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INSIGHT

VIEWPOINT

Anchors Away? Assessing Changes to China's Exchange Rate Policy

DAVID LOEVINGER | AUGUST 21, 2015

On August 11, the People's Bank of China (PBOC), China's central bank, announced that the exchange rate it sets just before the onshore market opens each day ("PBOC fixing") would become more market based. In the week following the announcement, the fix depreciated by 4½%, the most the fixing had moved since it was established over ten years ago.

This move has raised a number of questions not only about the Chinese economy, but also regarding the wider impact on global markets.

Why did China do this? Wasn't it just an attempt to steal growth from other countries and return to export led growth?

There was growing support in China for the view that an exchange rate heavily pegged to the U.S. dollar had outlived its usefulness. Reasons include:

- As China's economy has grown, it has become less dependent on trade. Growth has been driven increasingly by domestic demand and services;
- China's export markets had become increasingly diversified and less dependent on U.S. demand;
- Low volatility limited incentives to hedge foreign currency exposure: and
- An increasingly open capital account and an inflexible exchange rate have become more and more incompatible with an independent monetary policy (economists refer to this as the "impossible trinity"). China is likely to remove further restrictions on capital flows as it ramps up its efforts to join the International Monetary Fund's (IMF) Special Drawing Right (SDR), which is a basket of currencies currently composed of the U.S. Dollar, Euro, Japanese Yen, and British Pound.

The move was also likely intended to address operational concerns of the onshore exchange rate (CNY) joining the SDR. To value SDR holdings and transactions, the IMF publishes a daily SDR exchange rate which is an average of its component currencies. In a paper released on August 5 (a week before the Chinese policy shift), the IMF noted that, unlike the current component exchange rates, PBOC's fixing is not a market based rate.[1] Furthermore, the IMF noted that, since both the Yuan traded in Hong Kong and other offshore markets (CNH) and the PBOC fixing can deviate from the CNY spot, neither CNH nor CNY forwards (with the latter settled using the PBOC fixing) are perfect hedges for holdings of CNY denominated assets.[2]

1 http://www.imf.org/external/np/pp/eng/2015/071615.pdf.

2 Because China maintains restrictions on capital flows, and all investors can't move funds freely, there are two exchange rates, one reflecting supply and demand in Mainland China (CNY) and another outside (CNH).

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Over time, last week's move should help address both of the IMF's concerns, though if foreign investors expect the CNY and CNH to depreciate they will be reluctant to increase their holdings of assets denominated in these currencies, and the extent of foreign holdings of assets dominated in a country's currency is one of the key criterion for joining the SDR. While becoming part of the SDR basket has little practical importance, the goal of joining the SDR basket has helped drive a political consensus in China for financial and capital account liberalization, which will have an important impact on global investors as China continues to open up. We believe the balance of risks favor China's inclusion by late 2016.

There were also important shorter-term cyclical factors driving the Chinese decision:

- Overall growth is slowing, including export growth (see charts 1 & 2);
- Inflation is low, with some sectors with overcapacity experiencing deflation (chart 3);
- Monetary conditions had become tighter as credit growth to the corporate sector slowed, lending rates remained high after adjusting for inflation, and most importantly, given its link to a rising U.S. Dollar, the CNY appreciated significantly against most other currencies (chart 4); and
- The PBOC's attempts to support growth by cutting interest rates and injecting liquidity into the banking system were only having a limited impact as loan demand and investment remained weak due to excess capacity and corporate leverage (chart 4).

Bottom Line: We believe the move was driven both by China's long-term reform agenda and shorter-term cyclical considerations. By moving to reverse some of the CNY's appreciation against non-dollar currencies, we believe China is signaling that it is less willing now to absorb global deflationary pressures.

Why now?

We think there were three reasons:

- The Chinese probably thought that the Federal Reserve's impending "lift off" of interest rate hikes (which we believe will occur before the end of the year and could come as early as next month) would lead to further appreciation of the USD, and in effect make the CNY in their view even more overvalued;
- Weaker than expected data prints for July; and
- The release of the IMF SDR paper.

What does this mean for the CNY going forward?

With less than two weeks into the new regime, there's more we don't know than we do know about how China will operate its new exchange rate policy. So far it looks like:

- The spread between the CNY spot exchange rate and the PBOC's daily fixing exchange rate will be much lower (see chart 5);
- China will continue to manage the exchange rate, though the PBOC will rely much more on intervention in the foreign exchange market to guide market expectations;
- The PBOC will nudge the spot towards the direction it wants the next day's fixing to be; and
- The CNY will be somewhat, but not significantly, weaker.

