FX Watch

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Chinese yuan depreciation to remain gradual and modest

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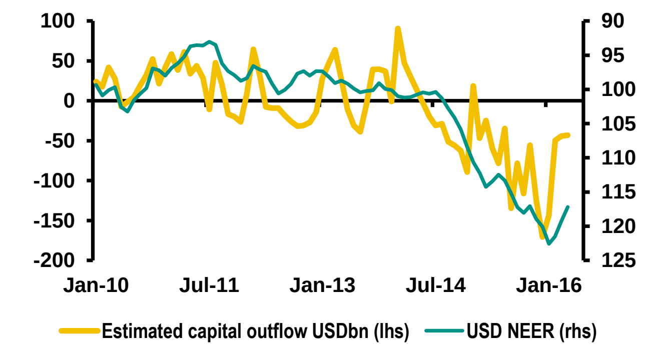
- **Fears of capital outflows fears have resurfaced…**
- **…likely to be less pronounced as market conditions have changed**
- **China will do whatever it takes to stabilise the economy and Chinese yuan**
- **No material change in CNY policy bias**
- **Potential expansion of CFETS yuan basket unlikely to trigger volatility**

Fears of capital outflows from China has resurfaced…

Since the beginning of May, the US dollar has recovered as US economic data improved. The strength in the dollar gained momentum after the FOMC minutes release on 18 May raised market expectations that the US Federal Reserve may tighten monetary policy sooner than later. This reignited market fears that capital outflows from China will accelerate, after moderating in recent months.

USD NEER and Estimated capital flows in China

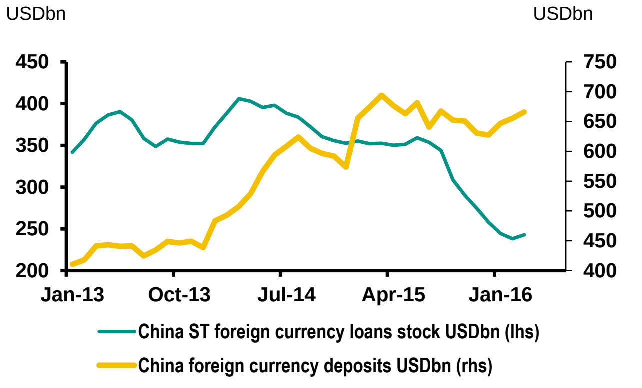


Source: BIS, Bloomberg

…likely to be less pronounced as market conditions have changed
In our view, there are several reasons why it is unlikely that a similar magnitude of capital outflows from China as we have seen in late 2015 will materialize. In the second half of last year, we judged that market fears that China was seeking to devalue its currency magnified capital outflows. This was due to China tweaking its exchange rate regime (introduction of new daily fixing mechanism in August and CFETS yuan basket in December 2015).

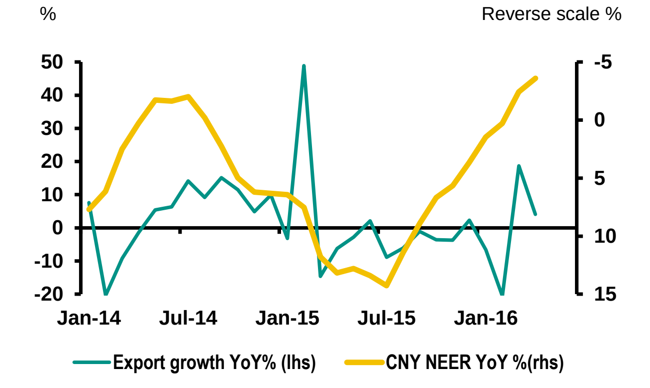
In 2016, China policy makers have a more important goal - to restructure the State-owned enterprises (SOEs) and deleverage the economy in an orderly fashion. Moreover, the current level of the yuan is not an impediment to exports growth and inflation. It is also worth noting that China short term foreign currency loans have declined while foreign currency deposits have risen. Hence capital outflows to repay foreign currency denominated debt is likely to be smaller. Recently, China has also opened up the domestic bond market to selected international investors. International investors also have more channels to invest in the domestic equity market. This is likely to support sentiment in the Chinese yuan. In addition, so far this year commodity prices have recovered as demand and supply dynamics have improved. This has helped to support market sentiment towards emerging markets. Last but not least, the weak US payrolls last Friday has reduced market expectations that the Fed may tighten monetary policy in the coming months.

