Macro Keys

Capital Outflows & RMB Exchange Rate

Economics & Macro Strategy

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Given the RMB's recent significant real effective appreciation, the ECB's and other central banks' QE and various easing/currency depreciations, will the PBC follow suit and depreciate significantly? Does this also mean another band widening? Can China handle the growing size of its capital outflows?

Understanding China's surging capital outflows

China's non-FDI capital outflows swelled to USD 160bn in Q4 and over USD 320bn in 2014, comprising of portfolio investment flows, trade credit flows, other foreign borrowing and lending, (unwinding) interest rate arbitrage flows, and capital flight. We think fading RMB appreciation expectations and a narrowing interest rate differential are key drivers behind the outflows. In addition, faster diversification of corporates and households asset into foreign assets may have occurred, thanks in part to a gradual relaxation of capital controls. China can easily manage the liquidity impact of outflow through "reverse sterilization" – RRR cuts, open market operations and liquidity facilities. Indeed we expect a combination of such tools in 2015.

Will RMB depreciate significantly?

No. We only expect a modest depreciation of about 3% in USDCNY this year. Despite large and persistent capital outflows, China still has a sizable and rising current account surplus; political pressures from the US and the government's ambition to promote RMB internationalization would also limit the weakening of RMB; and the government may also want to limit depreciation so as to not destabilize expectations and trigger bigger outflows, which would bring increased liquidity and financial volatility.

What about a band widening?

We think a further widening of the band soon is unlikely, as it is neither needed nor tactically desirable right now. If the government wanted to allow for a greater degree of depreciation, it can easily achieve this by moving the fixing higher more frequently and to a greater degree. Widening the trading band now would only further aggravate depreciation expectations, counter to what we believe is the PBC's goal of maintaining a largely stable currency.

We retain our 2015-end forecast of 6.35

With domestic demand still softening, the USD still strengthening, and China's competitiveness eroding, we think a modest pace of depreciation (<3%) is more likely, leaving the CNYUSD at 6.35 by year-end, with periodic bouts of two-way movements in a volatile EM currency environment.

Understanding China's surging capital outflows

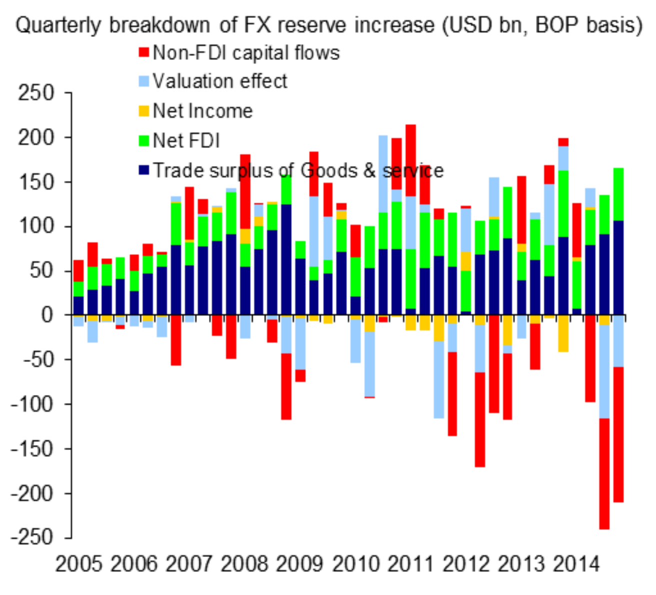
How much? China has seen significant capital outflows in the past few quarters; non-FDI outflow reached an estimated USD 160 billion in Q4 2014 alone. Despite a current account surplus of USD 214bn and almost USD 200bn in net FDI inflows in 2014, China's FX reserves rose by a mere USD 22bn, or USD 118bn excluding the valuation effect on FX reserves. We estimate that net non-FDI capital outflows – including portfolio flows, other financial flows, transfers and non-specified capital flight – reached USD 324bn in 2014, contrasting with 2013's net inflows of USD 56bn (Figure 1).