What we don't know is the extent to which:

- The exchange rate will actually be market driven. Will the PBOC step in only to dampen excess volatility or will they continue to push the CNY towards a desired rate;
- Other currencies, or a basket of currencies, will play a role; and
- The PBOC wants to roll back the appreciation of the CNY on a trade-weighted and inflation adjusted basis (known as the real effective exchange rate or REER, chart 4).

We believe China wants a weaker, but not necessarily a significantly weaker exchange rate, and we expect a further depreciation against the USD in the mid-single digits over the next twelve months. We believe that the PBOC will step in to keep any depreciation modest and orderly, and has ample tools to achieve this, including over $3.5 trillion in foreign exchange reserves. Expectations of a large depreciation could lead to disorderly capital outflows and, as noted, reduce foreign holdings of CNY assets, undermining China's bid to join the SDR. And there's little evidence that a strong CNY is hurting China competitiveness. Most of the decline in

exports has been due to weak global demand, and China's share of global imports continues to rise as its exports have been less adversely affected than other economies' exports (chart 2). Moreover, in the very short-term President Xi is still meeting President Obama at the end of September and G-20 leaders in mid-November and likely wants to avoid having the exchange rate be a point of friction.

Bottom Line: We expect the PBOC will wait to be sure that expectations are first more firmly anchored, with a narrowing of the gap between on and offshore exchange rates, and a strengthening of offshore exchange rate forwards, before giving us clues on whether it will allow the exchange rate to move more freely. That said, it will likely take weeks, if not months, for investors to figure out how the new system will work. This uncertainty will likely continue to weigh on markets, particularly other currencies in Asia.

Does this mean China is about to experience a hard landing soon?

This is not our base case because:

- Long-term drivers of growth such as urbanization, moving up the value added chain and investing in infrastructure and education still have years to run;
- Growth is slowing primarily because China is allowing the necessary adjustment in excess capacity in real estate and heavy manufacturing to occur now to avoid a larger and potentially disorderly adjustment later (charts 6 & 7);
- Infrastructure investment continues to support growth and the central government is mitigating local governments' financing constraints by providing more financing directly through the large policy banks (chart 7); and
- The central government is easing controls in the property sector given that prices have come down (particularly in smaller cities).

Moreover, a modest depreciation in the real effective exchange rate will provide some modest support to growth.

Bottom Line: In the months and years ahead we think investors should pay as much attention to how China is growing as they do to how high that growth is. Growth driven by more "see through" apartment buildings or steel plants won't be sustainable. And while some sectors and companies will contract, others will experience robust growth. Investors shouldn't forget that even sub-7% growth today creates more demand in U.S. dollars and investment opportunities, than the double-digit growth of eight years ago as the Chinese economy is more than three times bigger today in dollar terms.

How will this impact the rest of Asia?

China is the biggest trading partner of every Asian economy, a competitor in third country markets, and a major consumer of commodities. An important policy anchor has become unhinged, and the uncertainty over how China's exchange rate policy will evolve will increase risk premia, at least for the period of uncertainty. Those currencies adversely affected include currencies of economies that:

- Sell a lot to China, either directly or through third countries (like the Taiwan Dollar (TWD), Malaysia Ringgit (MYR), and Singapore Dollar (SGD) (see chart 8),
- Compete with China in external markets (like the Thai Baht (THB) and Vietnamese Dong (VND) in addition to the TWD, Korean Won (KRW) and MYR) (see chart 8);
- Have limited foreign exchange reserves to lean against depreciation pressures (MYR and the Indonesian Rupiah (IDR));
- Have weak growth, low inflation, and high leverage that would be particularly resistant to deflationary shocks (KRW, TWD, THB, SGD); and/or
- Are large commodity exporters (like the IDR and Australian Dollar (AUD)). They are affected less because a weaker CNY makes commodity imports more expensive to Chinese importers, and more because we believe this move signals an official acknowledgement that commodity intensive sectors (like property and heavy industry) are going to remain a headwind to growth.

Bottom Line: In EM Asia, we think the TWD, KRW, MYR, THB, and VND are most likely to be impacted. While weak commodity prices will put some pressure on the IDR, a declining current account deficit and high carry should provide some offsetting support. While the Indian Rupee (INR) and Philippine Peso (PHP) are also likely to weaken, they are linked less to China's economy and are thus likely to outperform the rest of EM Asia. We continue to expect no change in Hong Kong's USD Peg. Since China's announcement Asian currencies have moved largely in line with our views.