Foreign currency deposits and short term loans



Source: NBS

CNY is not an impediment to exports growth



Source: Customs General Adminstration, BIS, ABN AMRO

China will do whatever it takes to stabilize the economy…
We expect policy makers in China to do whatever it takes to stabilize the economy. Fiscal stimulus has been favoured to support the economy given that further monetary stimulus may reduce the attractiveness of the yuan and exacerbate credit growth and debt concerns. Concerns of high corporate debt and rising corporate defaults remain but in our view are unlikely to destabilize the economy (see our latest China Watch, *Digging into the debt dynamics* for more background). It is likely that a cross subsidy between government and corporate debt will materialize given that SOEs account for about two thirds of corporate debt. The latter is also mostly denominated in local currency. An orderly consolidation, restructuring and deleveraging strategy is likely to be favoured to mitigate risk of widespread defaults.

According to S&P ratings agency and the IMF, Chinese commercial banks have the ability to absorb potential losses due to rising non-performing loans which are expected to rise from 1.7% in 2015 to 3.1% in 2017. Furthermore, the eight round of US –China Strategic and Economic dialogue will take place in Beijing on 6-7 June. China also hosts the G20 meeting later this year in September. Hence the political stake is high for China policy makers to stabilize the economy.

…and the CNY

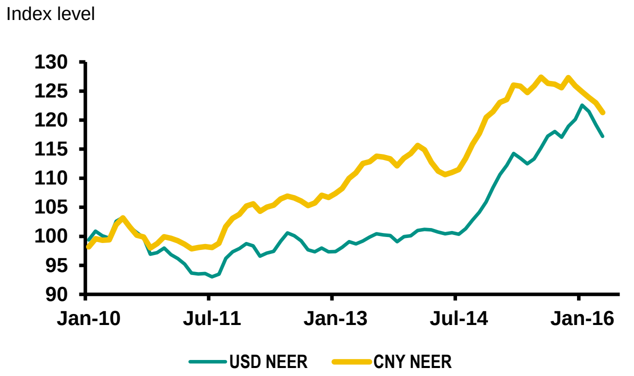
Ahead of the yuan implementation in the SDR basket on 1 October 2016, the central bank is likely to keep the yuan relatively stable. Hence policy makers may favour stability oriented measures in volatile times while maintaining their long term objective to let the yuan be more market determined. Indeed, market indicators show that financial markets are more confident that China policy makers will be able to control volatility and movements in the yuan. This is reflected by lower volatility and depreciation expectations in the currency options and forwards market. Our year end USD/CNY forecast is 6.70.

No material change in CNY policy bias

The graphs below show that the yuan policy has not materially changed recently, as was suggested by some market participants. The broader measure of the yuan against currencies of China's trading partners (CNY nominal effective exchange rate based on the Bank of International Settlements metrics) has continued to move in tandem with the USD NEER. This is due to the People's Bank of China various measures to reduce volatility in the currency.

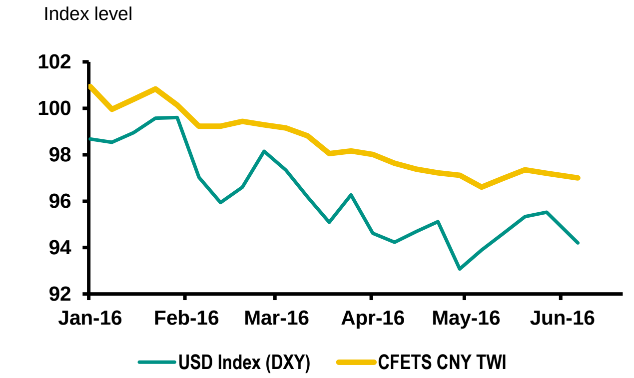
A narrower measure of the CNY TWI (CFETS CNY basket) and the DXY (Bloomberg USD index) against currencies of main trading partners also show a similar picture. The DXY is more volatile than the CNY TWI as the EUR accounts for 57.6% of DXY but only 21.4% in the CNY TWI. Hence movements in the EUR will amplify movements in the DXY.

CNY NEER and USD NEER moves in tandem



Source: BIS

No major deviation in CNY policy



Source: CFETS, Bloomberg, ABN AMRO

Potential expansion of CFETS yuan basket not likely to trigger volatility
We do not rule out that both the South Korean won (KRW) and the South African rand (ZAR) may be included in the China Foreign Exchange Trade System (CFETS) yuan basket later this year, as both currencies are likely to start trading against the yuan in the CFETS. This may trigger volatility in the yuan and reignite market fears that policy makers are seeking to devalue the currency again. The ZAR's higher volatility characteristic will be mitigated by the currency's lower weight (using the BIS as a reference) in the expanded yuan basket. Though the KRW is expected to have a larger weight - given South Korea's larger economic and trade linkages with China the KRW's volatility and correlation with other Asian currencies and the euro, which are already included in the CFETS yuan basket are quite aligned.

In conclusion, the inclusion of the ZAR and KRW in the CFETS yuan basket is unlikely to result in materially higher volatility in the yuan. The timing of expanding the CFETS yuan basket will be crucial. In our view, China policy makers are likely to choose an appropriate time when financial markets conditions are more conducive.

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