

# China Policy

## RMB depreciation as the pro-growth signal

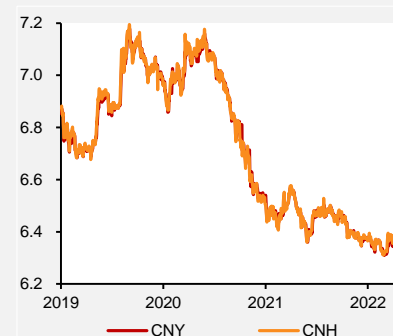
US\$/RMB spot rates rose 1.7% in the past three trading days, marking the end of strong renminbi and the start of a cycle of weakness. We believe the renminbi depreciation should be considered as the pro-growth signal from the policymaker, which should pave the way for further policy easing ahead. Based on the Sino-US growth divergence and interest spread dynamics, renminbi should have moderate downside room (over 8%) against US dollar in this weakness cycle. In the near term, renminbi depreciation may mildly increase capital outflow pressure and stock market volatility. As the depreciation is in place, however, capital inflows should rebound as renminbi assets become cheaper and stronger policy easing supports economic prospect. In the medium to long term, interest spreads, exchange rates and stock market performance are all driven by the economic prospect.

- **RMB depreciation is the pro-growth signal from the policymaker.** The weakening of renminbi has significantly lagged behind the economic slowdown cycle as well as the bust of renminbi assets. One possible reason is the policymaker's preference for strong renminbi in the past few months with the intension to facilitate renminbi internationalization and the concerns about capital outflow risk amid the Russia-Ukraine conflict. But the orientation towards strong renminbi has eroded the independence of domestic monetary policy and restrained the room of domestic policy easing. Due to the sharp slump of China economy in March and April, China faces increasing pressure to further loosen its monetary policy. The depreciation of renminbi can not only support exports, but also more importantly, create more room for domestic policy easing. Therefore, renminbi depreciation is the pro-growth signal from the policymaker, paving the way for further policy easing in 2Q22.
- **Renminbi has moderate downside room against US dollar in this weakness cycle.** In the past few months, renminbi exchange rates seemed too strong compared to the economic fundamentals and Sino-US interest spreads. The Sino-US spreads in 10Y T-bonds have turned negative recently as China's GDP growth should have declined to be below the US GDP growth in March and April. In 2Q22, the monetary policy divergence in the two countries should further increase. The above factors imply moderate downside room for renminbi ahead. We expect renminbi may depreciate over 8% against US dollar in this weakness cycle. In the medium term, the US economy will decline from the peak while China economy should gradually stabilize and resume from the bottom. This prospect may provide some buffer for renminbi exchange rates in the medium term.
- **Capital outflow and stock volatility may mildly increase in early stage of depreciation, but things will improve in late stage.** In early stage, the start of depreciation may evoke investors' expectations of further depreciation in future. This will mildly increase capital outflow pressure and stock market volatility. But things will change in late stage. As the depreciation is basically in place, renminbi assets become cheaper and economic prospect gradually improves amid stronger policy easing. Capital inflows will rebound. In the medium to long term, interest spreads, exchange rates and stock market are all driven by the economic prospect especially for large economies.

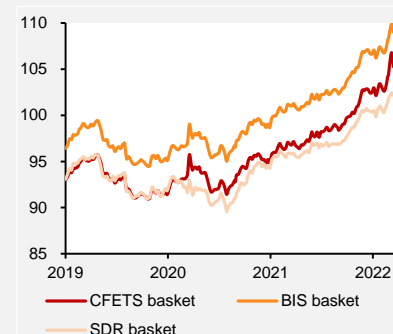
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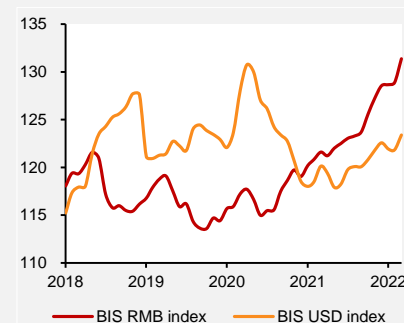
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Source: Wind, CMBIGM



