

RMB part 1: the cause of recent RMB depreciation

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- The recent RMB depreciation was not the result of changing domestic demand supply matrix for foreign currency and capital outflows.
- Instead, the depreciation was mainly attributable to two reasons including broad dollar rally and deteriorating expectation.
- The souring sentiment toward RMB was due to three factors including widening US-China rate differential, diminishing recovery hope due to dynamic zero Covid strategy and deteriorating trade outlook.

Since the middle of August, RMB has weakened against the US dollar by more than 3% after consolidating around 6.75 level for about a month. Although RMB's fluctuation was within a reasonable range against the backdrop of broad dollar index rally during the same period, the USDCNY's move towards 7, which is always depicted as "psychologically important" level by many media outlets, still put RMB under the spotlight.

In this series of RMB reports, we will try to answer following three questions.

First, why did RMB depreciate sharply this year despite a record goods trade surplus in the first eight months of 2022? (Part 1)

Second, why are China's regulators more sensitive to this round of depreciation as compared to the previous wave in April and May? (Part 2)

Third, why does RMB depreciation pressure remain? (Part 3)

Is this time different?

Since 2015, RMB has gone through a few cycles of ups and downs driven by various factors. Market has been used to RMB's two-way volatility. In the previous Fed tightening cycle in 2018-2019, RMB depreciated against the US dollar by about 15% within one and half year due to US-China trade war and strong US dollar.

Similar to previous few rounds of RMB depreciation, this year's RMB depreciation was also led by the offshore market, evidenced by the widening gap between USDCNY and USDCNH in April-May and August (Chart 1).

Nevertheless, different from the last depreciation in 2019 when the demand for foreign currency surged, demand for RMB this year remained strong. Our preferred gauge of overall cross border capital flows, foreign currency settlement and sale in spot, forward and options, recorded sizable surplus year to date except May (Chart 2). This contrasted with persistent deficit in 2019.

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Chart 1: Two waves of RMB depreciation in 2022 was mainly led by the offshore market.

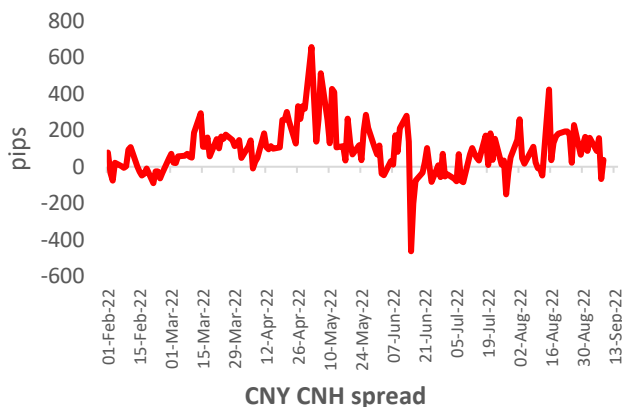
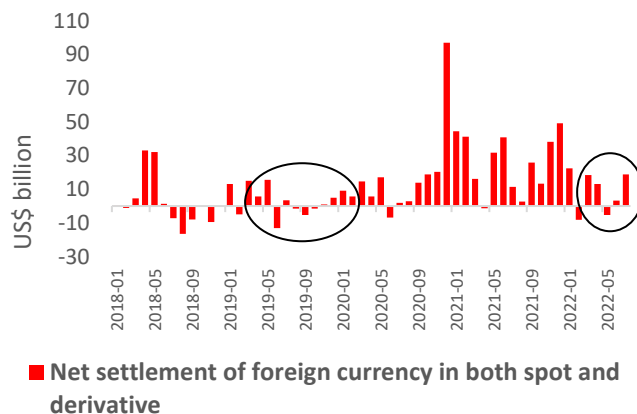


Chart 2: More balanced demand supply matrix for RMB as compared to that in 2019.



Source: Wind, CEIC, OCBC Bank

In addition, different from the first wave of RMB depreciation in April and May this year when sizable outflows under stock connect were recorded, the inflows under stock connect since August have remained relatively stable (Chart 4).

Chart 3: Willingness to sell foreign currency remained high in July despite RMB depreciation.

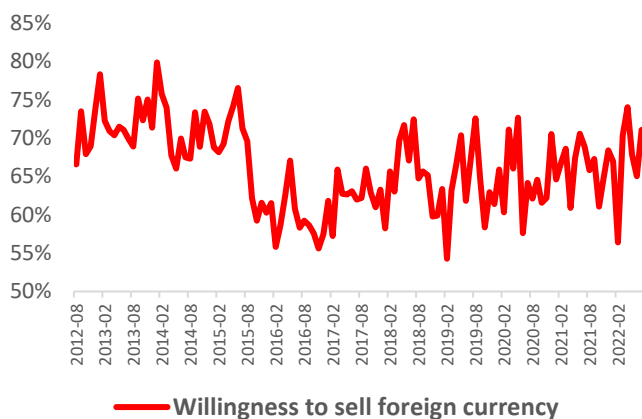
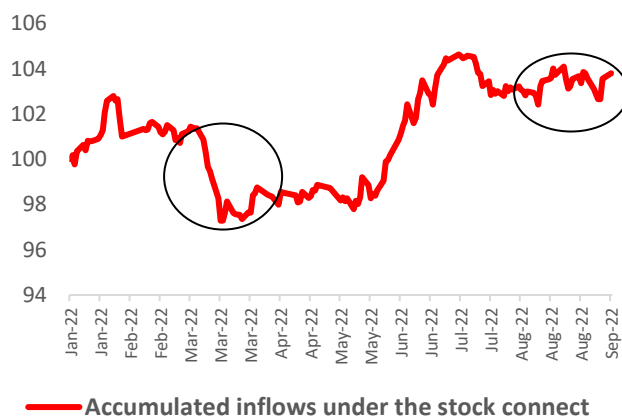


