CNY: A year for red packets

- **Having taken back control of the Renminbi in 2017, we expect the PBOC to be comfortable with USD/CNY edging down to 6.30 through-out 2018**
- **Modest CNY appreciation allows China to: (1) encourage modest capital inflows; (2) protect USD debt exposure of corporates; and (3) suit a more balanced economy**
- **We are not looking for any significant changes to the FX regime in 2018 and see**

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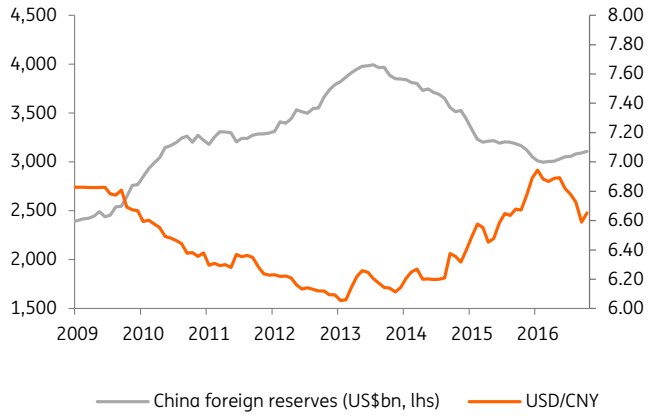
We expect 2018 to be a strong year for the yuan albeit not quite as strong as 2017, with appreciation of around 5% recorded as at 23 November 2017. We project 3% appreciation of CNY against the USD to 6.30 in 2018, from 6.50 at the end of 2017.

We see three good reasons to support a strong yuan view.
We place the following reasons in order of importance: (1) the PBOC would prefer net capital inflows; (2) Chinese corporates have to repay USD debt; (3) the impact of the exchange rate on trade is a two-sided coin and trade is not the top priority in determining the PBOC's exchange rate policy preferences.

Net capital inflows

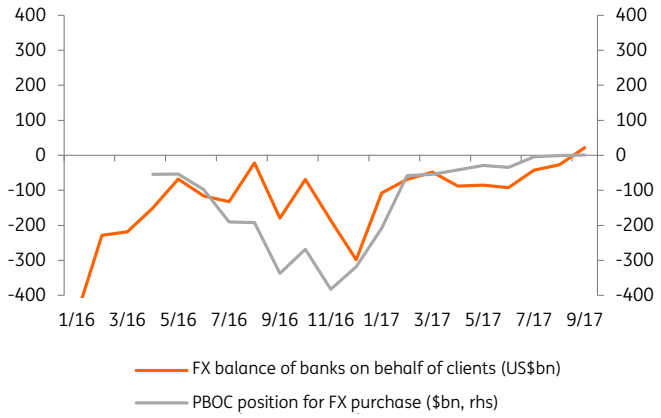
The regulators will be looking to avoid a repeat of the capital outflows seen between 2014 and mid-2017, which originated from the yuan depreciation that began at the end of 2013. The loss of a quarter of China's foreign reserves from a peak of almost US$4tr in June 2014 to a trough of less than US$3tr in January 2017 was an alarming demonstration of rapid capital outflows. This prompted the PBOC to appreciate the yuan in early 2017 in an attempt to stem capital outflows.

Government concern could trigger capital outflows



Source: Bloomberg, ING

But we expect net capital inflows in 2018



Source: Bloomberg, ING

The central bank's efforts to strengthen the CNY have successfully lifted foreign reserves slightly higher to around US$3.1tr as of October 2017.

We believe the central bank will continue to encourage mild capital inflows into the Mainland in 2018 through further conversion of dollars into yuan. PBOC data is already indicating that commercial banks have started to net buy FX from customers in recent months – a reversal of the trend seen through 2016 and early 2017.

Repayment of US debt

The second factor leading to our view of a stronger yuan is the tighter liquidity onshore from financial deleveraging that has prompted Chinese corporates to undertake greater borrowing offshore in USD. These companies would benefit from a stronger yuan when they repay dollar debts. Given reports that this USD borrowing is not particularly well hedged, clearly any large and unexpected yuan depreciation would create risk of possible defaults.

