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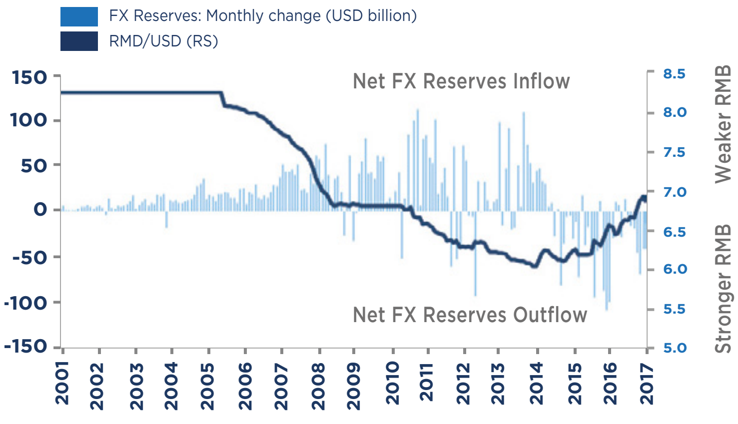
RMB depreciation, capital flow measures and new monetary stance - What are the implications for Chinese corporates?

The potential depreciation of the renminbi (RMB), along with the implementation of capital flow measures, are longstanding concerns for China. More recently, the country's new monetary policy stance of being "prudent and neutral", announced at the beginning of the year, and reiterated during the National People's Congress, has been attracting attention. This Focus aims to provide some insight into these three aspects and examine their implications for Chinese corporates.

CHART 1
FX reserves: Net change vs. RMB/USD



Source: Bloomberg, PBoC, Coface (Last update: Feb 7, 2017)

A longstanding uncertainty: Downward pressure on the Renminbi persists, and it's time to focus on the RMB's indices

On Aug 11, 2015, the People's Bank of China (PBoC) released a statement on "Improving the quotation mechanism of central parity between the renminbi (RMB) against the US dollar (USD)", while simultaneously setting the onshore RMB fixing rate 1.8% weaker against the USD. This triggered expectations of a depreciation of the RMB. Since then, China's foreign exchange (FX) reserves have been declining almost monthly, falling to USD 3.01 trillion at the end of 2016 (*Chart 1*). Yi Gang, the PBoC's Deputy Governor, confirmed its use of FX reserves to protect the RMB against depreciation[1]. Nevertheless, **despite this intervention by the PBoC, the RMB fell by 12.2% - down from 6.21 on Aug 10, 2015, to a low of 6.96 to the USD on Jan 3, 2017. It then recovered to 6.87 against the dollar, as at Feb 24, 2017.** The RMB was found to be overvalued by 0.7% in a analysis by Cline (2016)[2].

The analysis employed the fundamental equilibrium exchange rate estimation, using October's real effective exchange rates.

Although most corporations and individual investors focus on the RMB/USD currency pair, the PBoC stresses the importance of the RMB's indices, in particular the CFETS RMB Index[3]. The latter declined by 9.8% from 102.93[4] on Nov 30, 2015, down to a low of 93.78 on Nov 4, 2016. It subsequently reported a slight recovery, to 93.84, as at Feb 24, 2017. The BIS Currency Basket RMB Index and the SDR Currency Basket RMB Index (which the PBoC also refers to) followed similar trends. **The RMB's indices tend to be slightly less volatile than the RMB/USD currency pair, when comparing their annualized volatility, but all indicators point to a depreciation trend for the RMB.**

A longstanding uncertainty: Selective measures for capital flow management, postponing capital account reforms

Expectations over the depreciation of the RMB could result in capital outflows from China - which would further weaken the RMB and trigger flight from capital, causing a vicious cycle. Chinese household FX deposits jumped by 40.3%, to a record high of USD 126.44 billion in 2016 (against USD 90.11 billion in 2015). The deficit of tourism balance rose by 25.2%, to reach USD 223.03 billion (compared to USD 178.09 billion in 2015). In addition, there was a 44.1% surge in outbound direct investments by non-financial corporations, which rose from USD 118.02 billion in 2015, to USD 170.11 billion in 2016[5].