While we expect downward pressure on Asian exchange rates to continue for a time, the decline should be mitigated by the fact that these currencies have already depreciated significantly (with the JP Morgan Asia Currency Index (ADXY) down over 9% since the beginning of 2013). In fact, most, though not all, Asian currencies are now weaker than they were before the 2013 Taper Tantrum on a trade weighted and inflation adjusted basis.

A depreciation of the CNY, to the extent it's not matched by other Asian currencies, also represents a moderate deflationary shock for Asia. This should allow most of Asia to keep policy rates lower for longer, despite an impending (but well telegraphed) Fed lift off. For India, Korea, and Thailand in particular, CNY depreciation increases the chance of further policy rate cuts, though we think the likelihood of this for the latter two still remains quite low.

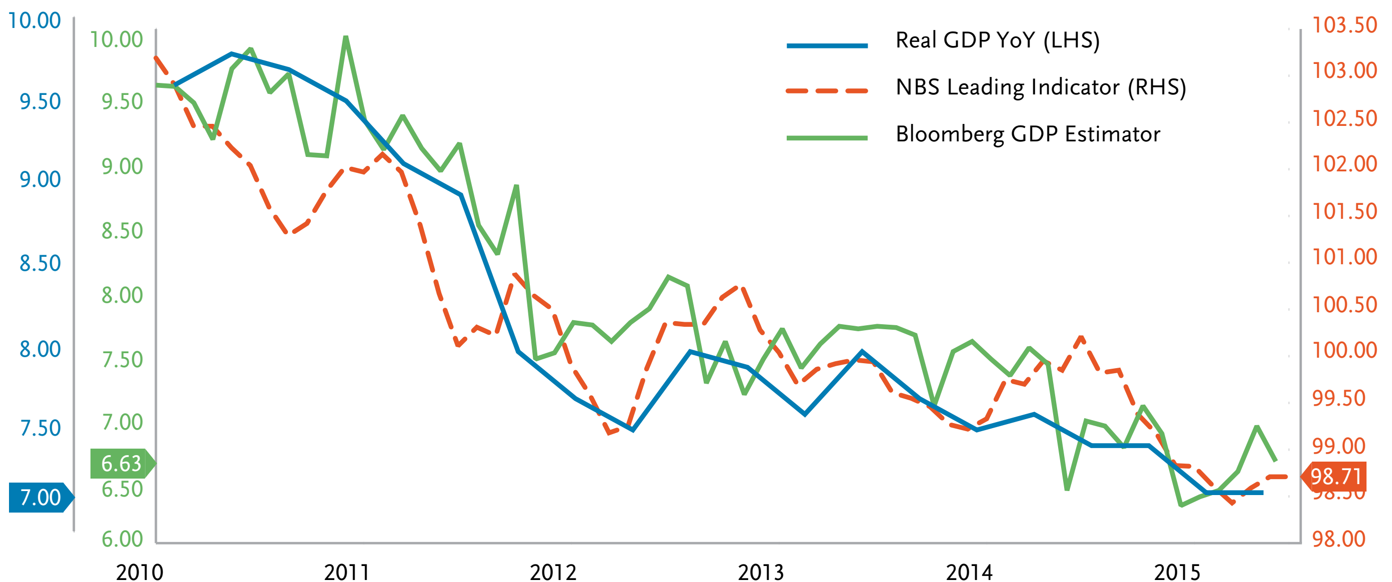
How will this impact the U.S. rates market? Will the Fed now delay hiking rates?

While a depreciation of the CNY could induce more capital outflows and potentially a further draw-down of China's foreign exchange reserves we think the impact on the Treasury market will be small because:

- Due to regulatory changes such as higher liquidity requirements for banks and insurance companies, along with quantitative easing by the world's major central banks, demand for long-term highly rated sovereign bonds is likely to remain high relative to supply; and
- China has most likely been diversifying its reserve holdings out of U.S. Treasuries for a long time, and its holdings of Treasuries have most likely declined since early 2014. Since then long-term U.S. Treasury bond prices have increased.

