Trivium China Markets

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RMB depreciation: No pain, no gain

Concerns about the Chinese economy and the divergence between its monetary policy and that of the US have triggered large-scale foreign outflows and, with it, echoes of the chaotic 2016 period.

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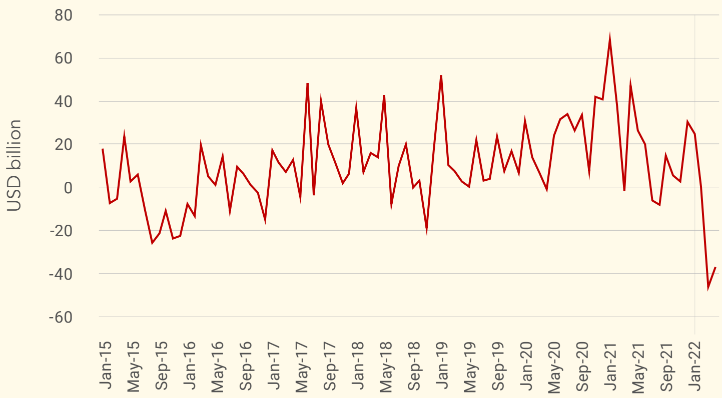
Key takeaways

- However, the similarities end there. In 2016, more foreign currency was leaving China than was coming into it. That is not the case at the moment. China's trade surplus and foreign direct investment flows have remained strong, offsetting foreign portfolio outflows.
- The other big difference between now and 2016 is that a stronger USD, the prospect of aggressive US rate hikes, and foreign capital flight from Chinese securities markets have not triggered domestic capital outflows. This partly reflects that it is much harder to illicitly move money out of the country than in 2016.
- These trends have meant that the Chinese currency has remained strong against other major currencies, with the fall against the USD mainly due to the greenback's strength rather than RMB's weakness. This explains the relative lack of intervention in currency markets by Chinese officials.
- Beijing will be relieved that US monetary tightening has not generated the kind of chaos seen in 2016. The downside, however, is that there has been little benefit to the Chinese economy from the moves in the RMB. The Chinese currency has remained near multiyear highs against the currencies of China's major trading partners, except for the US.
- This means there has been a limited boon to the export sector. RMB depreciation against the USD does mean, however, that China has to pay more for imports in local currency terms, given that most inbound shipments – especially commodities – are priced in USD.
- China may not be experiencing the kind of pain that it went through in 2016, but nor is a weaker RMB against the USD providing the kind of gains that the economy desperately needs.

While the RMB has recently caught a bit of a break from a weaker USD, the last couple of months have been painful for the redback. In mid-May, it approached 6.8 against USD, down 8% from its early-March peak.

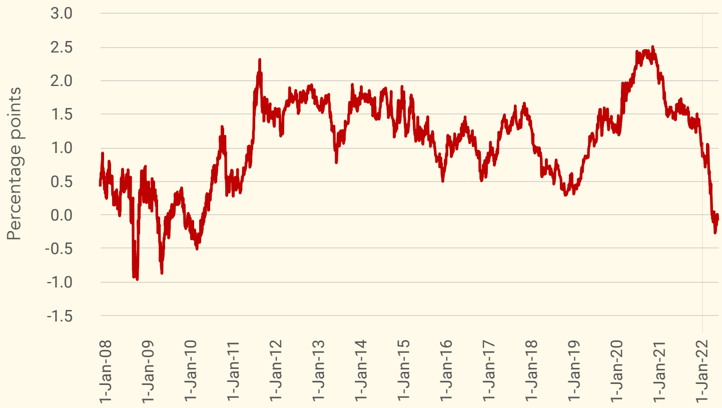
The reason: Foreign capital is fleeing China. In March and April, net northbound Stock Connect flows fell RMB 45 billion and rose by just RMB 6 billion. The outstanding value of foreigners' holdings of domestic bonds dropped RMB 113 billion and RMB 108 billion over these two months, respectively. Foreigners are also pulling money out of Chinese bank accounts. By the end of April, the value of these deposits was down $43 billion from February. Summing up these three channels, foreign outflows in March and April were the largest on record [FIG 1].