Source: Wind, CMBIGM



Source: Wind, CMBIGM

■ **China should adopt floating exchange rates to absorb external shocks and use independent monetary policy to support domestic economy.**

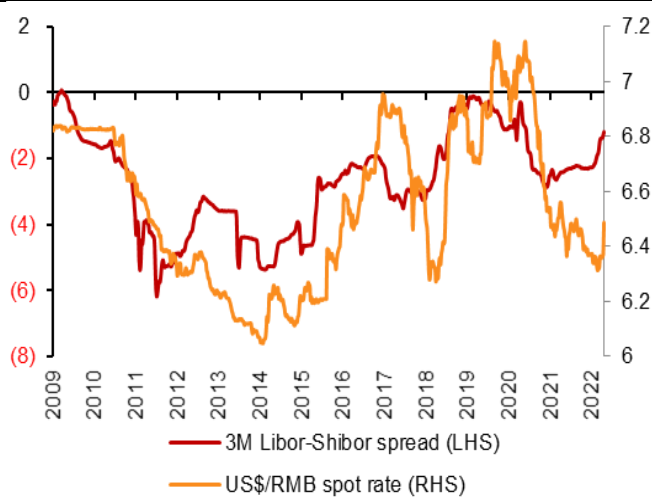
Only the economic prospect improves, can interest spreads, exchange rates, capital flows and financial markets truly stabilize. For renminbi internationalization, it is a process of natural competition and market selection and renminbi exchange rate is not the decisive factor. China's economic prospect, Chinese companies' bargaining power in global supply chain, renminbi's convertibility freedom, China's financial market competitiveness and openness and the yield and safety of renminbi assets are more important factors for renminbi internationalization. Take 2018 and 2019 for example, despite a depreciation over 10% of renminbi against US dollar, the market share of renminbi settlement in China's foreign receipt rose from 16.6% in 2017 to 26.2% in 2019. There were many reasons, including the decline in the proportion of trade with the US, the decrease of the security of US dollar settlement (US financial sanction risk) and the acceleration of China's financial market opening.