Bottom Line: A weakening in China's and other Asian currencies will impact U.S. growth and inflation. However, at this point we don't expect the impact to be large enough to change the timing of the Fed's liftoff or the trajectory of rate hikes. Following China's move the U.S. dollar appreciated by about relatively modest 1% on a trade weighted basis.

Chart 1: Slowing Growth Though Some Signs of Stabilization



Sources: Chinese National Bureau of Statistics, Bloomberg

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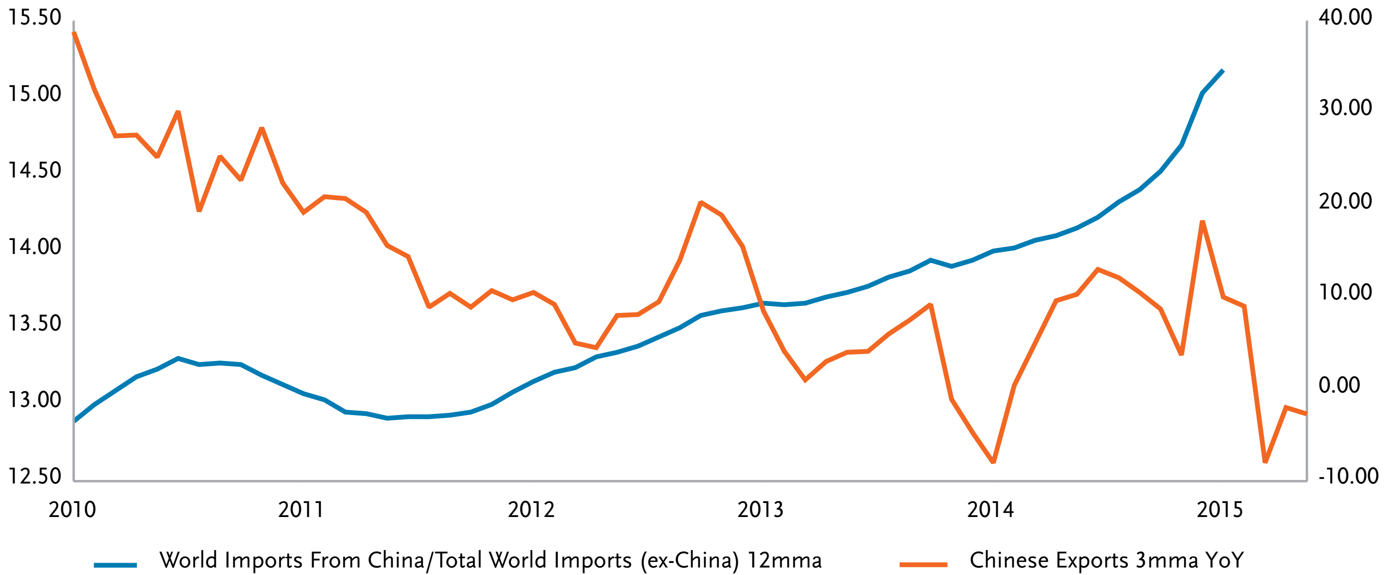
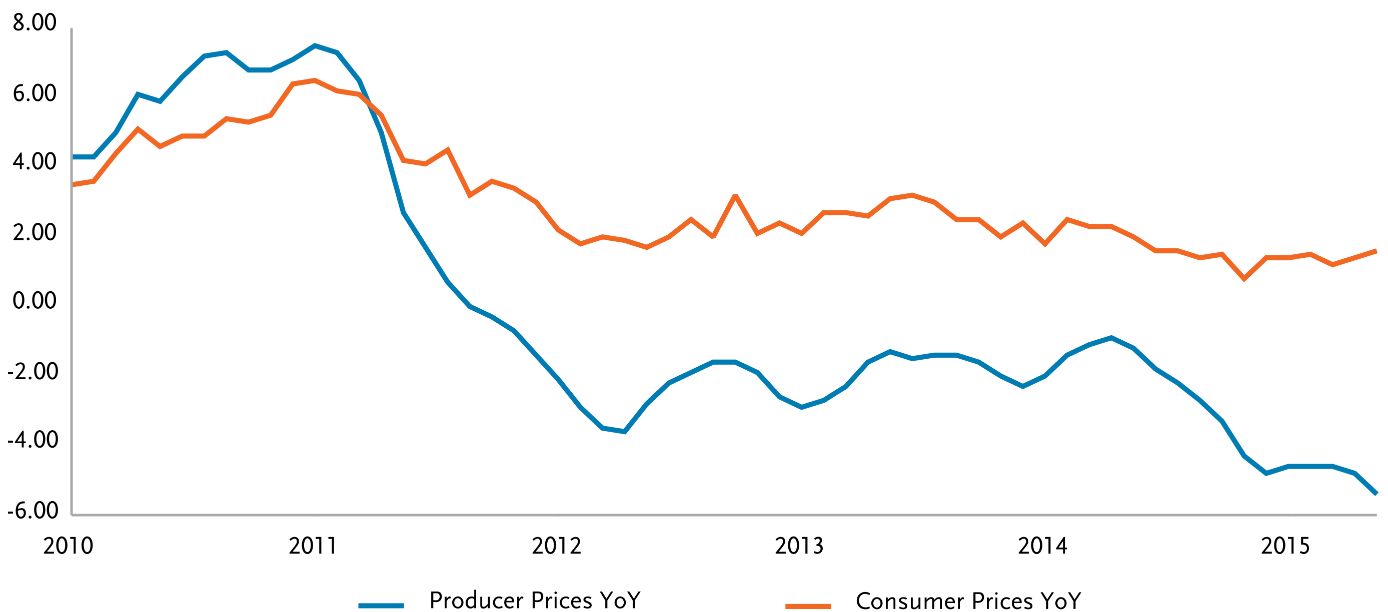
Chart 2: While Export Growth Slows, China Continues to Gain Global Market Share



