CHINA Insights

RMB: Muddling through two dilemmas

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Highlights:

- **China is facing two dilemmas now including the balance between monetary easing and currency stability and the balance between FX intervention to deter RMB depreciation and the decline of FX reserve.**
- **PBoC reflated its balance sheet by 6% in January via non-traditional monetary policy tools and open market operation to stabilize the money market without having significant sentimental impact on RMB. It worked.**
- **China may have used commercial banks again in January as buffer to intervene market with their own FX position to slow down the pace of decline of FX reserve. It worked either.**
- **RMB depreciation expectation has not been turned around due to still weak sentiment. The ballooning central bank balance sheet may draw short sellers' attention.**
- **It may be still a long way for China to walk a thin line.**

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China is facing two dilemmas now including the balance between monetary easing and currency stability and the balance between FX intervention to deter RMB depreciation and the decline of FX reserve. It is a difficult game to play, however, PBoC seemed to find a balance in January, which has helped RMB stabilize since the second half of January though RMB depreciation pressure remains.

Dilemma 1: Monetary easing and currency stability

The PBoC's balance sheet ballooned in January by 6% to CNY33.7 trillion, up from CNY31.78 trillion in December, marking the largest monthly change in record. The rebound of the PBoC balance sheet size after shrinking for 9 months out of past 10 months is mainly due to the spike of central bank's claims on other depository corporation despite foreign assets continued to go down.

Table: PBoC balance sheet (Asset)

CNYbn	Foreign assets	Claims on Gov.	Claims on other depository corporation
Oct-15	26281.71	1531.27	2598.90
Nov-15	26025.44	1531.27	2751.90
Dec-15	25383.07	1531.27	2662.64
Jan-16	24770.28	1531.27	**5200.06**

Although PBoC was reluctance to cut reserve requirement ratio amid persistent capital outflow due to concerns about the potential negative impact on RMB, onshore liquidity remained flush thanks to the adoption of new monetary policy tools such as Standing Lending Facility (SLF) and Medium-term Lending Facility (MLF) as well as more frequent open market operation.

RMB managed to stabilize against the dollar in the second half of January unaffected by ballooning central bank balance sheet. This suggests open market operation and non-traditional monetary easing measures have less sentimental impact on currency stability compared with traditional monetary easing measures such as RRR cut. The announcement on 19 Feb that the open market operation is available on the daily basis suggests that OMO and new monetary policy tools are preferred methods for PBoC to strike the balance between monetary easing and currency stability. As such, we think the change of PBoC balance sheet size in the coming months is likely to be more volatile.

Chart 1: Size of PBoC balance sheet ballooned again in January

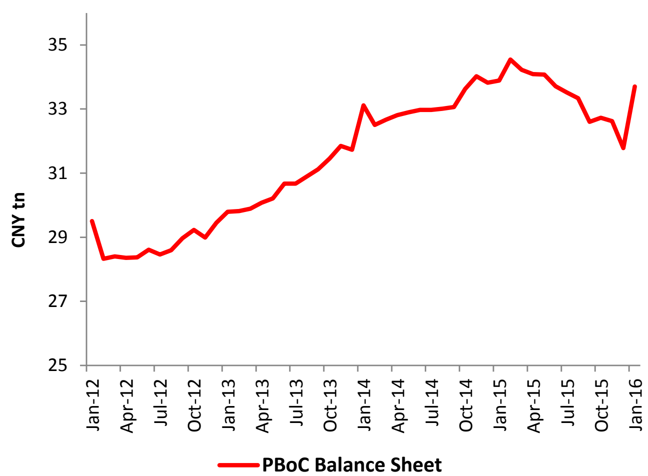
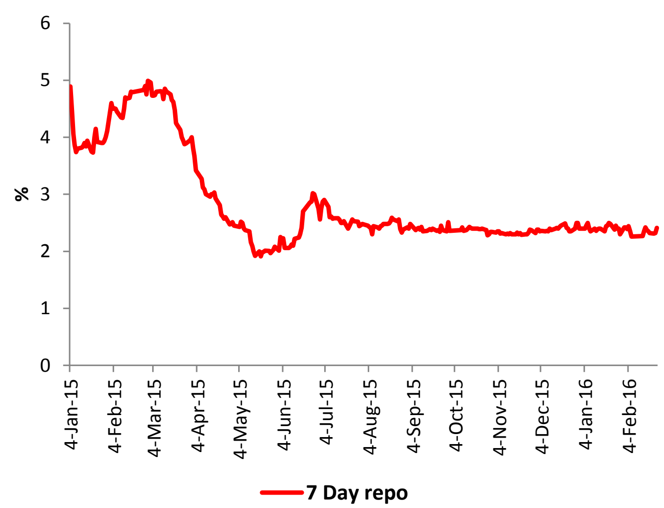


