China has more room to weaken the yuan

China's foreign exchange reserves fell at a slower pace than we expected which means there will be more room to weaken the yuan as opening up the market to foreign investors is helping to attract inflows and stabilise reserves

Source: Shutterstock

We had expected China's foreign reserves to fall to $3.106trillion in May from $3.125trillion in April, but the data surprised us on the upside at $3.111trillion.

The dollar index rose 2.43% in May on the back of the strong dollar rebound which directly lowered the value of non-dollar assets in the foreign exchange reserves. This had made us project a bigger fall in the reserves.

Less than expected loss in fx reserves could be the result of net direct investment driven by China opening up markets for foreign investors

We also considered net inflows, but we might have underestimated the impact of China's opening up policies. Less than expected loss in foreign reserves could be the result of net direct investment driven by China's opening up of markets for foreign investors starting near the end of April. The industries that could have brought money into China include asset managers, automobile companies and other financial institutions.

A weaker yuan is increasingly likely

If this is the underlying reason, then going ahead, China's foreign exchange reserves could fall at a more slower pace even when the yuan weakens, which means there will be more room for the yuan to weaken against the dollar.

We have already revised our yuan forecast to 6.60 until the end of 2018, and this seems much more likely now.

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com