Economic Watch

China | 2023 RMB exchange rate outlook: should we worry about the recent sharp depreciation?

Jinyue Dong and Le Xia

July 11, 2023

Recent sharp RMB depreciation has raised lots of market concerns

Recently, the RMB to USD exchange rate has experienced a bout of fast depreciation from regional peak 6.7 to 7.23, accumulatively 8% depreciation since the beginning of 2023, which aggravated investors' concerns over the potential financial market turmoil in China's foreign exchange market. (Figure 1 and 2)

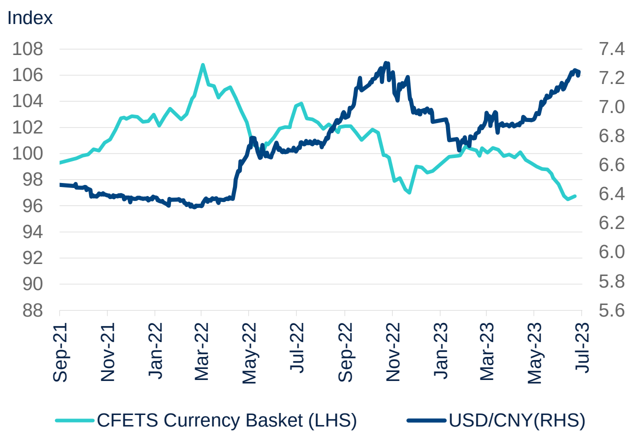
In particular, the recent RMB sharp depreciation happened as the FED interest hike approached to end, so that the market actually expected RMB appreciation in the rest of this year, but the reality went completely the other way around. Bloomberg consensus in May predicted RMB will reach 6.7-6.8 as median value at end-2023. It has been the first time in the past years to see such a divergence between the market consensus and the actual RMB trend. Thus, understanding the underlying reasons behind the recent depreciation is crucial to dispel the market worries.

A confluence of macroeconomic fundamentals indeed is behind this round of RMB sharp depreciation, but chief among them is the unsynchronized monetary policy between China and the US. The market expects FED will have another two hikes in the rest of the year although previously believed the hike would come to a halt after May; actually, 2-year US Bond yield recently peaked to historical high is the best illustration for the market expectation change. (Figure 3) On the other hand, the PBoC unexpectedly cut policy rate in June in a bid to stimulate sluggish economic growth, further enlarging US-China interest rate difference.

Other reasons also include weaker-than-expected Q2 economic activities as the reopening effect faded, shrinking current account due to weak external demand amid global economic slowdown, weak market sentiments and accelerating capital outflows, etc.

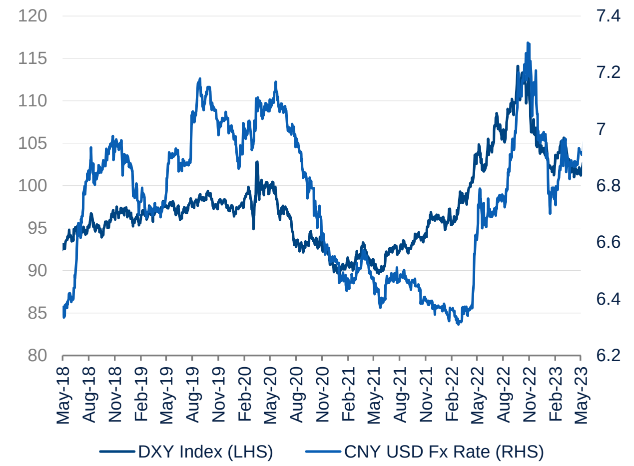
However, we need to realize that the recent depreciation is not a special phenomenon in China. The changing of US FED interest rate hike expectation dragged down almost all of the non-USD currencies, among them, RMB to USD exchange rate was definitely not the worst case. In particular, the significant FED hike expectation change led RMB exchange rate to go hand-in-hand with the tumbling Japanese Yen, and other emerging market currencies recently. In addition, it 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 sluggish external demand. (Figure 4)