Flow types and why? The main types of non-FDI capital flows include the usual portfolio investment flows (both debt and equity), trade credit flows, other foreign borrowing and foreign lending, domestic banks interbank borrowing and offshore lending, interest rate arbitrage flows (or the unwinding of such flows), and capital flight. While the release of more detailed balance of payment statistics is needed for this to be verified, we think recent capital outflows mainly came from the following:

- As RMB appreciation expectations faded during 2014 (Figure 2), corporates increasingly held on to their FX proceeds both onshore and offshore (Figure 3) and hedged against their FX exposures;
- With the interest rate differential narrowing and exchange rate uncertainty rising (Figure 4), previously strong interest rate-arbitrage inflows, including those conducted through trade credit, weakened or unwound;
- As China's domestic economy and property prices softened and the USD strengthened, corporates and households may have quickened their asset diversification into foreign assets; domestic banks may have similarly increased their long FX positions;
- Capital flight may have also been an important factor given the intensity of the ongoing anti-corruption drive.

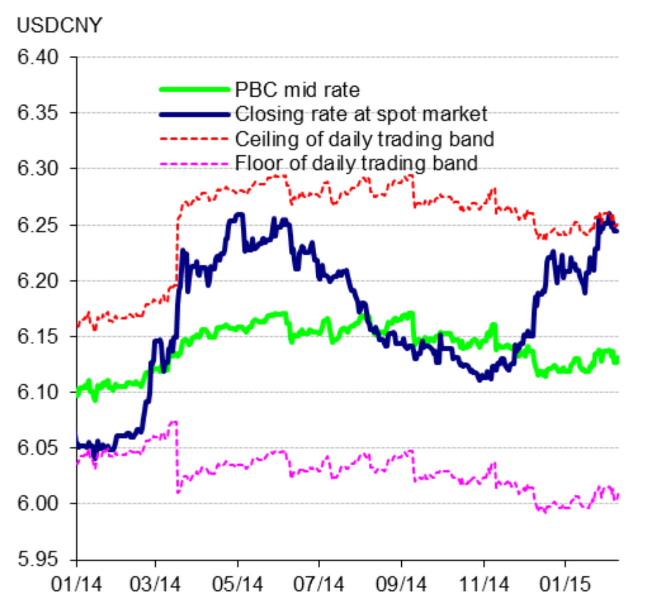
Meanwhile, to a small extent, the widening gap between China's trade and current account surpluses may also reflect the disguise of certain capital outflows within traded services. Last year, China saw a record goods trade surplus of USD 472bn, 30% bigger than in 2013 and 2008. It also saw a record service trade deficit of USD 198bn, but one that was 60% bigger than the deficit in 2013 and 17 times that in 2008. Nonetheless, while some capital flows may have been disguised as overseas spending, fundamentally, we think China's widening services deficit is being driven more by the growing spending power of China's middle class, helped by a strong exchange rate, and the country's weak competitiveness in services.

Figure 1: Capital outflows have surged of late



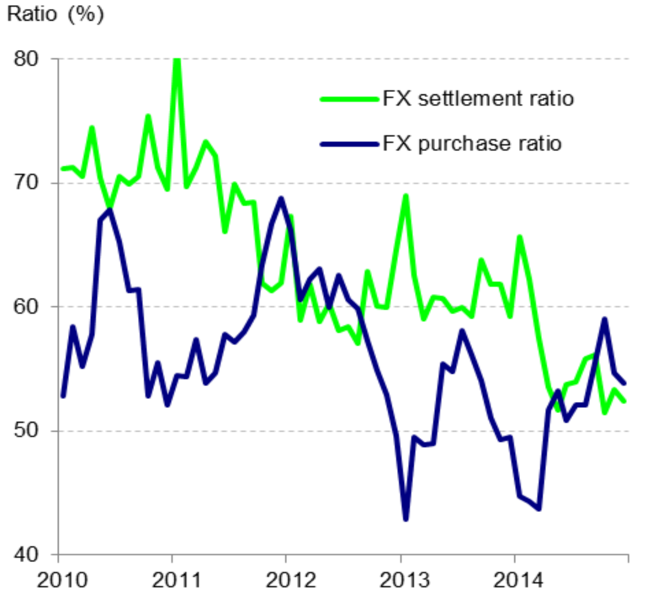
Source: CEIC, UBS estimates

Figure 2: Exchange rate expectations have changed – with the CNY spot rate weaker than its fixing for most of 2014



Source: Bloomberg, UBS estimates

Figure 3: Corporates are choosing to retain more of their FX holdings



Source: CEIC, UBS estimates.

