreciation amid diverging monetary policy

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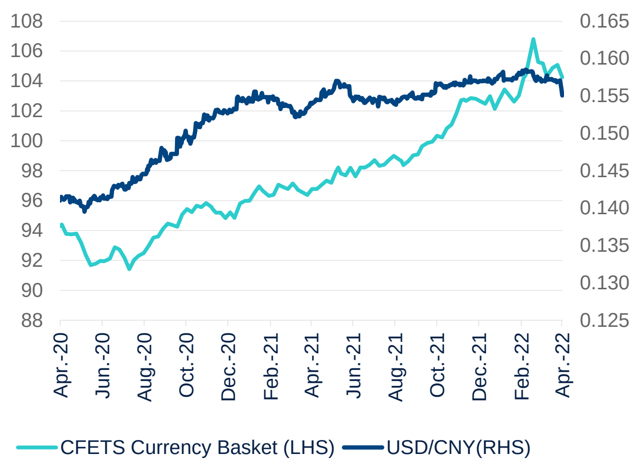
May 3, 2022

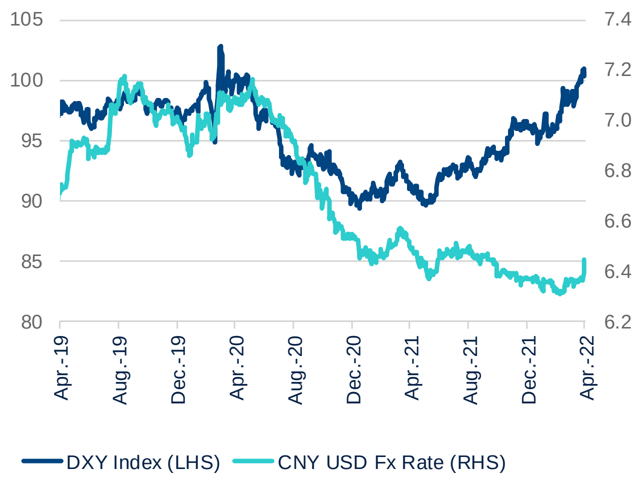
Recently, the RMB to USD exchange rate has devastatingly depreciated by 3.7% accumulatively within only two weeks from 6.367 to 6.6085, posing financial market turmoil together with stock market sell-off and largely attracting the global market's attentions. However, the recent sharp RMB depreciation is indeed in line with our expectations at the beginning of the year amid the unsynchronized monetary policy cycle between China and the US, as we predicted RMB to USD exchange rate will depreciate to 6.6 at end-2022. Macroeconomic fundamentals significantly drove this round of RMB 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. Notwithstanding, sharp RMB exchange rate is not a special circumstance in China only, indeed, we need to also pay attention that it is going hand-in-hand with the Japanese Yen dipping, as both countries have contrast monetary policy against the US FED aggressive interest rate hike. (Figure 1 and 2)

Figure 1. **RMB EXCHANGE RATE 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

First, the recent unusual reverse of China-US 10-year bond yield due to the central banks' sharp contrast behaviors led to the sharp RMB depreciation. (Figure 3 and 4) In front of the record high inflation, the US FED is trying to speed 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 coming FED FOMC meeting in May 3-4, the market unanimously forecasted the FED will hike interest rate by 50 bps, the first hike in such a large extent for the past decade. By sharp contrast, in China, the main monetary policy stance in 2022 is expansionary amid high growth pressure this year, stemming from Omicron flare-ups and Shanghai lockdown. The PBoC has already conducted 2 LPR cuts and 3 RRR cuts recently, displaying an unsynchronized monetary policy cycle with

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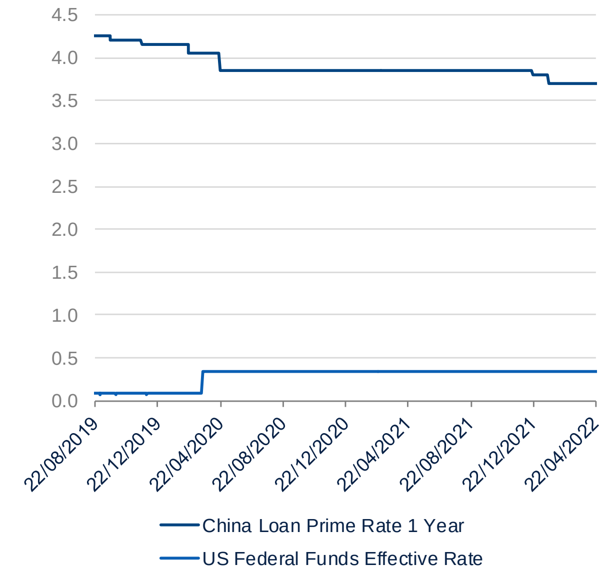
the US FED. As we know since China has much higher equilibrium growth rate than that of the US, China's bond yield has always and naturally been higher than that of the US. However, recently, the 10-year bond yield between China and the US appeared reversed pattern, the first time for the past decades, reflecting the sharp monetary policy divergence between the two countries in 2022.

