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Good MornING Asia - 6 August 2018

The People's Bank of China (PBOC) has announced a re-introduction of reserve requirements on FX forwards trading – a move clearly aimed at taking pressure off the renminbi as USD/CNY closed in on 7.00. This looks only a temporary reprieve for the renminbi; prior PBoC attempts to stem CNY weakness haven't been all that successful in reversing a trend

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China blinks at a 7.00 handle for the yuan

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By Chris Turner

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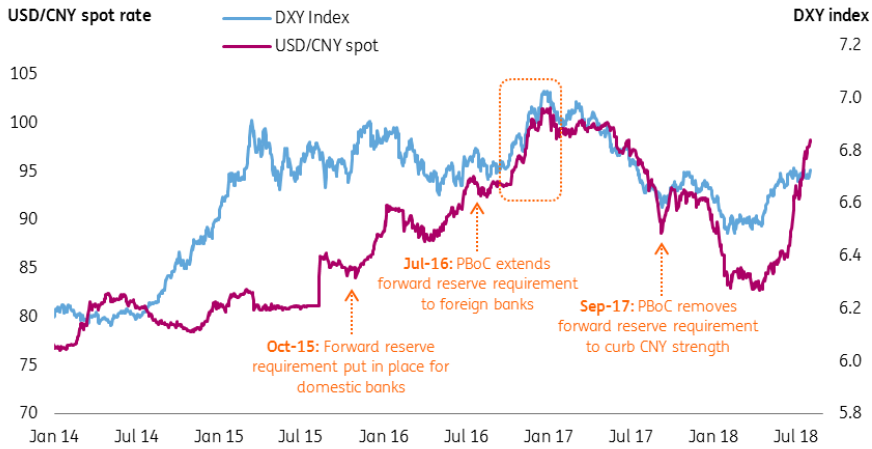
Reserve requirements back in play

Since 2015 the PBOC has used reserve requirements on FX forward transactions as a tool to control 'macro-financial risks'. The measure puts a 20% required reserve ratio for financial institutions when conducting onshore CNY forwards business on behalf of customers. The move makes it effectively costlier for the market to fund short CNY positions through the forwards market.

This measure was first used for domestic financial institutions in October 2015 and then broadened to include foreign institutions in July 2016 when USD/CNY was pushing above 6.70. These reserve requirements were scrapped when USD/CNY was dipping below 6.50 in September 2017 amidst broad dollar weakness.

Prior PBoC attempts to stem CNY weakness haven't been all that successful



Source: ING, Bloomberg

Why now?

It seems pretty clear that these measures have been introduced to trigger a squeeze in short CNY positions and keep USD/CNY away from 7.00. This reserve requirement is a relatively soft measure and avoids the bigger stick of FX intervention or rate hikes at a time policymakers are delicately deleveraging the economy.

We also think Chinese policymakers had a bad experience when USD/CNY was last trading near 7.00 in late 2016. Investors struggled to digest the message at the time that the renminbi was stable versus the basket and that the move to 7.00 was all about the dollar. That message will be so much harder to deliver today given the 6% decline in the renminbi against its trading basket since late June and the uncertainty over whether this is a market-led decline or the PBOC is using the renminbi as a weapon in the current trade war.

Temporary reprieve

USD/CNH has sold off 1% on today's (Friday) news, but we doubt investors will be encouraged to return to Renminbi exposure anytime soon. US Commerce Secretary Wilbur Ross has made the US trade position clear by outlining that Washington wants to create a situation where it's more painful for China to continue current practices than it is for China to reform.

An increase in the proposed tariff rate to 25% on the next $200bn worth of Chinese imports looks likely over coming weeks. And combined with firm US rates and what look like continued dollar strength over coming months, it looks as though the PBOC will be forced to use more of its currency toolkit to prevent USD/CNY going through 7.00.

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Source: shutterstock

The Malaysian authorities, especially Prime Minister Mahathir, view 3.8 as the fair level for the USD/MYR exchange rate. Just as the pair was going to get there earlier in the year global trade war tensions started to escalate. That persistent uncertainty will undoubtedly remain a forceful tailwind for higher USD/MYR going forward, which is driving our view of USD/MYR trading toward 4.35 by the end of the year. However, Malaysia's positive external payments situation sustains the scope for the currency outperformance which imparts a downside risk to our end-year USD/MYR forecast (spot rate 4.08).

7.6%

Lower than expected

Malaysia exports growth in June

Year-on-year

Downside trade surprise in June

Malaysia's trade growth in June surprised on the downside, with MYR-denominated exports rising by 7.6% year-on-year and imports by 14.9%. While these were slower than the consensus forecasts of 10.3% and 15.3% respectively, the pace was still faster than 3.4% for export growth and 0.1% for import growth in May.

In the exports category, the commodities cluster (crude petroleum, petroleum products, liquefied natural gas, and palm oil) slowed sharply to a 3.4% YoY fall from over 10% growth in May. Acceleration in electronics exports led by the semiconductors, which was up 21% YoY from 13% in May, saved the day. Imports of electronics, most of which are processed for re-exporting, and chemicals helped the acceleration of total import growth.

61bn

Malaysia trade surplus in 1H 2018 (MYR)

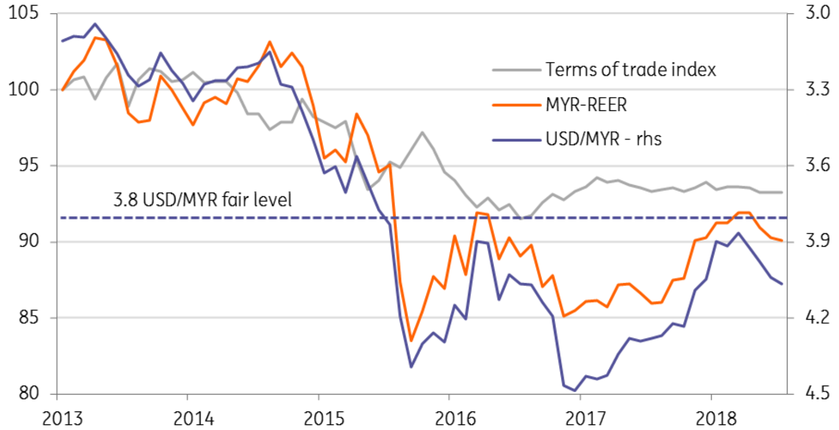
Up by MYR 18bn from year ago

Widening trade and current account surpluses

The outpacing of import growth over export growth was associated with a lower trade surplus in June of MYR 6.1bn than MYR 8.1bn surplus in May. Yet the cumulative trade surplus in the first half the year of MYR 60.6bn was MYR 18bn higher than the level a year ago. This came on the back of a sharp slowdown in the year-to-date export growth to 7.0% YoY and import growth to 3.4% from 21% and 23% respectively 12 months ago.

The wider trade surplus boosted the annual current account surplus to MYR 40bn in 2017 (3.0% of GDP) from MYR 30bn (2.4% of GDP) in the previous year. We forecast a further widening in the current surplus this year to about MYR 50bn (3.5% of GDP). The higher trade and current account surpluses are positive for MYR, and together with relative undervaluation (see figure) these underpin the MYR's continued outperformance this year; the 0.7% year-to-date depreciation against the USD was the least among Asian currencies.

USD/MYR's recovery toward 3.8 fair level is stalled



Source: Bloomberg, CEIC, ING

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