Chi Time

FOR PROFESSIONAL INVESTORS – 24 January 2018

WILL THE RENMINBI SURPRISE THE MARKET AGAIN IN 2018?

Opinion is the medium between knowledge and ignorance.

Plato

The renminbi has started 2018 on a firm footing, with CNY-USD trading at 6.394 at the time of writing (or more than 1.7% higher than the exchange rate at the end of 2017). CNY appreciated by more than 6.3% against the USD in 2017, surprising the market's expectation of a large depreciation and dwarfing our out-of-consensus expectation of 3.0% appreciation.

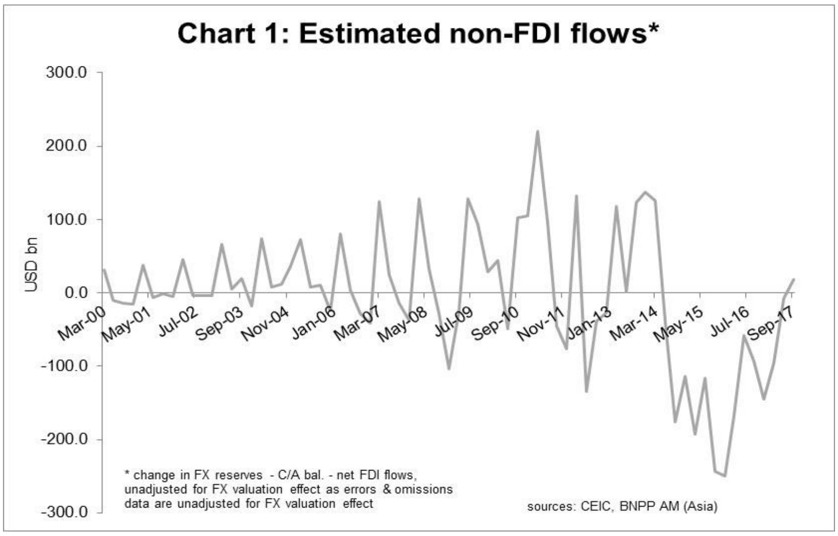
At this point, market consensus for CNY-USD is about 6.65 for end-2018, or 2.2% down YoY. We have a more positive view and see an appreciation of 3% YoY against the USD by the end of this year. The question is whether the renminbi's strength will last, or push even higher to below 6.0 per USD?

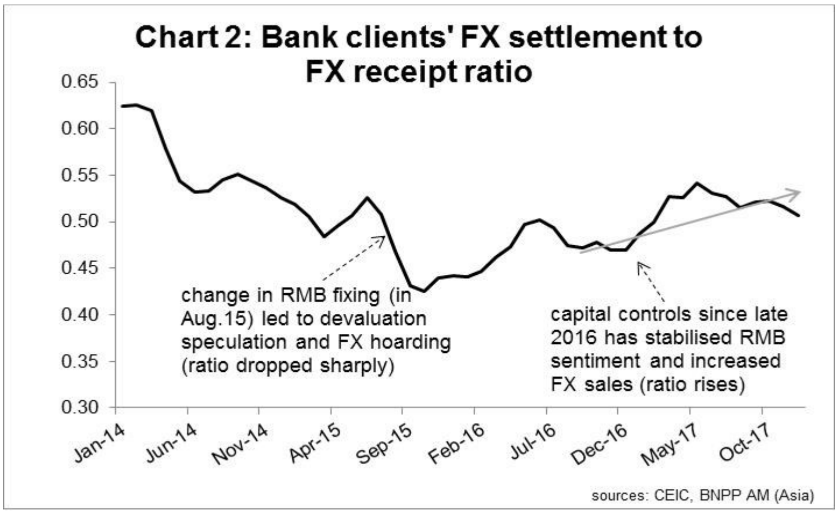
Capital flow dynamics

China's non-FDI capital flows (including speculative and illegal capital flows) have turned positive since late last year (Chart 1), thanks to the success of capital controls and improving economic fundamentals that have turned around the negative sentiment on the renminbi. As an indication, onshore bank clients have been selling more FX than buying since late 2016 when capital controls were imposed, leading to a rise in the FX-settlement-to-FX receipt ratio (Chart 2).

Capital flow dynamics are favouring a steady renminbi with a strong bias this year due to:

1) Continuation of a balance of payments surplus, as current account inflows are expected to overwhelm capital outflows. China's current account surplus may grow larger than the consensus forecast of 1.4% of GDP this year as import growth slows down (due to weaker domestic demand momentum) on the back of flat or even positive export growth. Meanwhile, capital controls will remain in place to regulate capital outflows
2) Continued improvement in world sentiment on the renminbi due to admission of Chinese assets in international equity and bond benchmarks on the back of fading concerns about China's economic hard-landing and debt problems.