Figure 1. **RMB EXCHANGE RATE HAS DEPRECIATED ACCUMULATIVELY BY 8% THIS YEAR TOGETHER WITH CFETS BASKET**



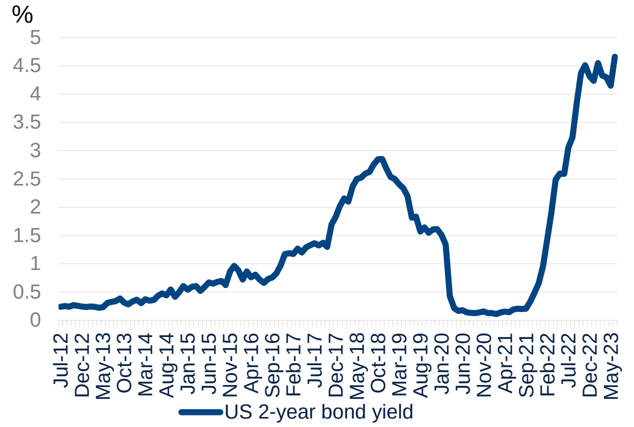
Source: CEIC and BBVA Research

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



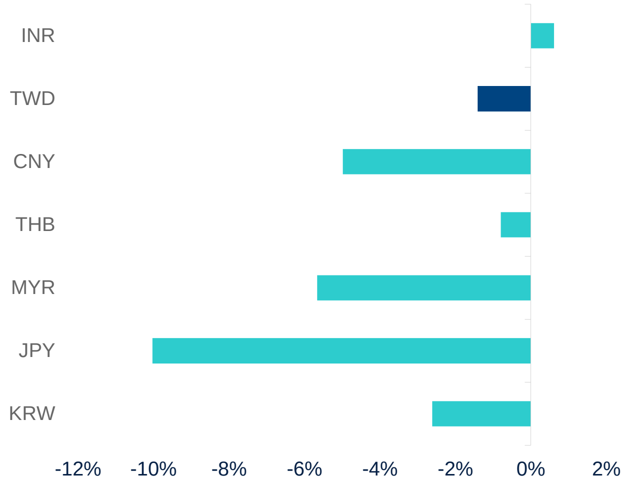
Source: CEIC and BBVA Research

Figure 3. **US 2-YEAR BOND YIELD WENT TO HISTORICAL HIGH AFTER EXPECTATION CHANGE OF FED HIKE PATH**



Source: CEIC and BBVA Research

Figure 4. **RMB DEPRECIATION WAS ALSO TOGETHER WITH CURRENCY COMPETITIVE DEPRECIATION AMONG ASIAN ECONOMIES (SINCE January 1, 2023)**



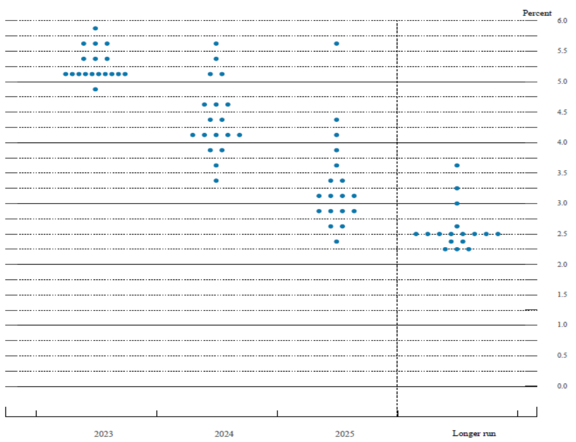
Source: CEIC and BBVA Research

Diving into domestic and global factors that led to the recent sharp RMB depreciation

Global and domestic economic fundamentals are able to sufficiently explain this round of RMB depreciation, but all of these reasons should be dominated by the recent change of FED rate hike expectation and the unsynchronized China-US monetary policy.

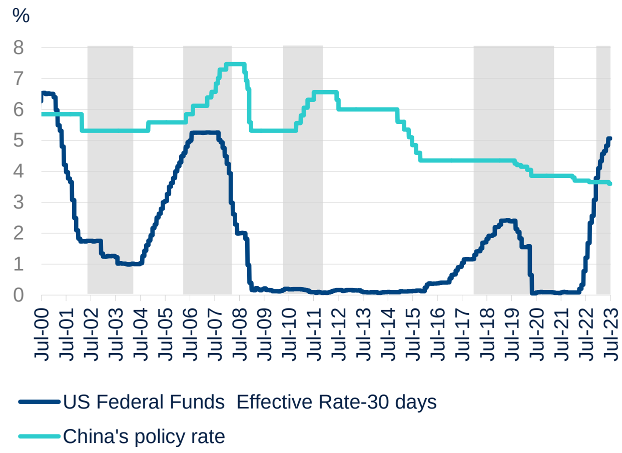
First, the unsynchronized monetary policy between China and the US is the prime reason for this round of sharp RMB depreciation. From the US perspective, there has been a significant turnaround of FED rate hike path expectation recently. The market previously unanimously believed FED will stop hiking interest rate after its final hike in May. However, the May and June inflation data were still sticky to above 4.5%, much higher than FED inflation target at 2%; at the same time, labor market was still overheating in the US and the wage-inflation spiral persisted. Under this circumstance, the market reversed its previous consensus and believed that the US FED will have another two hikes (50 bps each) in the rest of this year. This expectation turnaround could be best illustrated by the turnaround of the two US rates: US 2-year bond yield which is deemed to be tightly following Fed Fund rate as well as the US FED Fund Rate dot plot which shows a significant larger chance of another two hikes in the rest of 2023. (Figure 3, 5)