Unsurprisingly, measures have been introduced by the State Administration of Foreign Exchange (SAFE), China Banking Regulatory Commission (CBRC), the State-Owned Assets Supervision and Administration Commission (SASAC) and the PBoC, in order to manage capital flow risks. These measures target various stakeholders, from individual, state-owned enterprises (SOEs), to financial institutions (FIs), especially in the light of intensifying pressure on the RMB and declining FX reverses in Q4 2016. Examples of the capital flow measures are listed in *Table 1*.

TABLE 1
Examples of capital flow measures

Announcement: Key takeaways
SAFE's Huifa 2017 Number 3 (Jan 26, 2017), on FX settlement and cross-border fund remittance "国家外汇管理局关于进一步推进外汇管理改革完善真实合规性审核的通知" (in Simplified Chinese), effective Jan 26, 2017 • Introduction of new rules on the remittance of offshore funds: (i) domestic firms are allowed to repatriate offshore loans secured by domestic guarantee **(i.e.,** 內保外貸 in Chinese) for onshore use, and (ii) Multi-national corporations (MNCs) are allowed to use 100% of their offshore FX deposits for onshore operations, up from a cap of 50% • Amendments to existing requirements: (i) banks are required to have stricter information checks regarding trade-related FX transactions, FX remittances for earnings from direct investment and foreign direct investment transactions (ii) onshore entities are required to provide banks with information regarding foreign direct investments and outbound fund transfers. Renminbi loans and offshore FX loans are permitted, with the full amount subject to a cap of 30% of the owner's total equity value, based on the previous year's audited financial reports
CBRC's YinJianfa 2017 Number 1 (Jan 25, 2017), on more prudent controls on bank lending for outbound investments "中国银监会关于规范银行业服务企业走出去加强风险防控的指导意见" (in Simplified Chinese only), effective Jan 25, 2017
SASAC's Press Release (Jan 18, 2017), on revised regulations concerning investments and outbound investments by SOEs "国资委修订发布《中央企业投资监督管理办法》和《中央企业境外投资监督管理办法 " (in Simplified Chinese), effective Jan 18. 2017 •Announcement of a plan to introduce a "negative list" approach to the supervision of investment projects, with two categories of investment projects - those that are off-limits for entry and those that necessitate following certain regulations. Central SOEs are permitted to make their own decisions on projects that do not fall into these two categories • Amendments to existing requirements whereby, in principle, central SOEs are not permitted to conduct non-core business investments overseas
SAFE's Press Release (Dec 31, 2016), on adjustments to FX conversion for individuals "国家外汇管理局有关负责人就改进个人外汇信息申报管理答记者问" (in Simplified Chinese), effective Jan 1, 2017 •No change to the annual personal quota of USD 50,000 of FX conversion •Introduction of new forms which mean that individuals are legally responsible for information provided (i) pledges not to use converted funds for overseas investments; (ii) obligation to specify the planned use of funds; (iii) confirmation of compliance with anti-money laundering legislation, etc., (iv) undertaking not to lend or borrow quotas with other individuals
PBoC's Press Release (Dec 30, 2016), on Financial Institution disclosure requirements for large transactions "国家外汇管理局有关负责人就改进个人外汇信息申报管理答记者问" (in Simplified Chinese), effective Jul 1, 2017 •Amendments to existing requirements, whereby FIs are now required to report all single domestic and overseas cash transactions of over RMB 50,000 (down from RMB 200,000 with the prior regulation established in 2007) •Introduction of new requirements whereby FIs are required (i) to report on any daily cross-border transfers between an individual's bank account and other bank accounts of RMB 200,000 or more; (ii) to report any suspicious large transactions within five working days
SAFE's Press Release (Dec 31, 2016), on adjustments to FX conversion for individuals (in Simplified Chinese), effective Jan 1, 2017 •No change to the annual personal quota of USD 50,000 of FX conversion •Introduction of new forms which mean that individuals are legally responsible for information provided (i) pledges not to use converted funds for overseas investments; (ii) obligation to specify the planned use of funds; (iii) confirmation of compliance with anti-money laundering legislation, etc., (iv) undertaking not to lend or borrow quotas with other individuals