Fig. 1 – Net change in northbound Stock Connect flows, foreigners' holdings of Chinese bonds, and foreigners' deposits at Chinese banks



It is not hard to see why foreigners are pulling money out of China. Aside from the fact that the economy is nosediving, the gap between Chinese and US yields has now been eradicated [FIG 2]. Foreign investors in China are having to accept a lot more risk for less reward relative to investments in other countries.

Fig. 2 – US-China yield differential on 10-year government bonds



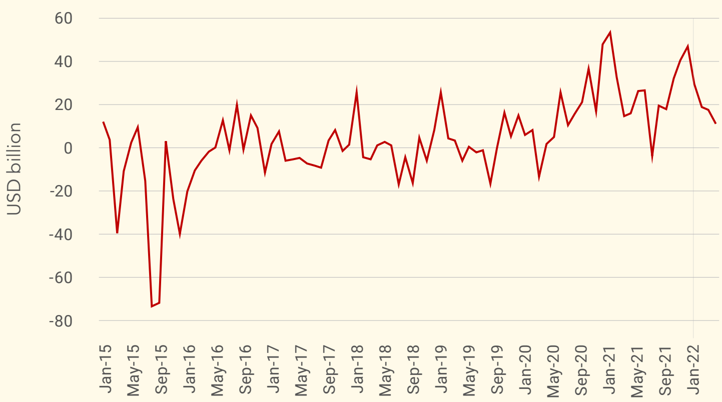
However, this pullback in foreign portfolio investment in China needs to be put into perspective. China is still generating an impressive surplus in the trade of goods and services. This hit RMB 45 billion and RMB 42 billion in March and April, respectively, down only slightly from the monthly average of RMB 41 billion last year. Foreign direct investment into the country also remains solid. In the first four months of the year, it rose 20.5% y/y.

Taking a step back

The bigger picture, therefore, is that while foreigners are shifting portfolio investments out of China, they are still buying plenty of Chinese goods and services, as well as moving long-term funds into the country.

This is a very different situation from the dark days of 2016, when foreign capital outflows overwhelmed the trade surplus. Back then, there was a lot less foreign money coming into China than leaving it, as was seen in the net value of banks' foreign currency receipts from cross-border transactions turning negative. This isn't the case at the moment. Banks are still receiving more foreign currency receipts from overseas transactions than the value of payments for foreign purchases that they are making [FIG 3].

Fig. 3 – Net value of foreign currency receipts related to cross-border transactions



The other big difference between now and 2016 is the behavior of domestic households and companies in response to a stronger USD and an increase in US rates. There have been few signs of the scale of capital outflows seen back then. Net southbound Stock Connect flows have remained marginal, for example, suggesting that domestic demand for foreign securities is muted [FIG 4].

More broadly speaking, there are signs that domestic demand for FX is increasing. The foreign exchange purchase ratio – the conversion of RMB to foreign currency – rose in March and April. This, however, is still well below the levels seen in 2016 [FIG 5]. Moreover, the total value of Chinese banks' FX sales still remains smaller than their FX settlements, resulting in a positive net FX settlement figure, unlike in 2016 [FIG 6].