Figure 4: The onshore-offshore interest rate differential has narrowed

Source: CEIC, Bloomberg, UBS estimates. Note: covered calculation uses CNH 3m.

How to manage outflows? What is the consequence of sizeable and still swelling capital outflows for China? How will its central bank manage?

First, it is important to note that this isn't the first time the PBC has had to deal with large capital outflows. As Figure 1 shows, China saw significant net capital outflows during the European sovereign debt crisis and at the beginning of the global financial crisis.

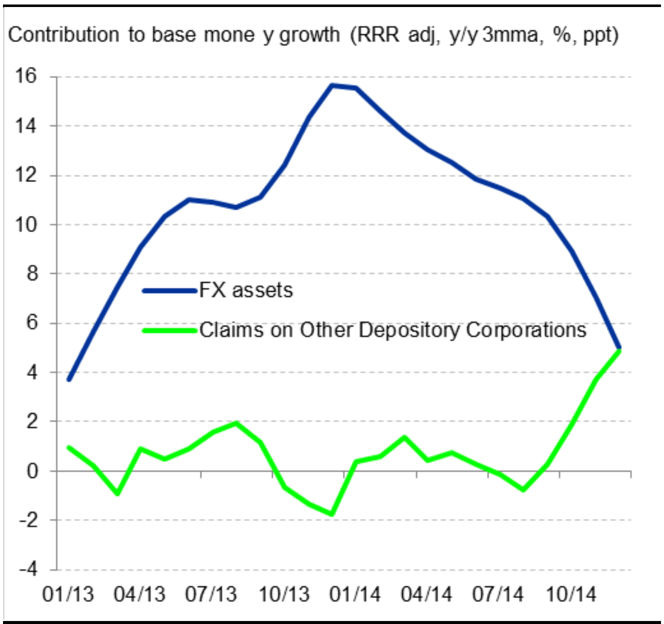
Second, capital outflows would reduce domestic liquidity supply if all else holds equal, and hence, require the central bank to provide liquidity through other means to ensure adequate liquidity provision – for which the PBC indeed has plenty of room to do. For one, the PBC had raised the required reserve ratios (RRR) of commercial banks from below 7% in 2004 to 20% in 2012 as a cheaper way to sterilize massive FX inflows (Figures 5 & 6). This means that it can easily reverse the sterilization now by cutting the RRR as capital outflow occurs and China's pace of FX accumulation stalls (even post the recent cut, China's RRR still averages 19% in the banking system). In addition, the PBC can continue to use open market operations and other liquidity facilities (MLF, for example) to ensure adequate base money supply.

In 2015, we expect interest rate differential to narrow further with at least another two benchmark rate cuts on the horizon (totalling 50 bps), and see the capital account deficit largely offsetting a bigger current account surplus. As a result, we expect FX reserves to increase by only USD 100bn, which suggests the PBC would need to cut the RRR at least two more times if it chooses not to rely more on other liquidity facilities. More likely, rather than relying exclusively on RRR cuts, the PBC will opt for a combination of all liquidity tools at its disposal.

Third, capital outflows could put further depreciation pressure on the RMB, which could trigger more outflows. Therefore, the PBC would need to manage the exchange rate well to anchor expectations.

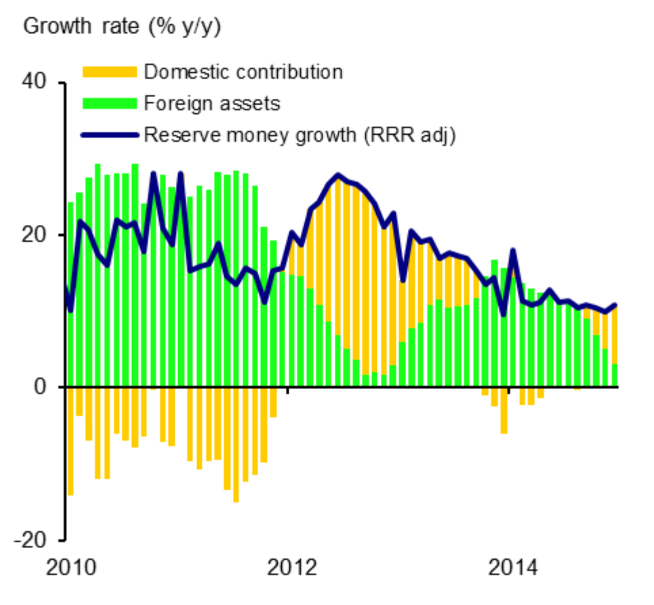
Finally, don't forget that China still has extensive capital controls. Although the government has moved gradually to ease capital controls in the past couple of years, an intensification of capital outflows and a more uncertain external environment may lead to increased caution on this front.