Figure 5. **FED FUND RATE DOT PLOT ALSO SHOWS THE REVERSE OF EXPECTATIONS THAT MORE HIKES ARE POSSIBLE IN REST OF 2023**



Source: CEIC and BBVA Research

Figure 6. **CHINA CUT LPR IN JUNE 2023 WHILE FED IS EXPECTED TO HIKE AGAIN: US FED FUND RATE HIGHER THAN CHINA'S POLICY RATE, VERY RARE IN HISTORY (%)**

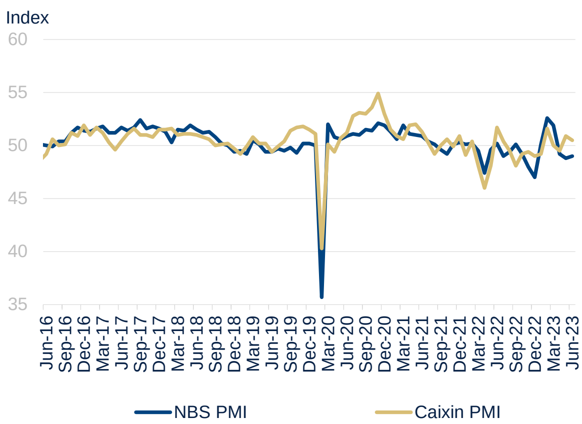


Source: CEIC and BBVA Research

Figure 7. **A REVERSION OF US AND CHINA'S 10-YEAR BOND YIELD HAS BEEN LASTING SINCE APRIL 2022**

Source: CEIC and BBVA Research

Figure 8. **NBS AND CAIXIN PMI DIVERGE, WITH NBA MANUFACTURING PMI DIPPING TO BELOW 50**



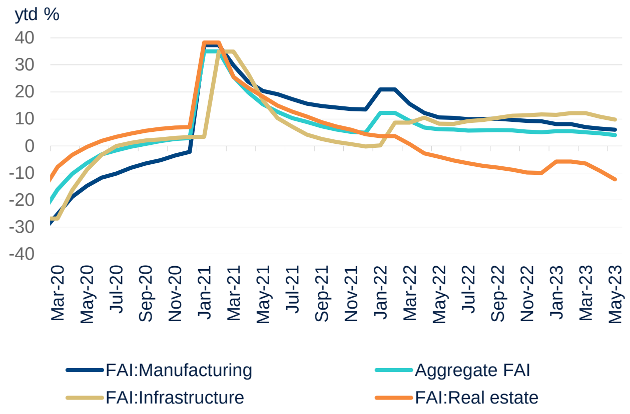
Source: CEIC and BBVA Research

By sharp contrast, in China, the main monetary policy stance in 2023 forcefully remains expansionary as the economic recovery after reopening seems to come to a halt in Q2 after its strong recovery in Q1. In order to stimulate growth, the PBoC has already conducted the LPR cut on June 20 2023. In particular, one-year LPR was cut from 3.65% to 3.55% while 5-year LPR was cut from 4.3% to 4.2%. The significant unsynchronized monetary policy cycles between China and the US has led to a reversal of their 10-year treasury bond yields and an enlarging China-US interest rate difference, adding pressure on the RMB to USD exchange rate. (Figure 6 and 7)

Second, China's growth slowdown in Q2 together with sluggish external demand and weak market sentiments also contributes to the recent RMB sharp depreciation from the macro fundamental perspective.

