The Intelligence Report

Our views on the latest investment events - FOR PROFESSIONAL INVESTORS - 6 March 2017

Overview

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Once again, the United States is front and centre stage. Trump's presidency marks a potentially major transition for the US and the surrounding world, the nature of which is still somewhat unclear, and the implications hotly debated. This week, the world's attention was focused on what US President Trump might say in his first congressional address on Tuesday 28th February. As already widely commented, his speech highlighted his major policy initiatives but remained short of details. Whilst Trump was predictably "tough on trade", we still do not know much more about his specific plans to boost US net exports. China has been singled out for criticism, and the threat of protectionist measures against China in particular remains high, although we still need to wait to see what form any measures will take.

Meanwhile China continues to go through its own major transition, balancing the policy goals of structural reform, economic liberalisation and financial market reform against an environment of structurally slowing growth. On February 20th, the People's Bank of China (PBOC) announced the second adjustment to its Foreign Exchange (FX) regime in the past eighteen months. The first adjustment, in August 2015, triggered a round of intense global risk aversion. This time around, the PBOC's change has garnered little foreign attention, and few ripples in global markets.

Chi Lo examines the recent announcement in more detail, placing it in the context of the FX basket changes in December, and making some interesting observations about the differences between managing an FX regime in an environment of capital outflows compared to a devaluation policy aimed at boosting net trade, a distinction all the more relevant given the concerns about President Trump's pronouncements on trade in general, and China in particular.

China's central bank gives yuan fixing mechanism another tweak

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On 20 February, the People's Bank of China (PBoC) adjusted the yuan fixing mechanism for the second time in eighteen months. The first time was in August 2015, when the central bank changed the calculation from using a 10-day moving average of the CNY-USD closing rates to using the CNY-USD closing rate of the previous trading day.

There are three elements to the yuan fixing mechanism:

1. The CNY-USD spot closing rate as of 4:30 pm the previous trading day;
2. The average of the 24-hour daily movements of the US dollar against the currencies in the China Foreign Exchange Trade System (CFETS) basket, the Bank of International Settlements CNY basket and the International Monetary Fund's Special Drawing Rights basket; and
3. A PBoC discretionary adjustment based on its judgement of the foreign exchange market's demand and supply conditions, risk appetite, and international developments.

In December 2016, the PBoC added 11 new currencies to the CFETS basket (see Table 1), most of them illiquid emerging market currencies. Arguably, their inclusion adds to the volatility of the yuan trade-weighted index.

So now by changing the 24-hour reference period in the second part of the fixing to 15 hours (between 4:30 pm of the previous trading day and 7:30 am of the next day, which is before trading starts in China), the PBoC hopes to reduce the volatility of the yuan's basket, since the currencies traded during the 4:30 pm to 7:30 am period are mostly liquid, developed market currencies.

Since the PBoC's foreign exchange policy is to keep a stable trade-weighted exchange rate (with reference to the currency basket), and to use the CNY-USD cross-rate as an adjustment factor to achieve such stability, the new shortened reference period should enhance the PBoC's grip over the CNY-USD cross-rate at a lower cost by reducing the volatility of the trade-weighted exchange rate.

We do not see this latest change to be a foreign exchange policy shift, but rather a fine-tuning of the PBoC's exchange rate management tool. With the PBoC targeting a stable trade-weighted exchange rate, the movement of the US dollar against other currencies will determine how much the CNY-USD cross-rate will move and in what direction.

Exhibit 1. Currency - old basket weights vs. new basket weights

Currency	Old basket weights (Dec 15)	New basket weights (since Dec 16)	Change
USD	26.4%	22.4%	4.0%
EUR	21.4%	15.3%	5.1%
JPY	14.7%	11.5%	3.2%
KRW	0%	10.8%	0%
AUD	4.7%	4.4%	0.3%
HKD	6.6%	4.3%	2.3%
MYR	2.5%	3.8%	1.2%
SGD	3.9%	3.2%	0.7%
GBP	6.3%	3.2%	3.1%
THB	0.7%	2.9%	2.3%
RUB	1.5%	2.6%	1.1%
CAD	3.3%	2.2%	1.2%
SAR	0%	2.0%	0%
AED	0%	1.9%	0%
ZAR	0%	1.8%	0%
CHF	3.8%	1.7%	2.1%
MXN	0%	1.7%	0%
TRY	0%	0.8%	0%
PLN	0%	0.7%	0%
SEK	0%	0.5%	0%
NZD	4.4%	0.4%	3.9%
DKK	0%	0.4%	0%
HUF	0%	0.3%	0%
NOK	0%	0.3%	0%