**Figure 1: Cycles of US\$/RMB Spot Rates**



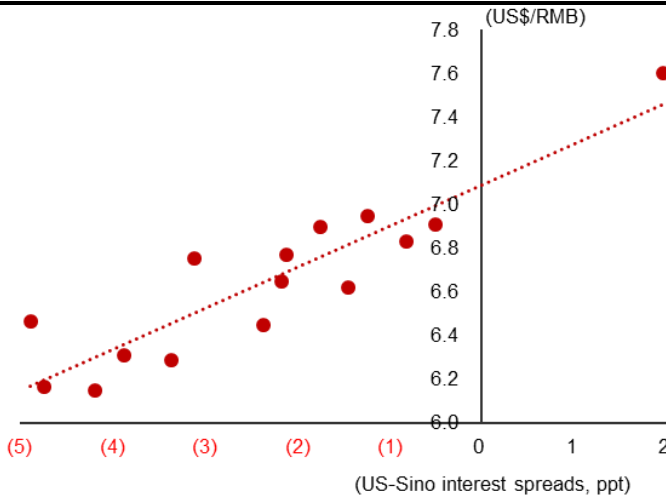
Source: Wind, CMBIGM

**Figure 2: US\$/RMB Spot Rates & Interest Spreads**



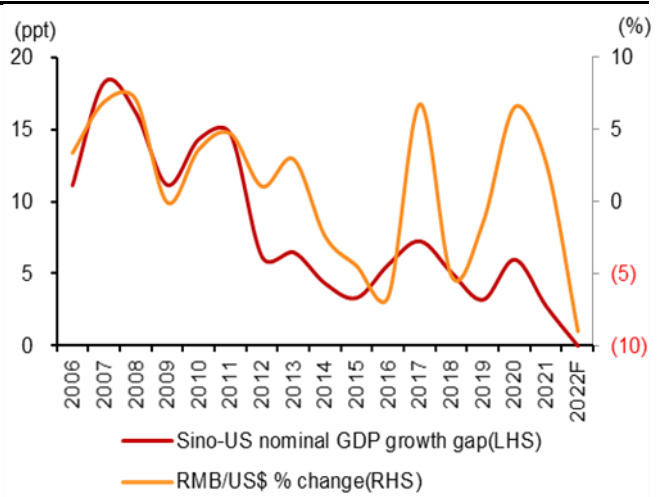
Source: Wind, CMBIGM

**Figure 3: Yearly US\$/RMB & Interest Spreads**



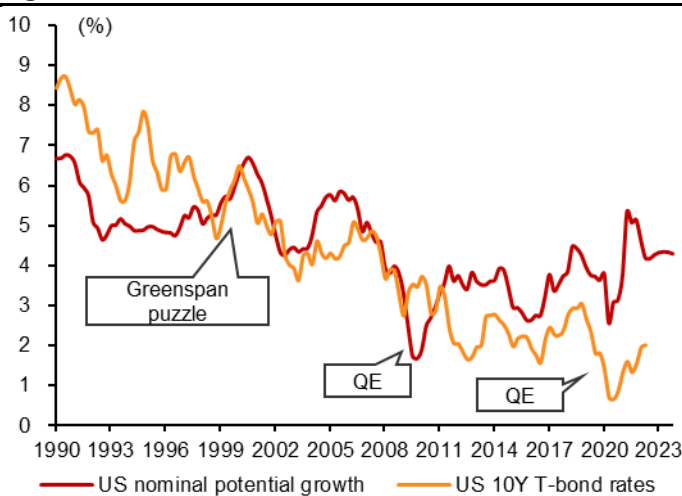
Source: Wind, CMBIGM

**Figure 4: Growth Divergence & Exchange Rates**



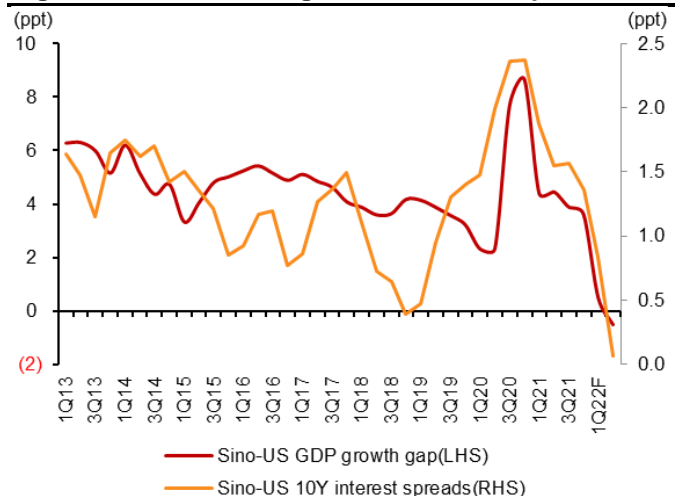
Source: MoF, CMBIGM

**Figure 5: US Nominal Growth & 10Y T-bond Rates**



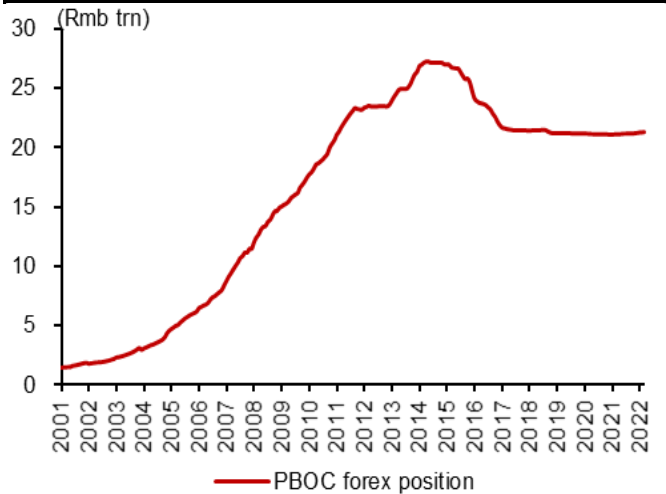