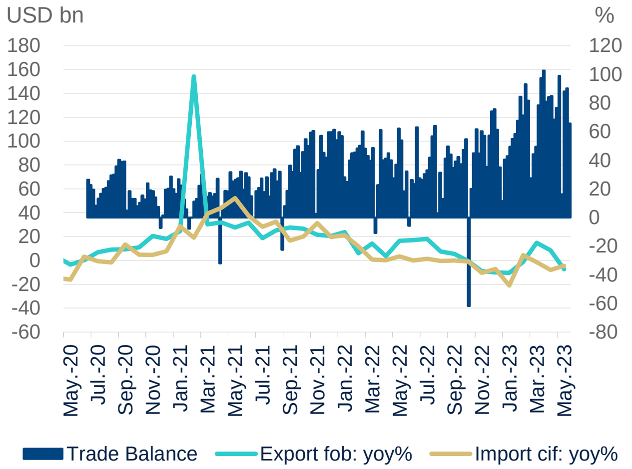
Although theoretically, economic growth is a long-term factor in determining exchange rate, a short-term staggering change of growth should not be ignored. After Chinese government reopened the economy from "zero Covid" policy at end-2022, there was a stunning economic recovery in Q1 2023. However, the reopening effect has been fading in Q2, while housing market crash and households and enterprises' "balance sheet recession" amid weak market sentiments significantly dragged the economic performance in Q2. A series of economic activities show that the economic recovery came to a halt in Q2, which calls for more monetary and fiscal easing to stimulate growth and to rebuild market confidence. (Figure 8 and 9)

Figure 9. **SLUGGISH REAL ESTATE MARKET DRAGGED INVESTMENT GROWTH**



Source: CEIC and BBVA Research

Figure 10 **SHRINKINGTRADE BALANCE ALSO CONTRIBUTE TO RMB DEPRECIATION**



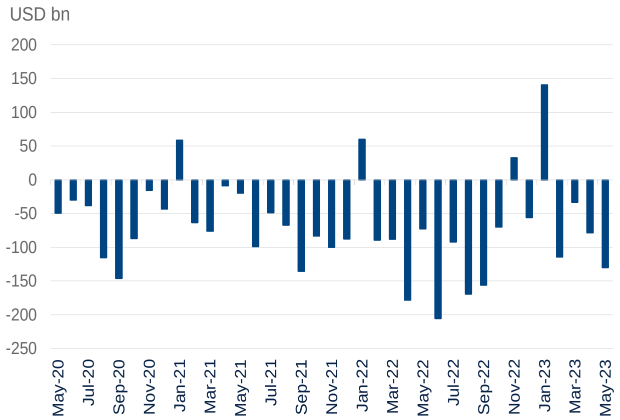
Source: CEIC and BBVA Research

Third, China's shrinking current account in 2023 also led to RMB exchange rate depreciation. For the past two years during Covid-19 pandemic, when Chinese exports growth continuously broke the records month after month, the market worried that its momentum may fade as the world economy normalizes. This concern eventually materialized this year based on the recent exports data outturns which tumbled from two-digit growth in pandemic time to negative growth of -7.5% in May 2023. (Figure 10)

Finally, the continuous China-US trade, financial and technology war together with geopolitical risks between mainland China and Taiwan dampen global investors' sentiments and the perception of China, leading to capital outflows and stock market sell-off, which also weigh on RMB exchange rate.

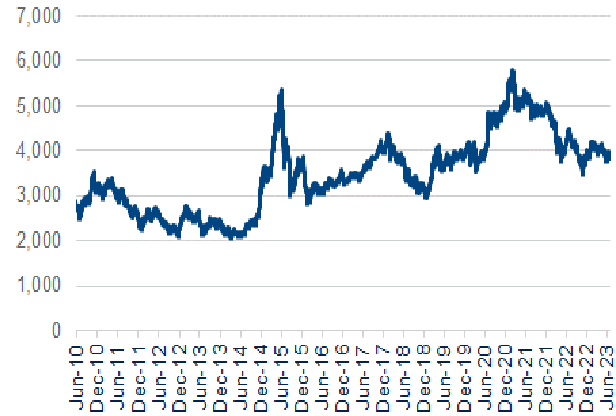
The recent escalation of trade war with the US included China's fight-back against the US and its allies by imposing export controls of gallium and germanium used in chipmaking for national security reasons. This move comes on the heels of the US and Netherland jointly limiting the exports of advanced chip-making equipment to China. The move might signal the change of China's strategy to deal with the US ever-escalating sanction measures in the high-tech sector by applying the tit-for-tat strategy more frequently in face of sanction escalation. Another case is the US PCAOB previously wanted Chinese listed stocks in US to hand over the audit documents to the US and required Chinese companies to disclose sensitive data and information to be listed in the US stock market which directly triggered sell-off of China-related stocks not only in US and HK market, but also in the onshore market. This leads to large-scale portfolio outflows and thus RMB depreciation. (Figure 11 and 12)

Figure 11. **CHINA'S CAPITAL OUTFLOW TRACKER**



Source: CEIC and BBVA Research

Figure 12 **STOCK MARKET SELL-OFF ALSO TRIGGERED CAPITAL OUTFLOWS AND RMB DEPRECIATION**



Source: CEIC and BBVA Research

Will this round of RMB depreciation lead to RMB sell-off and FX market turmoil?

