China Watch

XI WANTS STRONG RMB, TRUMP WILL STOP HIM

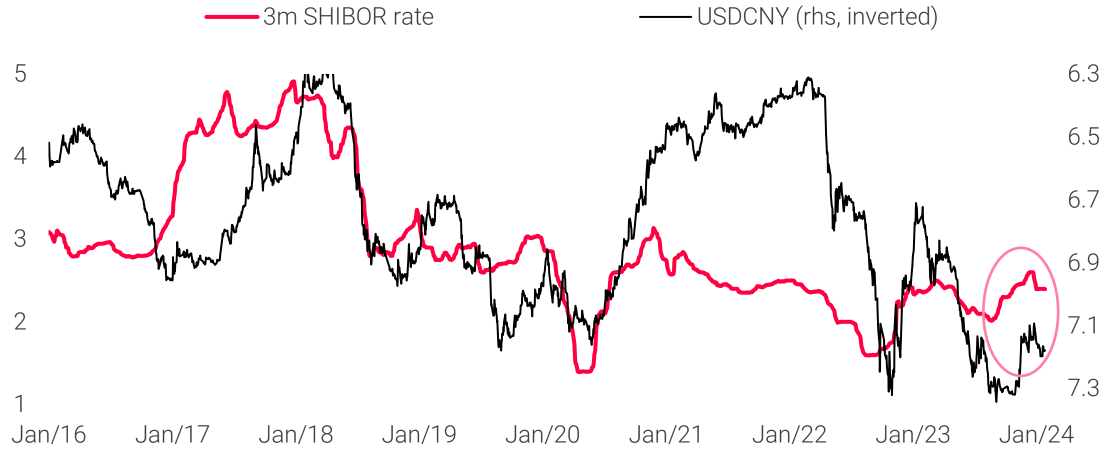
Rory Green

- The PBoC reaction function is changing to give more weight to FX stability
- The emerging "strong RMB" policy could constrain monetary stimulus
- H2/24 Trump fears will push yuan weakness and risk PBoC rate tightening
- Trade-war trades: Long USD/CNY, Brazil soybeans, short ADRs returning

A "strong RMB" policy appears to be emerging in Beijing – one that, like the "franc fort", the strong dollar and the infamous European exchange rate mechanism, could act to constrain monetary policy just at a time when the PBoC needs to engage in significant quantity and price easing. Beijing has proved capable of managing USD/CNY with limited use of FX reserves and rates. However, the chance of a second Trump term is likely to see markets price in trade-war trades (long USD/CNY, Brazil vs US soybeans, and short China ADRs) in H2/24. RMB weakness could then force Beijing to allow short-end rates to rise and rely even more heavily on structural lending tools and fiscal policy to drive growth.

For most of the post-GFC era – and, in particular, from 2016 onwards – the PBoC has pursued a policy of managed intervention. Policymakers moved to slow the pace of appreciation/depreciation in a stepped manner, rarely engaging in the sustained defence of a single level. At the same time, the PBoC put growing emphasis on the CFETS basket over the USD/CNY rate and gave greater weight to a monetary "dilemma" framework over the classical "trilemma", with capital controls considered a prerequisite for sovereign monetary policy and managed FX. That approach has gained increased international credence since the GFC and widespread DM central-bank asset purchases. The combination of a softer peg and capital controls enabled Beijing to diverge relatively successfully from US monetary policy while managing exchange rates.

Chart 1: Strong RMB policy would require painfully high rates



Sources: CEIC, BBG, TS Lombard.

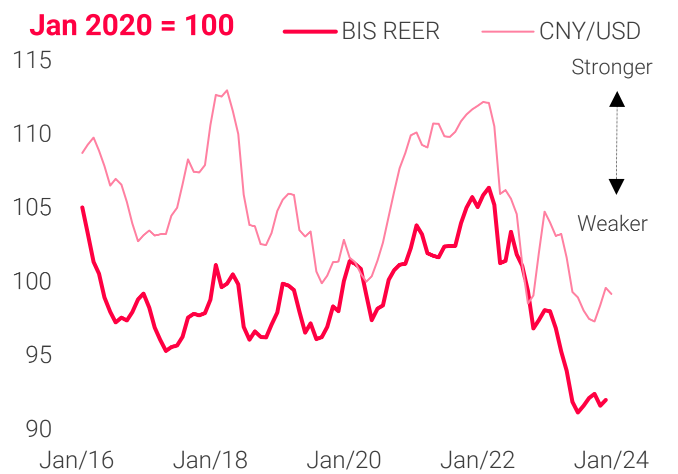
An emerging 'rich RMB' policy? In September last year we noted signs of change in PBoC FX management as the bank in effect drew a line in the sand at USD/CNY 7.32. This had a clear short term goal of boosting market and macro confidence. However, since then, Xi Jinping has talked about developing China into a "financial power": of the six prerequisites identified to achieve this goal, a "strong currency" is placed first. The CCP, as we noted in 2022, is pushing to build financial as well as technological resilience. Accordingly, Governor Pan Gongsheng has raised the importance of "currency stability" – both domestic price and foreign exchange – in recent comments. Pan gave a positive spin on the implications for PBoC easing, noting that onshore prices and the prospect of Fed cuts provided a rationale and room for more monetary action. And it is noteworthy that the authorities sought the repatriation of offshore funds – a move to strengthen RMB – when responding to recent market turmoil.