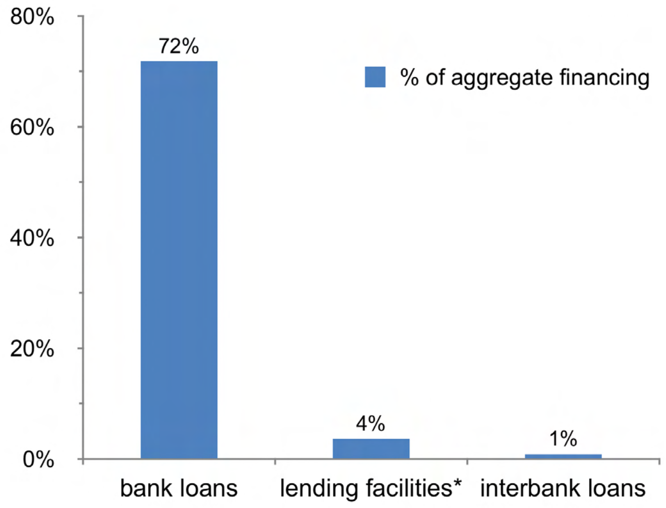
Source: PBoC, BNPP IP (Asia)

Indeed, the PBoC has recently tolerated more of a decline of China's currency against the dollar than it had done previously, and for good reasons, in our view. Pegging the yuan against US dollar becomes costly when the world turns against the yuan and capital flows out of China. It is costly because the loss of foreign exchange reserves resulting from a CNY-USD peg creates a passive liquidity drain that hits China's GDP growth. So allowing the yuan to fall against the dollar is more about easing this passive liquidity constraint than it is about boosting exports. This is different from a devaluation policy.

From an "Impossible Trinity" perspective (the idea that a central bank cannot simultaneously have an independent monetary policy, an open capital account, and a fixed exchange rate), persistent yuan depreciation expectations coupled with the US Federal Reserve's (the Fed) interest-rate normalisation have prompted the PBoC to re-impose capital controls to stem outflows so that it can regain control of both the interest rate and the exchange rate. China's economy is not strong enough to withstand any monetary tightening by the PBoC, which is also mandated to maintain a stable exchange rate (among other policy objectives). So the authorities have chosen to sacrifice capital account liberalisation in the short-term.

Contrary to the opinion of some market observers, in our view the recent 10 basis-point (bps) "rate hike" by the PBoC is too small to have any meaningful impact in terms of reducing the depreciation pressure on China's currency given that the Fed is raising rates by 25 bps at a time. We also believe the 10 bps rate hike will have only a limited impact on the Chinese financial system, as the lending segments affected by it account for less than 5% of total credit facilities (see chart). Furthermore, over 60% of the credit in the Chinese system is still priced off the one-year benchmark lending rate which stands at 4.35%, significantly below the market-driven rates. We see the small rate hike as being a PBoC policy signal to continue forcing the reduction of debt in China's wholesale funding market, which is increasing financial stress in the small and shadow banking areas.

Exhibit 2. China's credit facilities (% of aggregate financing, December 2016)



Source: CEIC, BNPP IP (Asia)
*MLF + SLF + PSL + net SLO

We believe the yuan may depreciate against the US dollar by a further 3%-4% in the short term due to capital outflow pressures stemming from both domestic challenges — such as GDP growth issues and asset diversification — and external ones, such as the uncertainties surrounding US trade policies and this year's elections in Europe. China's interest-rate policy will likely focus on domestic needs, assisted by capital controls so that it does not necessarily follow the US rate trajectory. We expect the PBoC to rely more on capital controls in the short term to manage the yuan's depreciation, supplemented by foreign exchange reserve drawdowns and minor interest-rate adjustments.

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