Sources: Chinese National Bureau of Statistics, International Monetary Fund

Chart 3: Inflation Low With Deflation in Some Sectors



Source: Chinese National Bureau of Statistics

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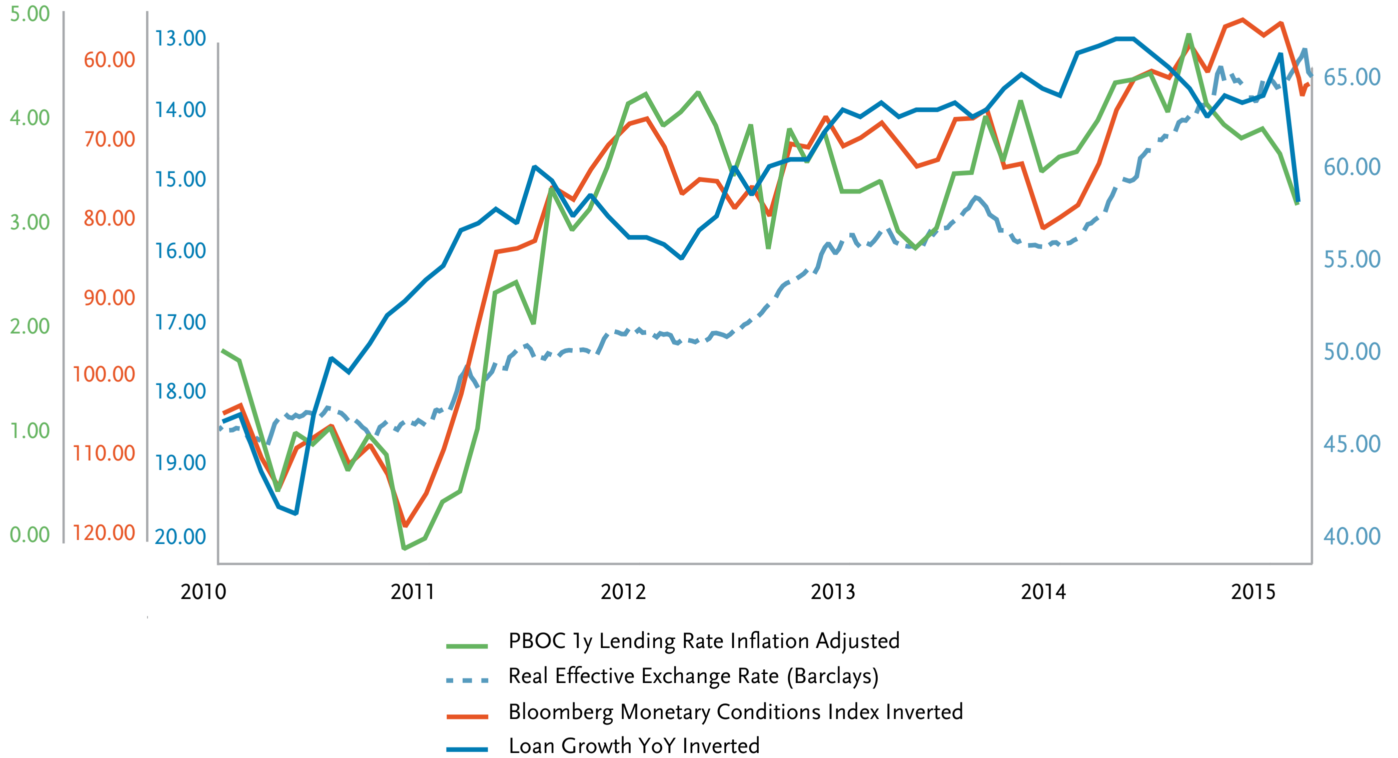
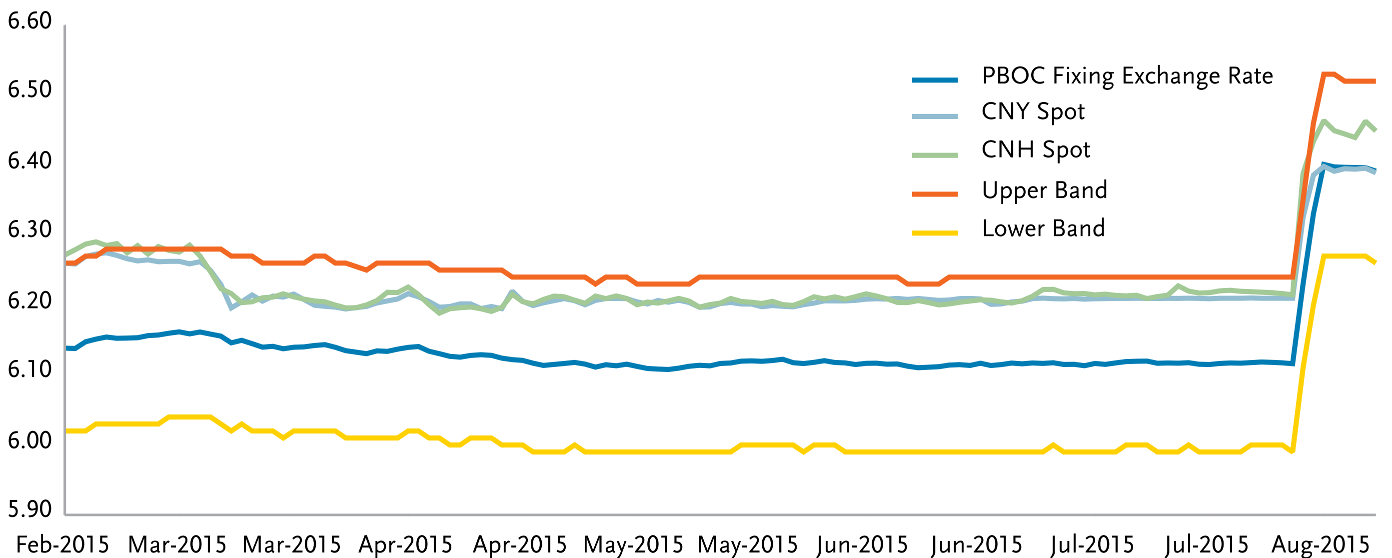
Chart 4: While Easing Monetary Conditions Still Relatively Tight



Sources: China National Bureau of Statistics, People's Bank of China, Barclays, Bloomberg