Source: Wind, CMBIGM

**Figure 6: Growth Divergence & Interest Spreads**



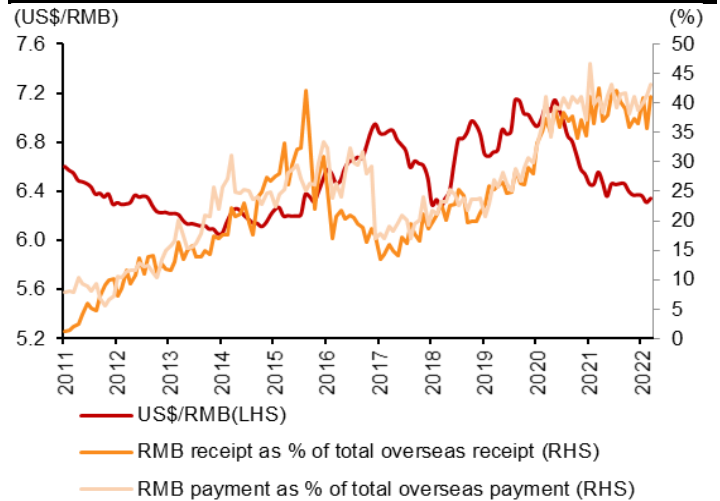
Source: Wind, CMBIGM

**Figure 7: PBOC Forex Position**



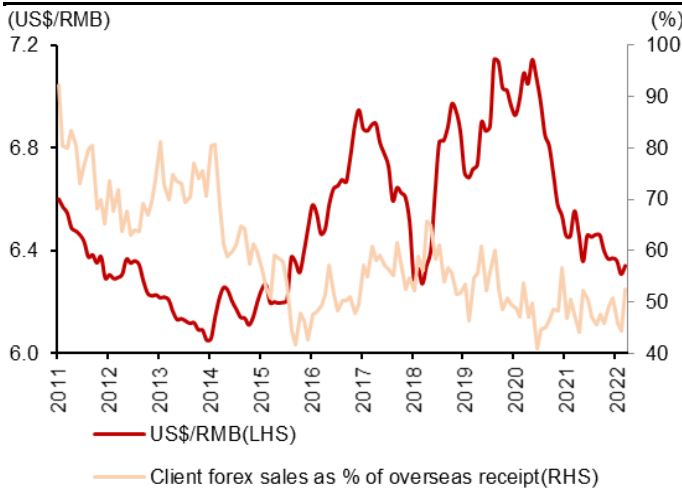
Source: Wind, CMBIGM

**Figure 8: US\$/RMB and RMB Internationalisation**



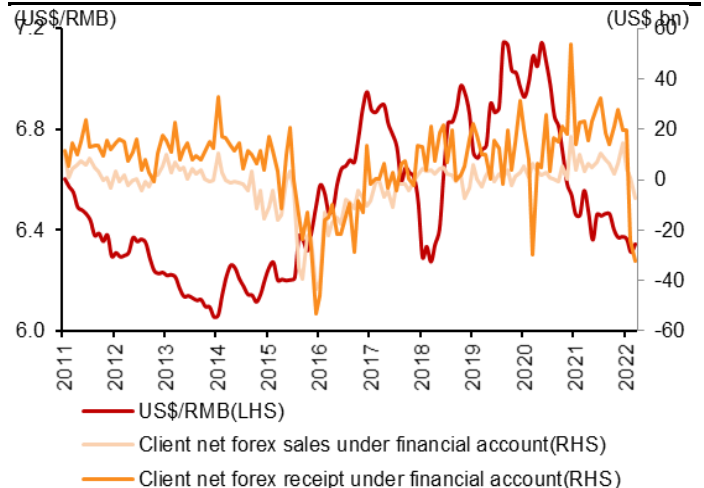
Source: Wind, CMBIGM

**Figure 9: US\$/RMB Rates & Forex Settlement Ratio**



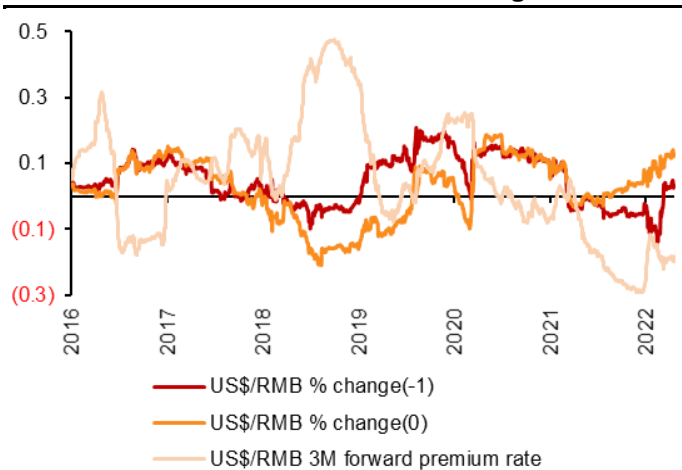
Source: Wind, CMBIGM