We believe that we do not need to be panic so far because the RMB depreciation is quite synchronous with other emerging market currencies amid the unexpected expectation change of US FED interest rate hike. And more importantly, the main trigger is external factor-the US FED interest rate hike path change and the unsynchronized monetary policy with the US, instead of the domestic factors.

On top of that, China's central bank has a series of policy tools to circumvent one-way depreciation of RMB, thus, policy intentions of Chinese central bank on RMB exchange rate need to be carefully considered and evaluated as well. 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, an even-weakening sentiment and RMB 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 many policy weapons in its arsenal to lead the direction of RMB exchange rate and to circumvent one-way depreciation in a bid to sustain RMB exchange rate stability.

These counter-cyclical policy tools include the following:

(i) The PBoC could again conduct the RRR cut for foreign currencies;

(ii) 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;

(iii) 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;

(iv) The PBoC may re-start the usage of “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;

(v) 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.

(vi) 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 at end-2023 and end-2024?

Looking ahead, RMB depreciation above 7 is unavoidable in the short term amid the unsynchronized monetary policy measures between China and the US. We believe the future RMB exchange rate path will be tightly depending on the FED rate hike path. That means, above-7 level will continue in the coming months because there is still large probability that FED will continue to hike another 2 times (25 bps each) in the rest of the year and will postpone interest rate cut to 2024. In addition, some of the negative factors stated above will continue and even deteriorate in the short run. However, all of these negative factors are likely to improve in 2024.

Under these circumstances, we predict the RMB to USD exchange rate at end-2023 to be around 7-7.1 (Bloomberg consensus: 6.95) but will appreciate to 6.7 (Bloomberg consensus: 6.68) at end-2024. That means, there will be some bounce-back in 2024 after the US FED starts the interest rate cut cycle. Our prediction is also in line with the following four evidences:

(1) The RMB exchange rate 12-month forward rate actually shows the appreciation trend compared with 3-month RMB forward rate; (Figure 13)

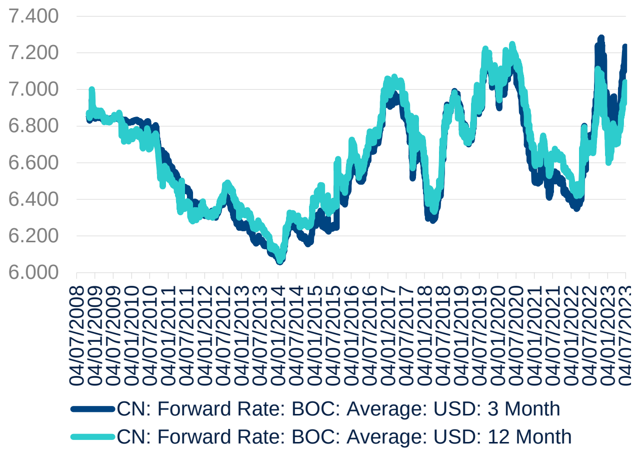
(2) The deviation of current RMB exchange rate to China’s foreign reserve actually came to historical high, indicating RMB exchange rate might already passed its trough and will have some reversion soon. (Figure 14)

(3) RMB real effective exchange rate (REER), a measure of the value of a currency against a weighted average of several foreign currencies divided by a price deflator or index of costs, has accumulatively depreciated recently for 11.7%, more than the nominal RMB exchange rate depreciation (8% accumulative depreciation). A sharp decrease in REER implies that exports become much cheaper and imports become more expensive; according to Purchase Power Parity (PPP) and Law of One Price, a shaper depreciation of REER than NEER indicates there might be some reversion of RMB exchange rate going forward. (Figure 15)

(4) We do not expect further LPR cut in the rest of the year, considering financial stability and particularly RMB exchange rate stability. A further LPR may further depreciate RMB and may trigger market panic, thus, we believe the PBoC will carefully consider the drawbacks before the FED truly ends its rate hike cycle. (Figure 16)