Chart 5: China Has Closed The Gap Between the PBOC's Fixing and the CNY Spot



Sources: China Foreign Exchange Trading System, Bloomberg

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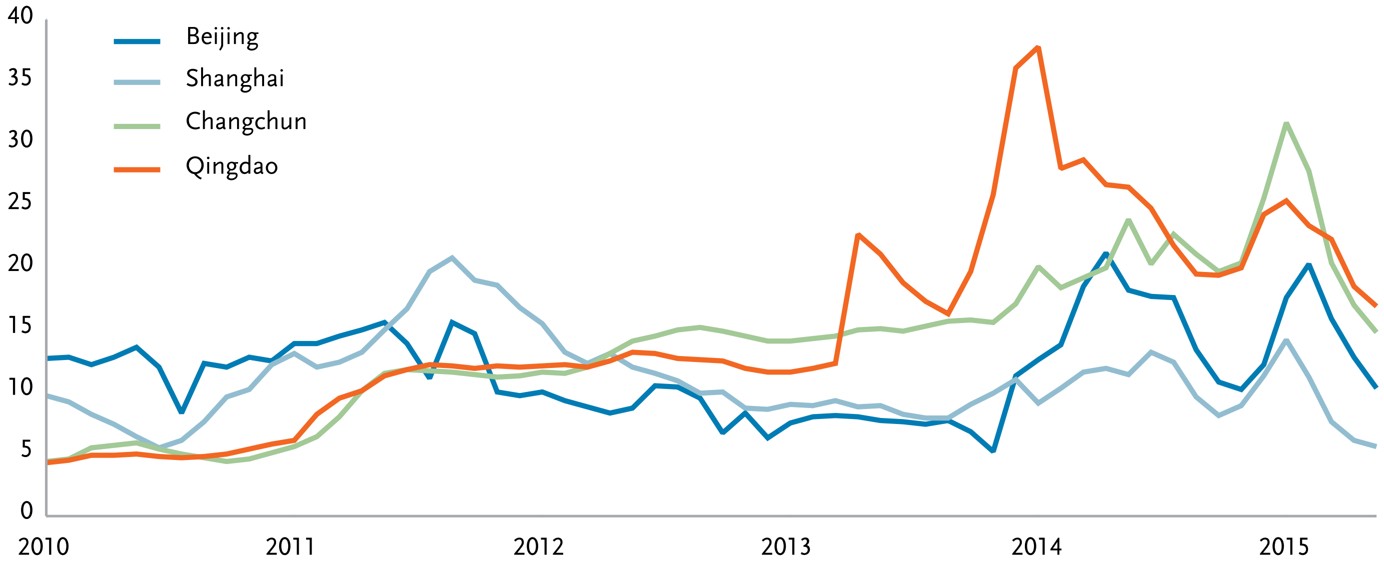
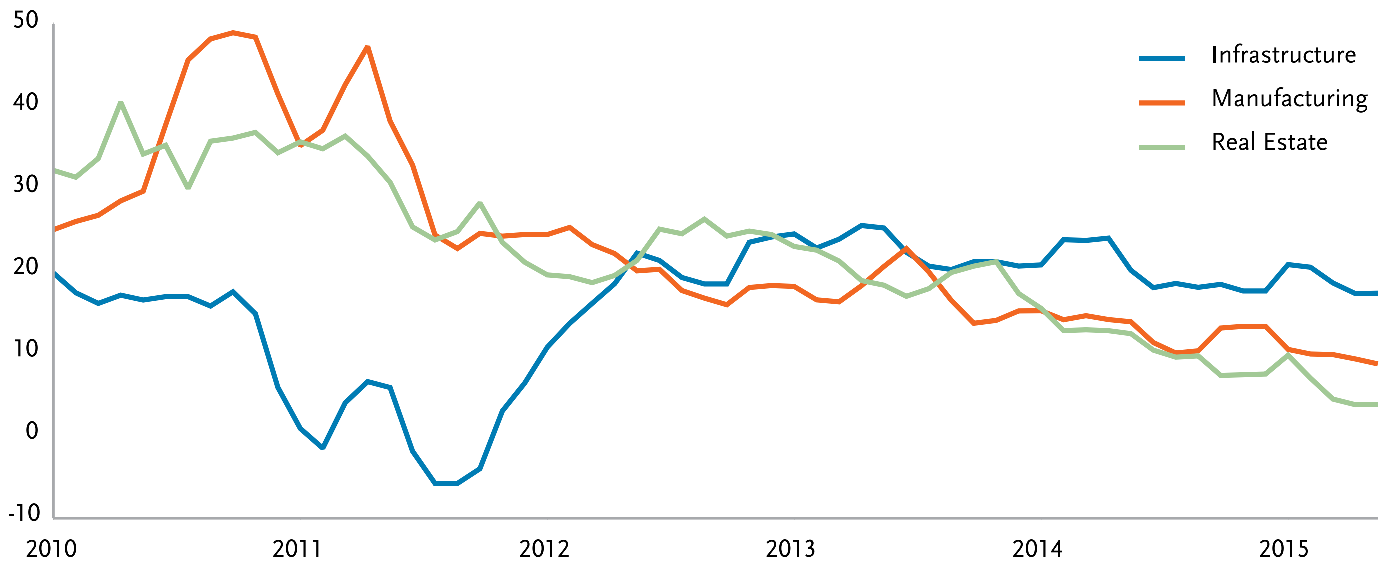
Chart 6: Inventories of Unsold Apartments Coming Down (Stock of Unsold Units/Monthly Average Sales)