Source: PBoC, SAFE, SASAC, Coface (Last update: Jan 26, 2016)

1 - Source: The People's Political Consultative Daily's article (in Simplified Chinese): 外汇储备就是为了用的 目前收益不错, Jan 25, 2017
2 - Cline, R. (2016), Estimates of Fundamental Equilibrium Exchange Rates, Nov 2016, Peterson Institute of International Economics' Policy Brief PB16-22
3 - In late 2015, CFETS introduced the CFETS RMB Index, making reference to a basket of 13 currency pairs. The official value of the CFETS RMB Index is released on a weekly basis. The baseline date and baseline index value are Dec 31, 2014 and 100, respectively. In late 2016, CFETS announced changes to the currency basket used by the CFETS RMB Index, with the addition of 11 new currency pairs, to bring the total number to 24, effective Jan 1, 2017. Source: China Foreign Exchange Trade System (CFETS)'s Press Releases: Calculation Methodology of RMB Indices v1.0, Dec 11, 2015. Public Announcement of China Foreign Exchange Trade System on Adjusting Rules for Currency Baskets of CFETS RMB Indices, Dec 29, 2016
4 - This is the first available value. Source: CFETS
5 - Source: Ministry of Commerce, PBoC, SAFE (Feb 28, 2017)

With expectations over the depreciation of the RMB, increases in capital outflows (from both residents and non-residents) are expected to continue (Graph 2). The Chinese authorities are therefore likely to remain cautious on the implementation of its capital account reforms. The administrative measures to curb capital outflows by residents (with the exception of measures targeting SOEs), are expected to be temporary. Additional measures, such as changes to the «negative list» which sets out industries that foreign companies are permitted to access, are likely to be implemented, in order to encourage capital inflows from non-residents. These would be in addition to recent efforts, such as the introduction of Shenzhen-Hong Kong Stock Connect (which began on Dec 5, 2016[6]) and the forthcoming inclusion of China bonds in the Global Aggregate Index, effective Mar 1, 2017[7].

A more recent uncertainty: "Neutral" monetary policy, reflecting on the expected short-term interest rate corridor

Expectations of the depreciation of the RMB triggered measures to alleviate FX concerns and control capital flows. The PBoC's monetary policy stance remained steady in 2016, with only a reduction in the banks' reserve requirement ratio (RRR)[8] of 50 basis points and a cut to interest rates on its Medium-Term Lending Facility (MLF) in Q1, without changing the benchmark savings and lending rates for the full year.

In the light of the full liberalisation of benchmark lending and deposit rates, close attention should be paid to the proposed interest rate framework (also known as the interest rate corridor). This more market-based interest rate regime was announced by the PBoC in late Oct 2015[9]. Under the framework, the PBoC will use short-term repo and its Standing Lending Facility (SLF) to guide short-term market rates, and its MLF and Pledged Supplementary Lending (PSL), etc, to guide mid and long-term market rates.

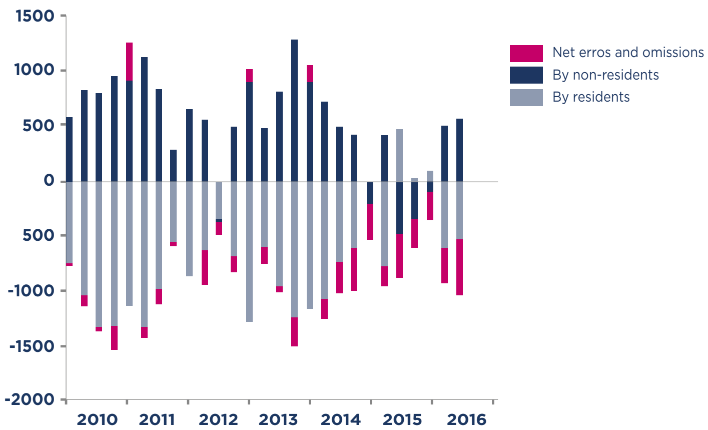
During the latest annual Central Economic Work Conference (CEWC), which ended on Dec 16, 2016, the PBoC indicated that monetary policy for 2017 would be "prudent and neutral" compared to that of 2016, which it termed as being "prudent but flexible". It is widely expected that **monetary policy will become less accommodative this year.** These expectations were rapidly confirmed at the beginning of 2017, when the PBoC hiked interest rates on its MLF by 10 basis points, and reverse repo rates on its open market operations and its SLF by a range of 10 to 35 basis points. This caused a slight upwards shift in almost the entire short-term interest rate corridor *(Graph 3)*, for two key reasons:

1. Managing real interest rate differentials between the US and China would help alleviate depreciation pressures on the RMB. As the US Federal Reserve (Fed) has hiked its target range for the federal funds rate twice by 25 basis points since late 2015, to 0.50% and 0.75%, the real interest rate differentials between the US and China have narrowed. The median projection for forthcoming interest rate changes by the Fed shows an increase of 75 basis points by the end of 2017[10], fuelling rate hike expectations.

2. With inflationary pressures and steady economic conditions, the PBoC has more scope for curbing financial risks and addressing asset prices. China's producer prices, which had been falling on a year-on-year basis every month since the beginning of 2012, began to return to positive in September 2016. The country's economy ended 2016 with a growth of 6.7% (within the official target range of between 6.5% and 7.0%), thus confirming expectations of a soft-landing scenario. Bearing in mind that total credit for the private non-financial sector stood at 209.4% of GDP in Q2 2016[11] and that prices of homes in first and second tier cities are overheating, the PBoC should adopt a prudent monetary policy in order to mitigate increasing financial risks.

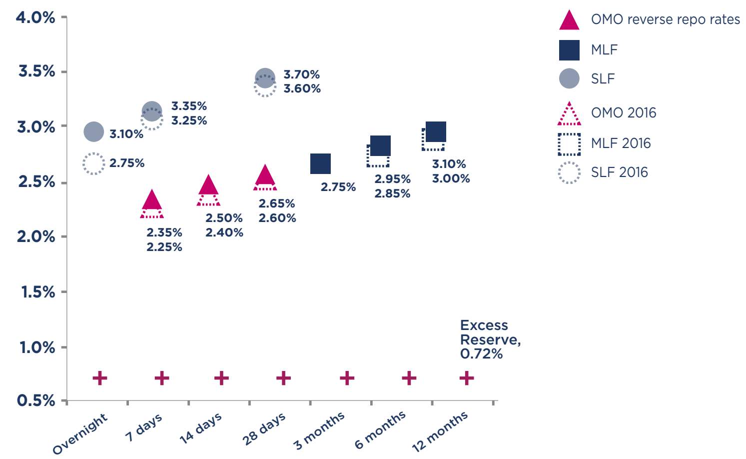
In the China's Premier Li Keqiang's work report to the National People's Congress 2017 (released on March 5, 2017), not only the monetary policy stance for 2017 was once again confirmed as «prudent and neutral», but also the targets for both the M2 growth and total social financing growth for 2017 were cut to 12% from the last year's targets of 13% (vs. their actual growth of 11.3% and 12.8%, respectively). All of this signals tighter monetary and credit conditions in 2017.

CHART 2
Financial account flows and net error and omissions (in billion RMB)



Source: SAFE, Coface (Last update: Feb 5, 2017)

CHART 3
PBoC's widely expected short-term interest rate corridor



Source: PBoC, Coface (Last update: Feb 5, 2017)

6 - After the launch of the Shanghai-Hong Kong Stock Connect in Nov 2014, a second stock link - the Shenzhen-Hong Kong Stock Connect began on Dec 5, 2016. This gives foreign investors access to stocks on the Shenzhen Stock Exchange, where many Chinese technology companies are listed. Source: The Stock Exchange of Hong Kong (HKEX)'s Press Releases: HKEX Celebrates Launch of Shenzhen-Hong Kong Stock Connect, Dec 5, 2016 HKEX Welcomes Market Regulators' Announcement of Shenzhen Connect's Start Date, Nov 25, 2016
7 - Source: Caixin's news article Global Benchmark Adds China Bonds in New Index, Boosting Foreign Appeal, Jan 25, 2017
8 - PBoC announced a change to RRR calculation methodology in June 2016, an attempt to improve the monetary tools.
Source: PBoC's Press Release (in Simplified Chinese): 中国人民银行决定进一步完善平均法考核存款准备金, Jun 3, 2016
9 - Source: PBoC's Press Releases (in Simplified Chinese): 央行有关负责人就降息降准以及放开存款利率上限答记者问, Oct 23, 2015 - 央行有关负责人就降息降准以及放开存款利率上限进一步答记者问, Oct 26, 2015
10 - Source: Fed's statement (Feb 2, 2017)
11 - Source: Bank for International Settlements (Last Updated: Dec 11, 2016)