Needless to say, an artificially strong currency attached to a weak economy is not a good combination. There is clear logic to preventing rapid and uncontrolled depreciation. The USD/CNY rate is a closely watched barometer of economic health and has a significant impact on business confidence and capital flows. Nevertheless, a sustained period of suppressing domestic consumption or engaging in tighter monetary policy – the latter being the more likely – to prevent the yuan weakening would risk further harming already sluggish spending, loan growth and monetary velocity.

The PBoC will increase stimulus this year, largely through structural lending programmes such as PSL. In China, the cost of money is less important than the quantity, especially in the current environment with demand for loans so weak. But even so, higher short-term financing costs will add to the squeeze. The pain will be felt in net interest margins, particularly for beleaguered small banks that rely on interbank markets for funding. City and rural lenders are the most exposed to weaker property markets and are also the biggest lenders to SMEs. A stronger currency is less detrimental to exports. China remains highly competitive and has managed to maintain pandemic market share through increased efforts to "de-risk".

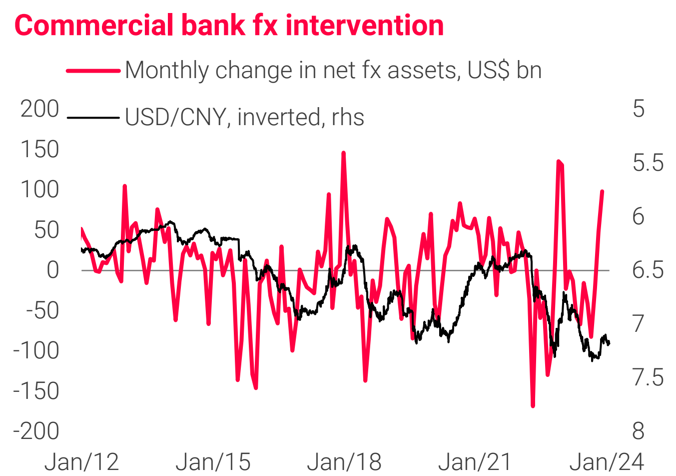
Longer term, we continue to expect a structural depreciation in RMB, even as the trade surplus remains large through self-sufficiency gains. The multi-year property-sector contraction and, to a lesser extent, Xi's new tech-investment heavy-growth model will require expanded central government borrowing. The drivers of liquidity will switch from real-economy demand for credit to policy-generated supply. Typically, borrowing to invest or consume drives monetary expansion. However, Beijing is forcing an increase in supply via state-directed lending above and beyond

Chart 2: More real depreciation than nominal



Sources: BBG, TS Lombard.

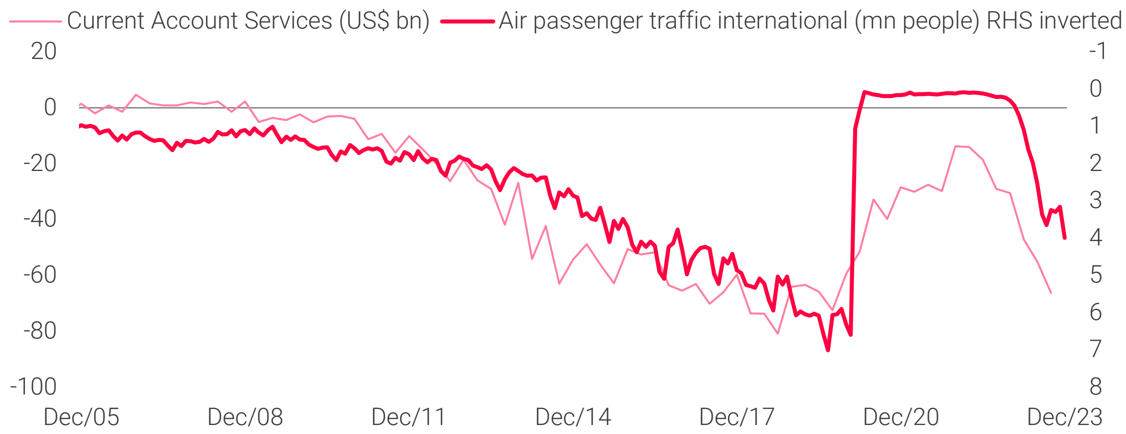
Chart 3: Limited reserve sales in 2024



Sources: NBS, BBG, TS Lombard.

underlying economic demand. This is likely to lead to a decline in velocity: the ratio of GDP to money falls as people and firms hold onto surplus liquidity. As the volume of RMB continues to exceed what can be bought in the real economy, the value of the currency is reduced– whether through nominal or real channels.