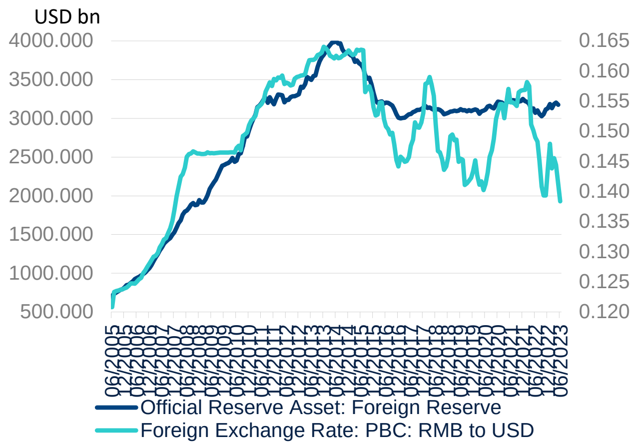
In the medium-to-long term, the PBoC is willing the RMB exchange rate to display some two-way fluctuations around its equilibrium level, and they will certainly intervene in the FX market if the RMB exchange rate displays some persistent one-way trending, either one-way appreciation or depreciation. That means, China's monetary authorities are likely to stick to their pledge of keeping the CNY stable on a trade-weighted basis.

Figure 13. **THE CURRENT RMB FORWARD RATE ALSO INDICATE RMB EXCHANGE RATE WILL BE WEAK IN 3 MONTHS BUT WILL APPRECIATE IN 12 MONTHS**



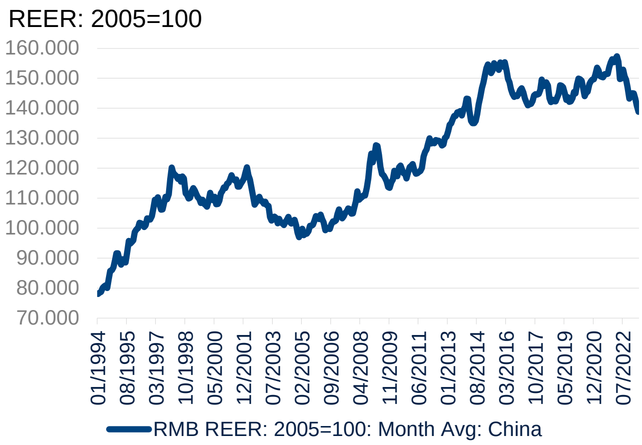
Source: CEIC and BBVA Research

Figure 14. **THE DEVIATION OF RMB TO USD EXCHANGE RATE TO CHINA'S FOREIGN RESERVES HAS BEEN THE LARGEST IN HISTORY IN THE RECENT MONTHS**



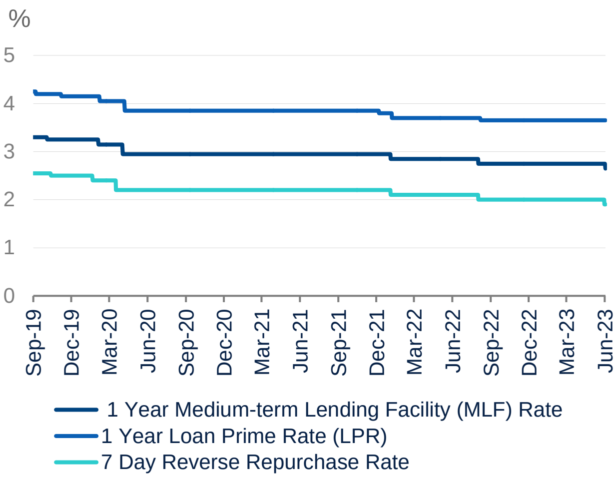
Source: CEIC and BBVA Research

Figure 15. **CHINA'S RMB REER ACCUMULATELY DEPRECIATED (11.7%)MORE THAN NEER (8%)**



Source: CEIC and BBVA Research

Figure 16 **WE PREDICT THERE WILL BE NO LPR CUT IN THE REST OF THIS YEAR CONSIDERING RMB STABILITY**



Source: CEIC and BBVA Research

Creating Opportunities

DISCLAIMER

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Any estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

With regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

ENQUIRIES TO:
BBVA Research: Level 95, International Commerce Centre, Austin Road West, Kowloon, Hong Kong.
Tel. + 2582 3111 / Fax. +852-2587-9717
www.bbvaresearch.com