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

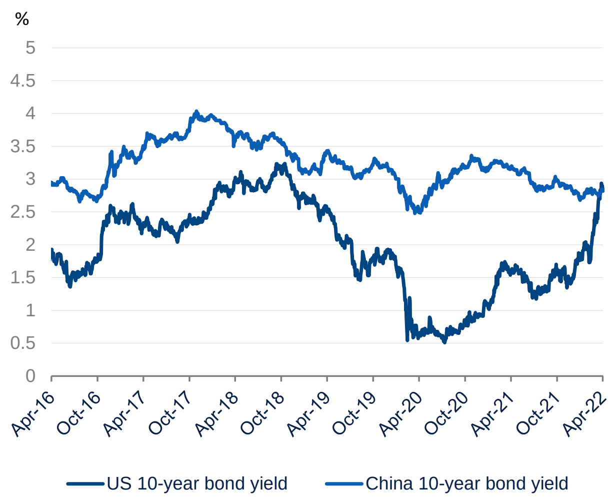
Third, the recent accelerating capital outflows from China and the Chinese stock market sell-off also expedite the RMB exchange rate depreciation. There are different tiers of reasons of this round of capital outflows and at the same time we have to realize that the capital outflows are going hand-in-hand with the recent intensive sell-off of HK stock market, Chinese stocks listed in the US exchange and their adverse spillover to the onshore stock market. (i) 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. (ii) The US tightening measures and contrast monetary policy together with the growth slowdown, as we explained, interacted with the capital outflows. (iii) 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 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.

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



Source: CEIC and BBVA Research

Figure 4. **A REVERSION OF THE US AND CHINA'S 10-YEAR BOND YIELD HAPPENED IN APRIL**



Source: CEIC and BBVA Research

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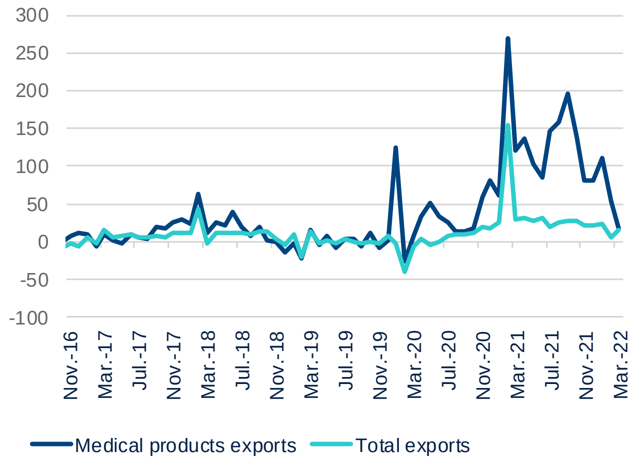
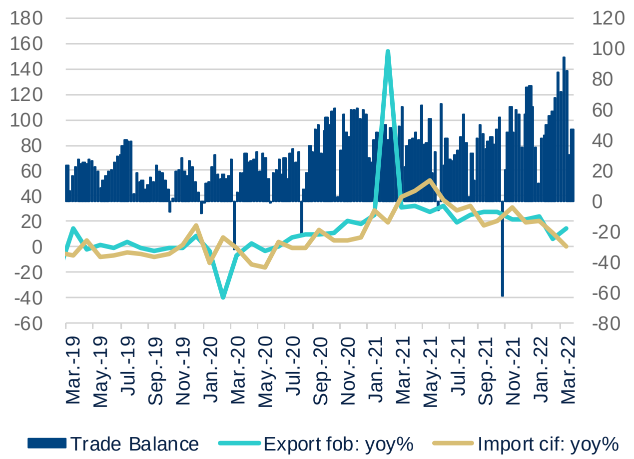
Finally, the shrinking current account in 2022 also leads to RMB exchange rate depreciation amid global economic recovery. For the past months when Chinese exports broke the records from month to month, the market has been worried that its momentum may fade as the world economy normalizes that will need fewer goods from China it demanded when factories were shut elsewhere. This kind of worry seems to be materialized recently based on the March exports data outturns. That means, the gradual current account normalization in China will lead to the RMB exchange rate depreciation. In addition, the competitive depreciation among Asian economies amid JPY and RMB depreciation cannot be excluded. (Figure 5 and 6)

Figure 5. **CHINA'S EXPORTS REACHED RECORD-HIGH IN PANDEMIC TIME BUT GRADUALLY NORMALIZES (%)**



Source: CEIC and BBVA Research

Figure 6. **SHRINKING THE TRADE BALANCE ALSO CONTRIBUTE TO RMB DEPRECIATION**



Source: CEIC and BBVA Research

Looking forward, depreciation is unavoidable amid the contrast monetary policy measures between China and the US when we talk about RMB exchange rate trend till end-2022. We predict the RMB to USD exchange rate at end-2022 to be 6.6 with some upside risk, while a macro analytical framework is more important to understand the underlying logic and make the forecasting. In addition, policy intentions of Chinese central banks on exchange rate need to be carefully considered and evaluated. For instance, the PBoC on April 25th announced to decrease the reserve requirement rate for foreign currencies in mainland China, indicating a clear signal that the central bank is intervening in the recent RMB depreciation to circumvent one-way depreciation.

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