Chart 4: Tourism and capital flight to accelerate in 2024

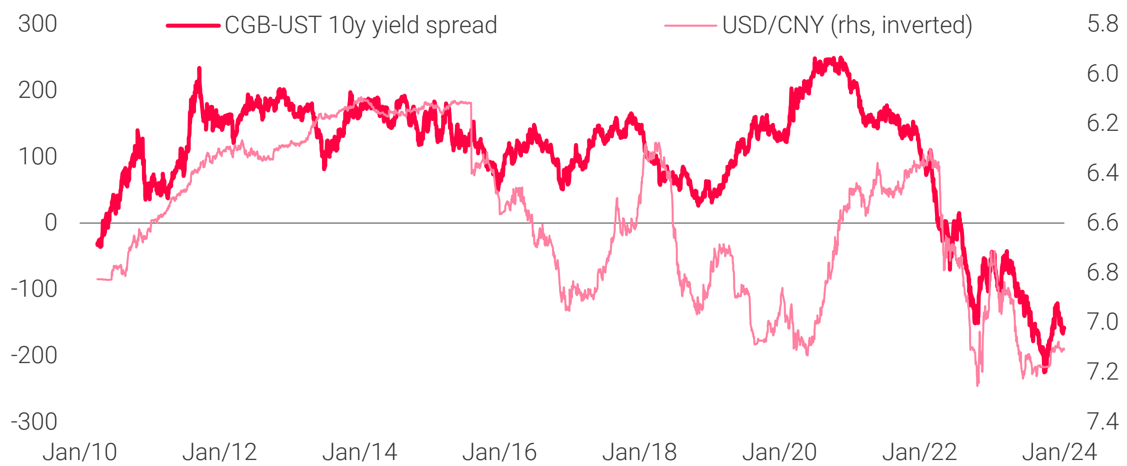


Sources: NBS, TS Lombard.

As we have long maintained, this depreciation is likely to be more real than nominal – a prospect further supported by the emerging strong currency push. We wrote in 2022 that domestic and international politics would limit the scope for change in USD/CNY, with the bigger move coming in REER. This has played out: China's REER has fallen 8% and RMB has been broadly flat against the dollar over the past three years (chart 2). Domestic deflation will continue to favour real exchange-rate depreciation, as will the political backdrop.

Crucially for foreign investors, **real as opposed to nominal depreciation increases the opportunity to add diversification** through exposure to the last refuge of the 60/40 portfolio (China) and to profit from what we see as a long-term bull market in CGBs. Near term, Trump-related FX risk (even as currency hedging provides a yield pickup), valuation and the potential political limits on PBoC rate cuts discussed in this note lower the attractiveness of Chinese rates.

Chart 5: Growth and rate differentials drive USD/CNY



Sources: BBG, TS Lombard.

This puts Chinese monetary policy – or at least the price component – partly hostage to the Fed and Trump. A hawkish surprise from Jerome Powell would – if we take Governor Pan at his word – limit the scope for PBoC easing. As for the election, Trump's 2024 policy platform is still largely unknown. China will probably not feature as prominently as in previous campaigns. However, this will not stop markets pricing in renewed US-China trade friction. Current and former staffers for the Republican candidate have leaked suggestions that range from a return to pre-WTO trade arrangements with China to a flat 60% tariff on Chinese imports. The yuan is likely to reflect such projections as the election nears.

The domestic backdrop in H2/24 should see relative stability and improving confidence from a low base. We expect Q4/23 stimulus to impact the real economy this quarter and additional easing – particularly for real estate – to materialize in Q2/24. Alongside a modest improvement in exports, the backdrop is generally conducive to RMB strength. The main macroeconomic drag will be tourism outflow and, with it, capital flight. Outbound travel will reach pre-Covid levels this year and the current-account service deficit could break the record of negative US$80bn, which was set in 2018 (chart 4). The service deficit, combined with the prospect of a Trump Presidency, could push USD/CNY towards 7.3 around Q3/24. If our stimulus and stabilization call proves wrong, the yuan will set a new low.

A strong RMB policy might be emerging in Beijing. The focus on maintaining a stable USD/CNY exchange rate risks putting PBoC policy hostage to the Fed and market pricing of a Trump election victory. We think Beijing will be forced to tighten short-end rates in Q3/24 to combat the impacts identified above. And this will mean pressure on the fragile recovery and require greater quantity easing.

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