**Figure 10: US\$/RMB Rates & Capital Flows**



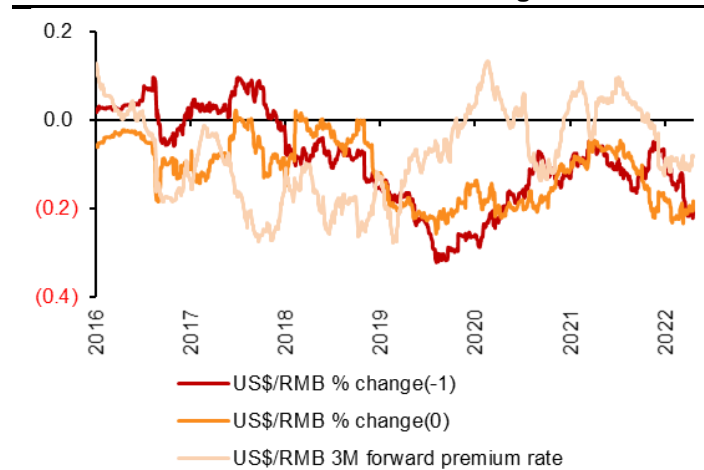
Source: Wind, CMBIGM

**Figure 11: 250D-Moving Correlation Between Southbound Net Flow & US\$/RMB Changes**



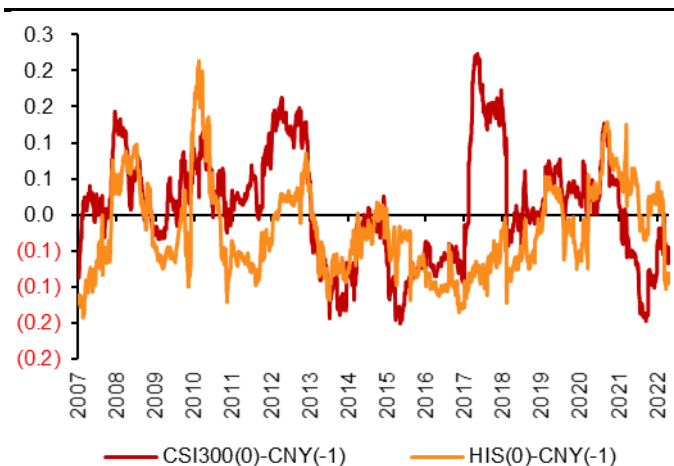
Source: Wind, CMBIGM

**Figure 12: 250D-Moving Correlation Between Northbound Net Flow & US\$/RMB Changes**



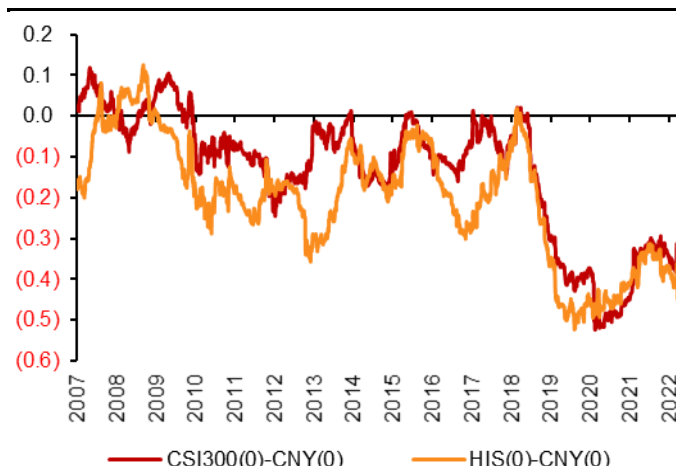
Source: Wind, CMBIGM

**Figure 13: Correlation Between Exchange Rates and Chinese Stock Indexes**



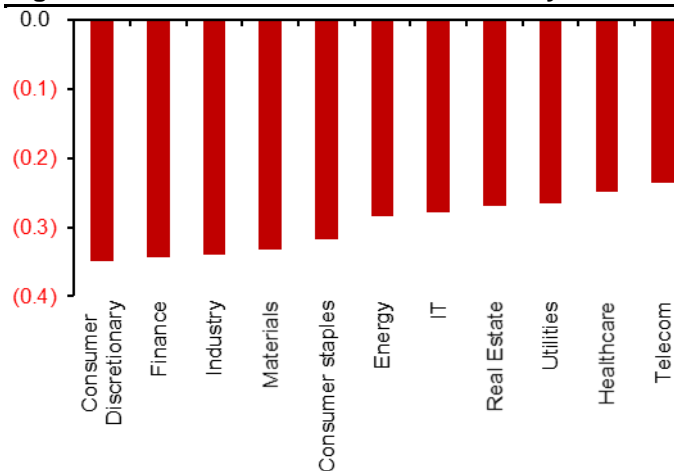