2017 outlook: A challenging year for Chinese corporates

Going forwards, the PBoC will probably adopt a wait-and-see approach when reacting to the real interest rate differentials between the US and China, particularly as the Fed's monetary policy will be subject to more details from US President Donald Trump's administration regarding tax policy, trade policy and infrastructure investment. **Should the Fed hike its key policy rates faster than expected in 2017, the PBoC is likely to follow suit - albeit at a more progressive pace.**

Notwithstanding the impact from the US, the PBoC is expected to gradually tighten its monetary policy, by shifting the expected interest rate corridor up by 20 to 30 basis points in 2017, mainly to contain financial risks and asset bubbles. This would mean higher borrowing costs for Chinese corporates and possibly the kick-start of long-expected corporate deleveraging. This would imply **higher credit risks for Chinese corporates, especially for those with weak financials.**

With the prudent monetary policy and capital flow measures implemented by the Chinese authorities, the **RMB is likely to continue its depreciation at a slightly slower pace, of 3% to 5%**[12] **by the end of 2017 (compared to the** decline of 6.5% to 6.49 against the USD in 2016). **Capital outflows from China will therefore probably persist** and, according to the Institute of International Finance, are expected to reach USD 560 billion this year (down from USD 654 billion in 2016).

It can be difficult to estimate the relationship between currency and international trade. The paper written by Liu and Jin (2017), published in the Blue Book of China's Economy 2017[13], suggested counter-intuitive findings that a 1% **RMB depreciation resulted in a 0.05% decrease in export volume, albeit with a broad-based slight improvement within a range of 0.01% to 0.24% for 8 out of the 10 major sectors**. Mining and the textile and clothing sectors, on the other hand, would suffer from a depreciation in the RMB, declining by 0.63% and 0.53% respectively. Caution should be used when interpreting these findings. One possible explanation can be found in the World Trade Organization paper, written by Auboin and Ruta (2011)[14], which shows that **"on average, exchange rate volatility has a negative (even if not large) impact on trade flows"**. Liu and Jin (2017) also suggest that the level of negative impact would generally be amplified by a higher percentage of RMB depreciation.

The PBoC's stronger emphasis on the RMB indices probably indicates higher tolerance on the volatility of the RMB/USD exchange rate, which therefore moderates the positive impact of the RMB's depreciation on boosting China's export volumes. At the same time, **import costs are expected to gradually increase. This is likely to weigh on the Chinese corporates that rely heavily on imported products for production.** China's top five imports in 2016, by trade value, were electronic integrated circuits and micro assemblies (14% of total imports), crude petroleum oil (7%), iron ore (4%), motor vehicles and chassis (3%) and plastics in primary forms (3%)[15].

In summary, most Chinese corporates are expected to have a challenging year ahead, with higher borrowing costs (amid the upward shift of the interest rate corridor) and keener market competition (with the opening up of more industries to foreign companies). Some companies may face higher import costs, due to the RMB's depreciation. All of these factors are likely to weigh on the profitability of Chinese corporates, although a recovery in external demand (if not interrupted by trade protectionism) could provide a buffer.

12 - Source: Blue Book of China's Economy 2017, Chinese Academy of Social Science (CASS)
13 - Liu and Jin (2017), "B17 2017 External trade analysis and outlook", Blue Book of China's Economy 2017, CASS
14 - Auboin and Ruta (2011), The Relationship between Exchange Rates and International Trade: A Literature Review, World Trade Organization's Staff Working Paper ERSD-2011-17, October 2011
15 - Source: Custom General Administration (Last update: Jan 13, 2017), with Coface's calculation.

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