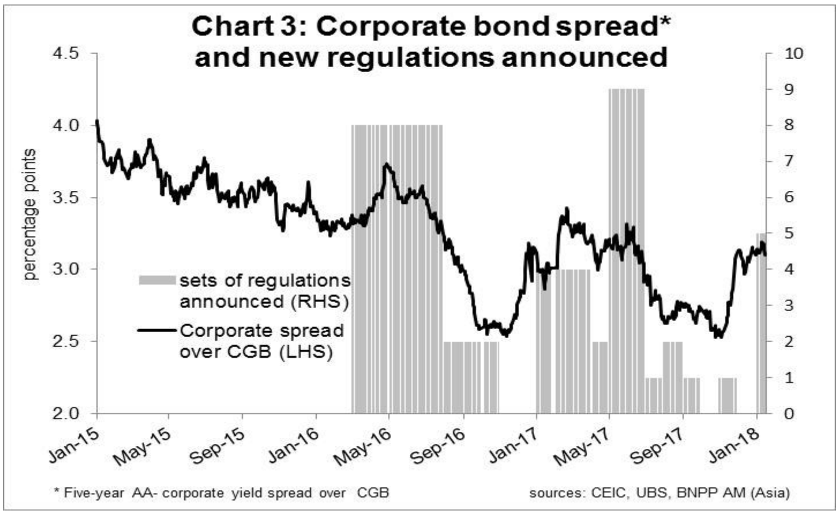




Upholding confidence in the renminbi

These factors could reduce the capital outflows incentive and invite more non-FDI inflows to augment the support from the current account surplus for the renminbi. But here also lies the crux of the matter: Can Beijing uphold public (including international) confidence in China and prevent capital outflows incentive from rising again? To do that, it will have to reduce domestic financial stress which is the major economic cause of capital outflows.

Indeed, Beijing has made deleveraging and structural reforms the top policy priorities since mid-2016, and reiterated such priorities at both the 19th Communist Party Congress and the National Economic Work Conference in October and December 2017, respectively. It has implemented a large amount of regulations since mid-2016 to force debt-reduction. Onshore yield spread has risen in response as the regulatory tightening has raised fears about firm- and sector-level credit risk (Chart 3). Crucially, the regulators are not just adding new rules, but are also intensifying inspections and strictly enforcing punishment for non-compliance.



A perfect storm for CNY strength?

So there are reasons to believe that Beijing would be able to uphold confidence in the system and, thus, reduce the capital outflow incentive. However, in my view, the market has still not factored in the current combination of fiscal, monetary and structural reform policies by Beijing that could be very supportive of the renminbi.

Beijing is implementing tight monetary (albeit selectively through regulatory and money market tightening rather than broad monetary tightening) and loose fiscal policies to facilitate structural reforms to reduce inefficiency/boost productivity. Arguably, this policy mix is similar in spirit and in form to "Reaganomics" pursued by US President Ronald Reagan in the 1980s.

Notably in his first term of presidency between 1981 and 1985, Mr. Reagan[1] and the hawkish US Fed chairman Paul Volcker[2] implemented the Mundell-Laffer policy mix of tight money to combat inflation, loose fiscal policy (in the form of tax cuts) to boost demand and supply-side and regulatory reforms to boost productivity. Remember Mr. Reagan fired 12,000 federal air traffic controllers who went out on strike as his first step to kick-start regulatory reforms by breaking up the labour unions? The USD soared throughout those years (Chart 4).

[1] Ronald Reagan's presidency ran for two terms from 1981 to 1989.
[2] Paul Volcker was US Fed chairman between 1979 and 1987.

The wildcard

Will this be macro-structural policy mix work the magic to push up the renminbi exchange rate this year like its surprising strength against the USD last year?

The market seems to have priced in three US rate hikes in 2018. Intensifying debt-reduction in China will likely push up Chinese onshore yields further. So expect Sino-US yield differential to remain in China's favour. Meanwhile, positive capital flow dynamics and capital controls will curb the renminbi's downside risk.

In fact, a lot depends on the USD's movement. IF for some reasons it soars unexpectedly, that would put significant downward pressure on the renminbi, which could invite policy responses that cause a lot of market volatility.

What's your call on the dollar?

Chi Lo, Senior Economist, BNPP AM

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Hotline: 2533 0088 Address: 30/F, Three Exchange Square, Central, Hong Kong.