Chart 4: No outflows since mid-August under the stock connect



Source: Wind, CEIC, OCBC Bank

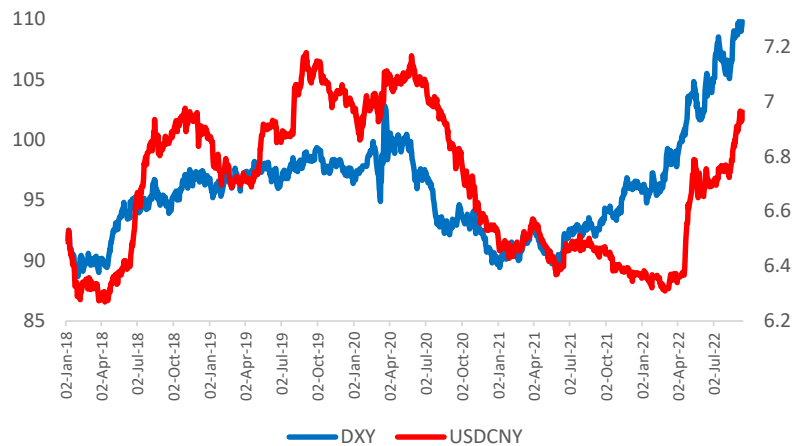
As such, we think the recent RMB depreciation was not the result of changing demand supply matrix for foreign currency and capital outflows. So, the question is what has caused the RMB weakness this year?

Dollar matters

We think the recent RMB depreciation was mainly attributable to two reasons including broad dollar rally and deteriorating expectation.

Historically, the USDCNY has a close correlation with the DXY (Chart 5). Given the DXY has strengthened by more than 14% year to date, it is not a surprise that the USDCNY moved higher significantly. In the previous Fed tightening cycle in 2018-2019, RMB weakened against the dollar by about 15% at peak when DXY gained by about 11-12% during the same period.

Chart 5: USDCNY tends to have a close correlation with the DXY



Source: Wind, CEIC, OCBC Bank

Souring sentiment

The souring sentiment toward RMB was mainly due to three factors. **First**, the collapse of forward points due to inverted China-US rate differential made short RMB trade easy to hold thanks to the positive carry. The key catalyst for the recent RMB depreciation since the middle of August was China's unexpected interest rate cuts. The yield differential is expected to widen further given a more hawkish Fed.

Chart 6: The collapse of CNY forward points

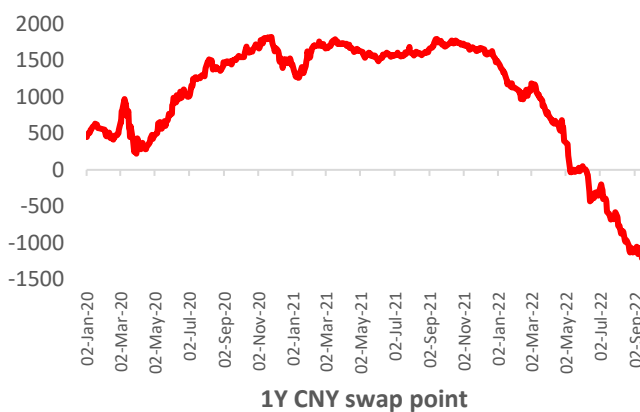
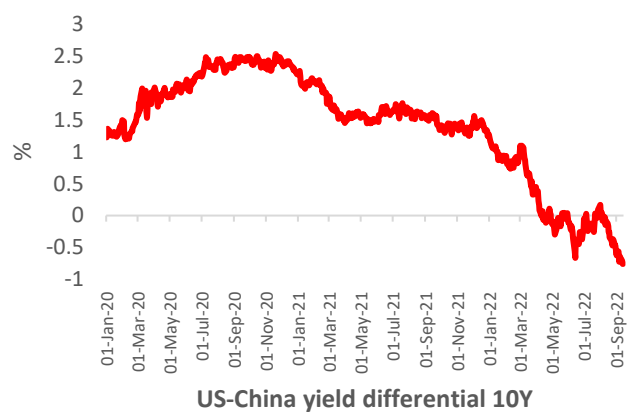


Chart 7: Widening US-China rate differential



Source: Wind, CEIC, OCBC Bank

Second, the increasing bearish sentiment on China's recovery hope due to China's Covid zero strategy also weighed down on RMB sentiment. 2022 is likely to mark the first time in modern Chinese history that China will miss its growth target by a big margin.

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Third, trade outlook also deteriorated due to renewed concerns about global recession and significant slowdown in semiconductor supply chain. We will discuss about China's trade outlook in part 3.

Overall, we think the broad dollar rally and souring sentiment over RMB are the key drivers to RMB depreciation rather than the change of demand and supply matrix for foreign currency and capital outflows this year.

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