Figure 5: Reverse sterilization has been carried out



Source: CEIC, UBS estimates

Figure 4: Despite growing capital outflows, base money growth has been kept stable

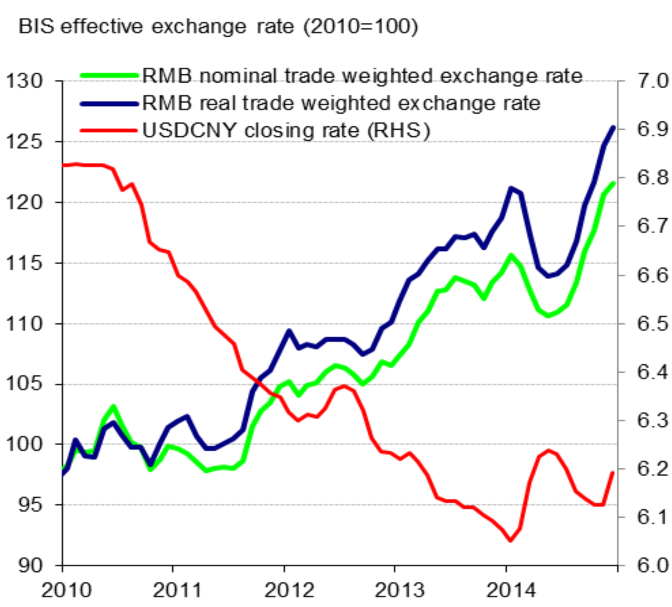


Source: CEIC, UBS estimates

Significant RMB depreciation unlikely

In light of surging capital outflows and a still weakening domestic economy, and given that the RMB has appreciated by over 30% since 2008 and 6% in 2014 in real effective terms (Figure 7), many in the market think that the RMB could depreciate significantly against the USD in 2015. Not in our view.

Figure 7: RMB appreciated by 6% last year in real effective terms



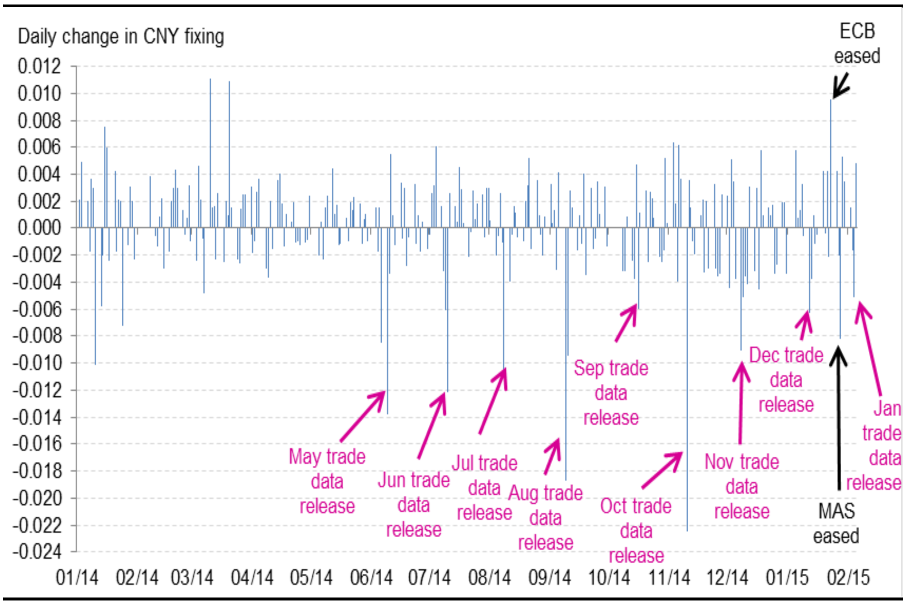
Source: CEIC, Bloomberg, UBS estimates

We expect a modest RMB depreciation this year but see little chance of a significant move (i.e. anything above 5%) in 2015. As we elaborated in an earlier report (RMB conundrum), there are a number of reasons why a large depreciation is unlikely:

- China's current account surplus is expected to rise further in 2015 (to over USD 250bn with a trade surplus over USD 500bn), providing a sizeable offset to capital outflows in addition to nearly USD 4 trillion in FX reserves;
- Political pressure from trading partners – the US government has continued to put pressure for China to appreciate its currency and such pressure does matter. In addition, although many may think that a currency war is already upon us, a large depreciation by China would almost certainly intensify competitive devaluations in the region, which in the end, may not benefit China much;
- A large depreciation could destabilize exchange rate expectations, trigger bigger outflows, and increase liquidity and financial volatility. With increasingly unpredictable global market volatility and challenges to maintaining financial stability at home, the PBC is likely to make exchange rate stability a priority;
- China's government remains in active pursuit of RMB internationalization, and the IMF will be discussing the possible inclusion of RMB in the Special Drawing Rights (SDR, which member countries count toward their official reserves) basket this October. Maintaining a stable and relatively strong currency is important for promoting the greater use of RMB.

Indeed, the PBC has consistently lowered its USDCNY fixing after each trade surplus data release for the past 9 months (Figure 8), with the latest being last Friday's visible appreciation from 6.1366 to 6.1261 just before the release of January's record high trade surplus of USD 60bn (assisted by improving terms of trade). The divergence in how the fixing moved following the ECB's easing on 22 January (higher) and the MAS' easing on 28 January (lower) was interesting however, suggesting that the PBC has no desire to get caught up in a regional round of devaluations.

Figure 8: Daily change in RMB fixing



Source: Bloomberg, UBS estimates

Of course, there are also strong arguments for some weakening of the RMB. Despite its 2.6% nominal depreciation against the USD in 2014, the RMB strengthened along with the USD against other major currencies to appreciate by 6% versus its trade weighted basket last year. This trend will likely continue in 2015. The relentless appreciation of the RMB has undoubtedly eroded China's competitiveness, and the latest trade data showed a notable cooling of Chinese exports to the

G3. Although China's trade surplus is surging, it is being mainly driven by an import collapse, underpinned by domestic demand weakness and huge commodity price declines. Moreover, China's services deficit is widening at a rapid pace.

Given the above considerations, China's still softening domestic demand, and the USD's continued strengthening, we think a modest pace of depreciation (< 3%) is more likely - taking the CNYUSD to 6.35 by year-end, with periodic bouts of two-way movements in a volatile EM currency environment.

What about a band widening?

Many FX investors have been closely watching the CNY daily fixing, and seeing similarities with last year just before the PBC's CNY band widening.

Though we continue to expect increased two-way volatility in the RMB exchange rate this year, we think a further widening of the daily trading band is unlikely any time soon. Currently, the spot exchange rate can fluctuate +/- 2% around the daily fixing. Although market rates have frequently hit the upper band in recent weeks, the central bank, as usual, did not adjust its fixing accordingly to reflect the market move. If the government wanted to allow for a greater degree of depreciation, it can easily achieve this by moving the fixing higher more frequently and to a greater degree. Clearly, the PBC is more focused on maintaining a largely stable currency and expectations.

Widening the daily trading band under current circumstances, with expectations now tilted firmly towards depreciation, would only further aggravate those expectations. If the government is seriously concerned about weak domestic demand and wants to free its hand somewhat on the exchange rate front, widening the daily trading band could be a useful tool for tolerating a somewhat larger depreciation while keeping the official fixing mostly unchanged. However, as we believe the government wants to keep the exchange rate largely stable, manage its international political relations, and further internationalize the RMB, widening the trading band at this juncture would not seem to be a good tactical move, and likely only lead to increased daily volatility.

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