Note: 0 means the current period and -1 means the previous period.  
Source: Wind, CMBIGM

**Figure 14: Correlation Between Exchange Rates and Chinese Stock Indexes**



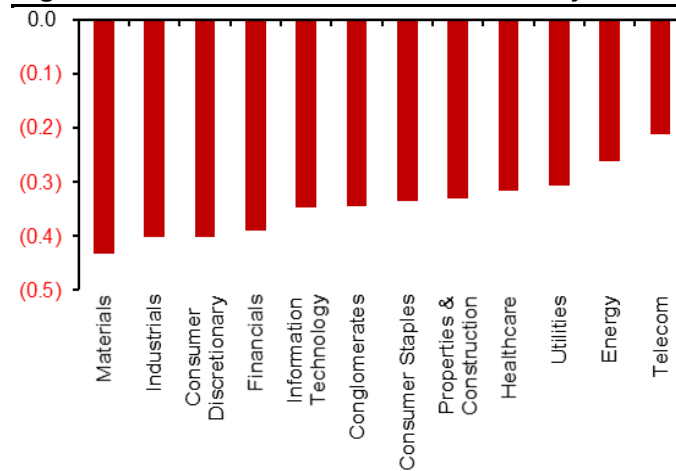
Note: 0 means the current period and -1 means the previous period.  
Source: Wind, CMBIGM

**Figure 15: A Share-US\$/RMB Correlation by Sector**



Source: Wind, CMBIGM

**Figure 16: HK Stock-US\$/RMB Correlation by Sector**



Source: Wind, CMBIGM

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