Fig. 4 – Net southbound Stock Connect flows

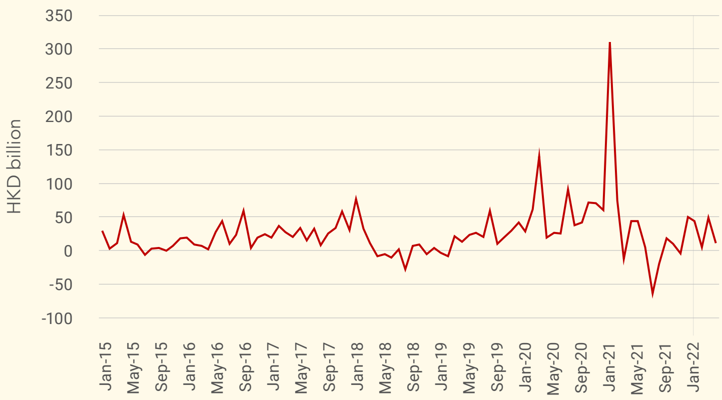


Fig. 5 – Foreign exchange purchase ratio

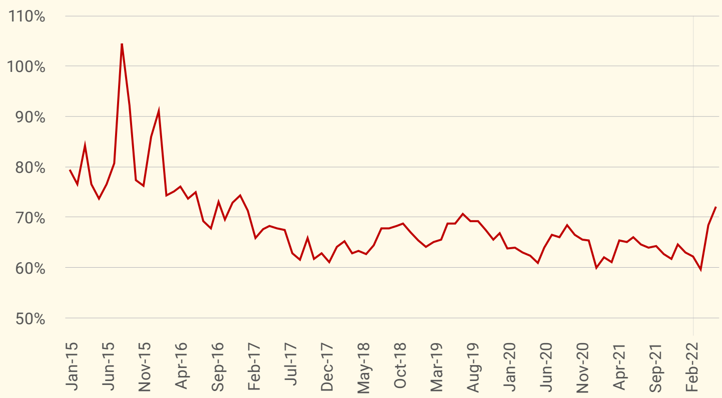
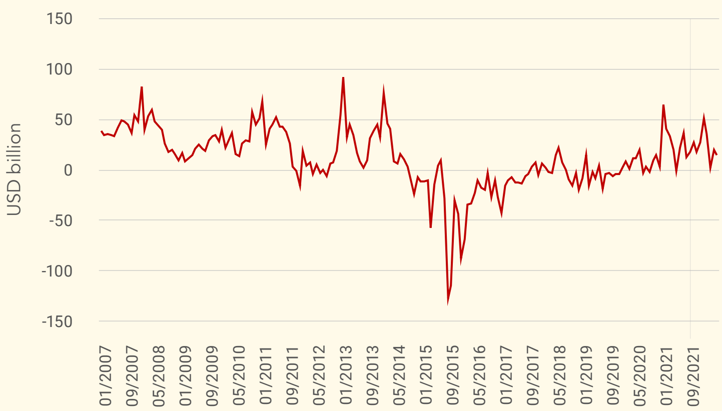


Fig. 6 – Banks' net FX settlement on behalf of clients



One constraint on domestic capital outflows is that it is harder to get money out of the country now than in 2016. This is partly because of increased scrutiny of outflows. It also, however, reflects the fact that one of the main channels for illicit capital outflows in the past – outbound tourism – has been pretty much closed down.

RMB still strong on a trade-weighted basis

The fact that the USD's strength is not leading to a flood of domestic capital outflows and that China's trade surplus and FDI remain elevated means that, in broad terms, the RMB is performing well. While the RMB has plummeted in value against the USD, that was largely a result of the greenback's strength rather than the RMB's weakness. In fact, the RMB is still very strong relative to other major currencies. The CFETS index basket has fallen 6% since its mid-March peak, but on a trade-weighted basis, the RMB is still at its strongest level in years [FIG 7].

Fig. 7 – CFETS index basket

This is a totally different situation to 2016, when a strong USD triggered a depreciation in the value of the RMB against the greenback that was a lot larger than that of other currencies, causing the redback to plummet on a trade-weighted basis.

This has also meant that a far, far lower level of intervention has been required by Chinese officials as the USD strengthens, compared with 2016. The value of FX reserves held by the China's central bank fell by just RMB 18 billion in April. In 2016, the average monthly decline was RMB 243 billion. On the policy front, the only substantial move to support the RMB has been the decision in April to cut banks' required reserve ratio for FX by 1 percentage point to 8%. But this still left the ratio higher than a year ago, when it was just 5%.

Not all positive

The relative strength that the RMB has enjoyed in broad terms, despite the sharp fall in value against the USD and the prospect of aggressive rate hikes in the US, is not all good news, however. While it is positive that China is not seeing the snowballing in capital outflows and uptick in depreciation pressure on its currency that occurred in 2016, the RMB remaining relatively strong against other currencies is a mixed blessing.

The continued strength in the RMB on a trade-weighted basis means that there has been a limited boost to China's export competitiveness. For example, against the EUR and YPY, the Chinese currency is still near multi-year highs. Because most Chinese imports – particularly commodities – are priced in USD, however, the fact that the RMB has fallen against the greenback means that the country is paying more for imports in local currency terms.

Chinese officials will be relieved that the divergence in monetary policies between China and the US is not triggering the kind of chaos that it did in 2016. But nor is a weaker RMB against the USD providing the boost to growth that the economy desperately needs.