Chart 2: Stable money market despite rising capital outflows



Source: PBoC, Bloomberg, OCBC

Dilemma 2: FX intervention and the decline of FX reserve

The foreign exchange sale and purchase data released by the currency regulator State Administration of Foreign Exchange (SAFE) yesterday showed that net purchase of foreign exchange fell to US$54.4 billion in January from US$89.4 billion in December, signalling the reduced outflow pressure. However, the decline is partly offset by banks' sale of their own foreign exchange position. Chinese banks sold US$26.1 billion worth of foreign exchange in January, second highest in record, up significantly from US$6.3 billion in December. This reminds us the period from August to October last year when PBoC used commercial banks as agent to intervene FX market. Overall speaking, we believe, China may have used commercial banks again in January to intervene market with their own FX position to slow down the pace of decline of FX reserve.

FX position held by commercial banks is on top of China's official FX reserve and has been used by China as buffer to slow down the pace of decline of FX reserve. As shown on charts below, FX position by commercial banks has fallen from the peak of US$396 billion in May 2015 to US$250 billion as of December 2015. This suggests that this buffer is not unlimited. Unfortunately, PBoC suspended the publishing of this data from 2016, which reduces transparency on China's intervention strategy.

Chart 3: Banks has increasingly off loaded their own FX position as buffer to slow down the decline of reserve

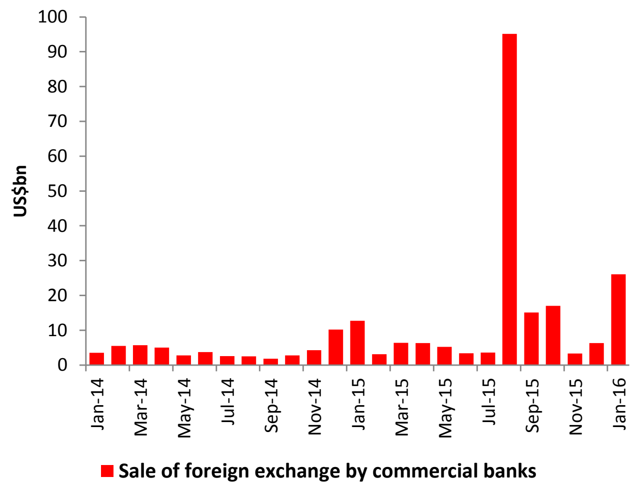
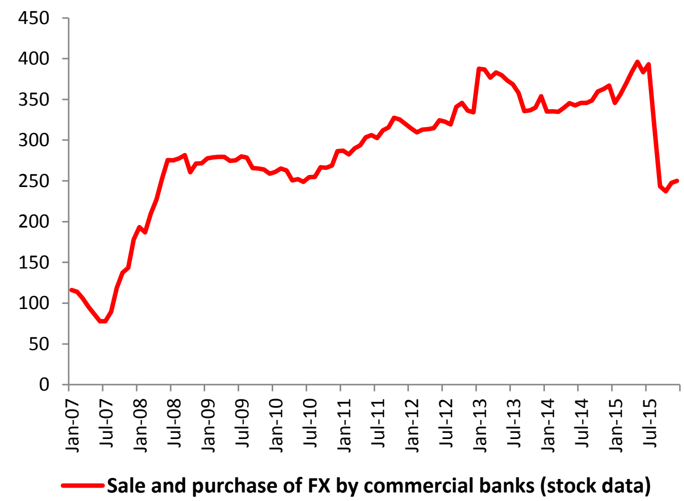


Chart 4: Banks' own FX position has fallen sharply in 2015, however, the data has been suspended since 2016



Source: PBoC, SAFE, OCBC

Nevertheless, in the near term, we think FX position by commercial banks will continue to play a role of buffer to help China strike the balance between FX intervention and the decline of FX reserve.