Source: China Real Estate Information Corp

Chart 7: Infrastructure Supporting Growth As Real Estate and Manufacturing Investment Taper Off (3 month moving average YoY % Change)



Sources: Chinese National Bureau of Statistics, Bloomberg

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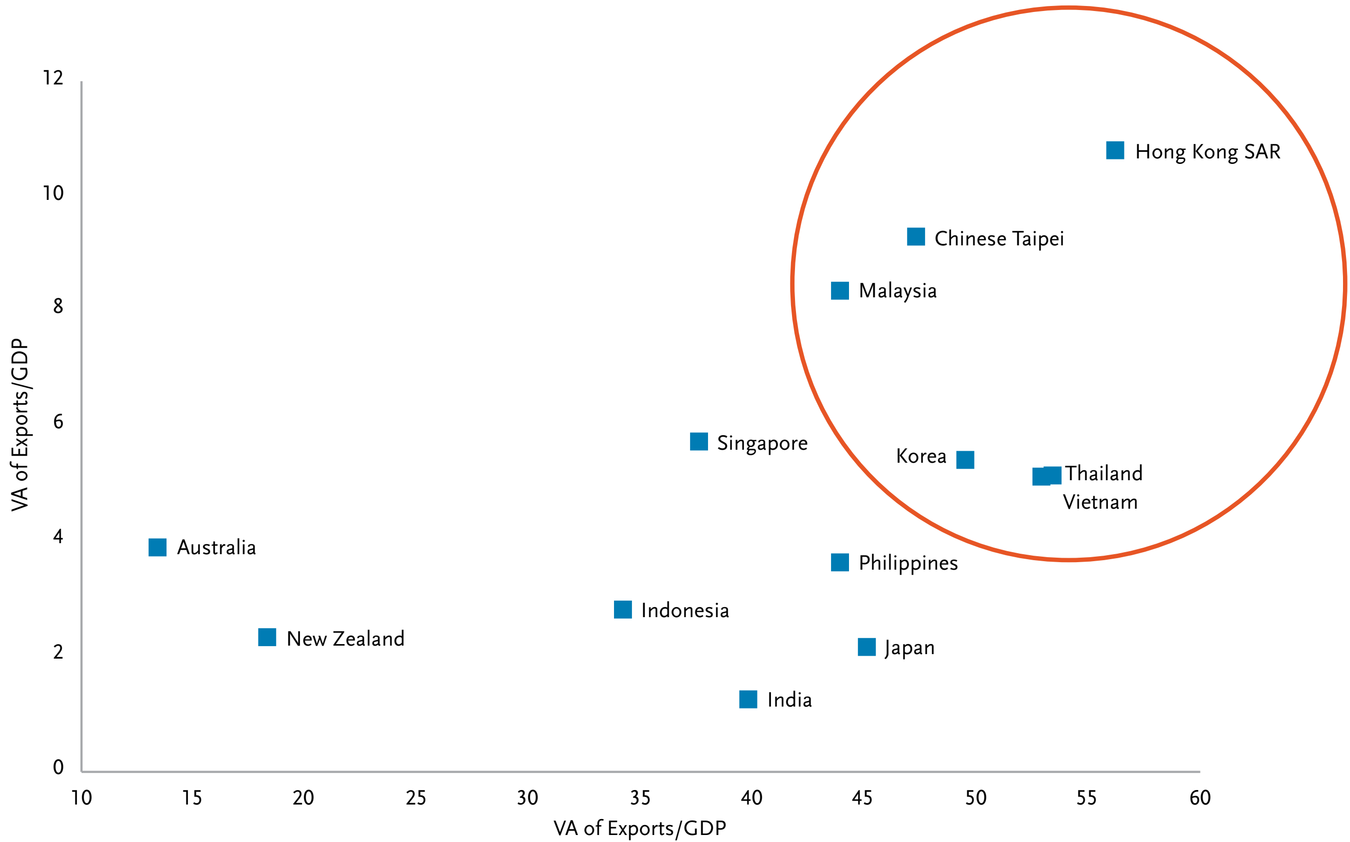
Chart 8: Impact of CNY Depreciation Biggest on Economies That Export to & Compete With China



Source: OECD-WTO, UNCTAD
Includes Domestic Value Added in Intermediate Goods Exports to Third Countries Ultimately Shipped to China.

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