RMB depreciation pressure remains

We think recent data did not change the big picture that RMB depreciation pressure remains for two reasons. First, sentiment remains weak. China's long dollar forward position increased by US$28.4 billion in January, up from US$21.5 billion. Noting that long dollar forward position collapsed in September 2015 after China imposed the margin. And this trading activities have gradually recovered in the past two months and corporates restarted their long dollar forward position to hedge against RMB depreciation risk despite higher costs. This suggests the weak sentiment among corporates. Second, China's move to reflate its balance sheet via non-traditional monetary policy may also draw attention of short sellers, who may continue to look for opportunity to bet against RMB.

To conclude, we think PBoC has been doing a good job to muddle through two dilemmas. We think non-traditional monetary policies as well as open market operation are still preferred measures to balance between monetary policy easing and currency stability.

Meanwhile, the FX position held by commercial banks, which is on top of official reserve, may continue to be used as buffer to balance between FX intervention and the decline of FX reserve. Nevertheless, expectation on RMB depreciation is unlikely to be reversed any time soon. It may be still a long way for China to walk a thin line.

Chart 5: Short dollar forward position has collapsed

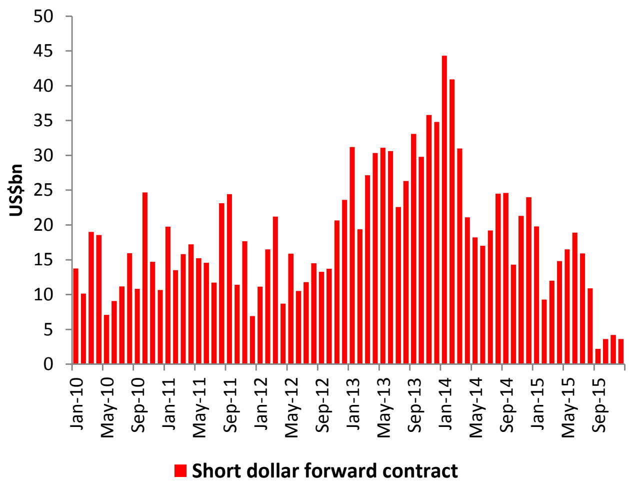
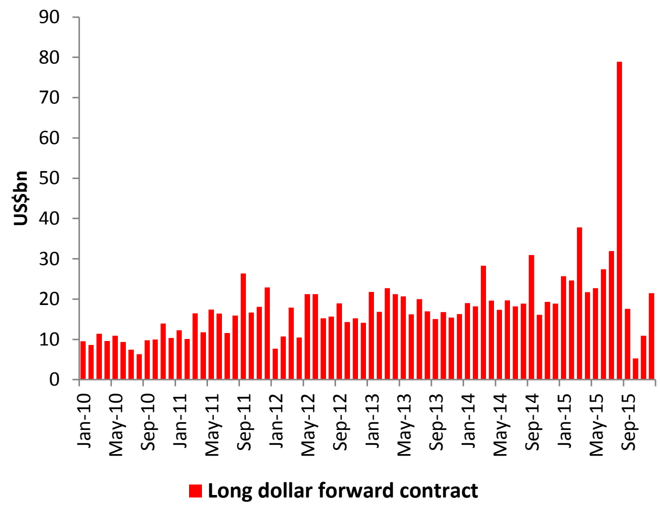


Chart 6: Long dollar forward position recovered despite high cost



Source: PBoC, OCBC

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