Thus, as stated in the 19th Congress, the central bank will want to avoid any trigger of systemic risk. It will therefore carefully monitor the ability of corporates to service their dollar debts. We therefore believe that the PBOC's preference will be to appreciate rather than depreciate the yuan against the dollar.

Impact of trade

Our third argument for a stronger yuan is that we do not believe export growth is an important factor for the PBOC.

Would a strong yuan dampen exports and add extra pressure on economic growth, especially during a period of corporate and financial deleveraging? We believe there is little to suggest this would be the case since not every trade between China and the rest of the world uses USD as the payment currency. China's exports to Europe account for 16.5% of its total exports (as of October 2017) while the US accounts for 19.0%, and some of these use the euro to settle.

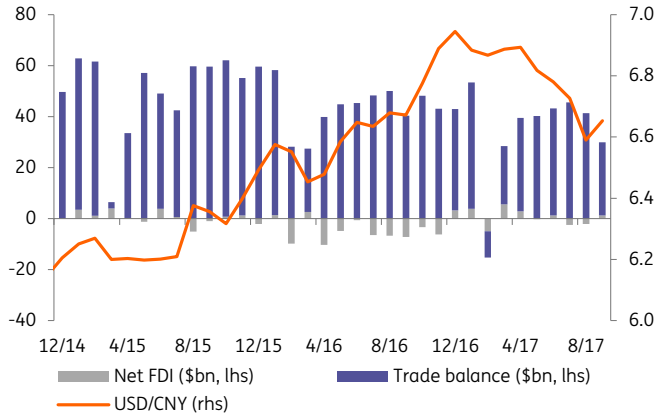
The central bank would not appreciate the yuan solely because of increased imported consumer goods ...that explains our moderate appreciation forecast

From a macro perspective, we should not exaggerate the net impact of currency movements on China's overall export position.

The other side of trade is imports. As the Chinese economy unrelentingly moves towards a consumer-driven economy, imports of consumer goods will continue to grow. We doubt that the central bank would prefer an even stronger yuan to secure cheaper imports of consumer goods. The exchange rate is interlinked to multiple factors, and buying cheaper imported goods may not be the most important consideration when it comes to determining exchange rate policy.

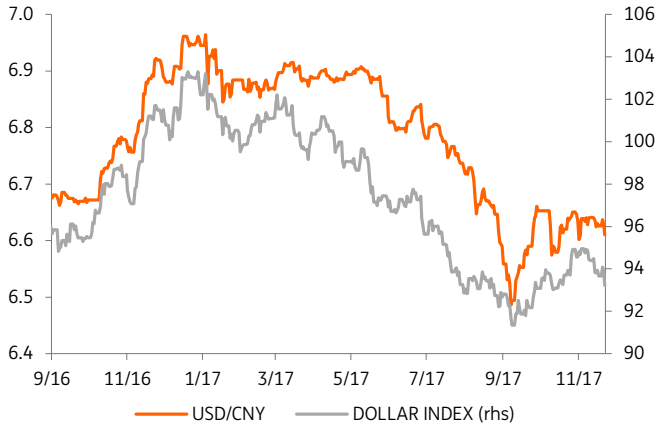
It may only be when exports are no longer relevant for economic growth that the central bank would choose to favour a stronger yuan to increase consumption.

Trade is not a key factor dictating yuan direction



Source: ING, Bloomberg

USD/CNY to follow dollar index



Source: ING, Bloomberg

One exception that might lead to a stronger yuan than we currently expect would be if China were to need to import significant natural resources. However, even that would only be a temporary bout of appreciation, rather than a trend for the whole year.

Expect less volatility for the yuan when reforms of the financial sector are in progress

This would be the one of the few causes of volatility for the yuan that we can foresee initiated by the Chinese government. Volatility might otherwise be caused only as a result of external factors, for example, from the dollar index, which the daily yuan fixing closely follows. Overall, we expect a less volatile yuan because financial deleveraging has pushed up onshore interest rates – and reforms are ongoing. Adding extra volatility to the yuan would hinder reform progress.

We expect reform to a more transparent fixing mechanism

We do not expect reforms of the fixing mechanism. The current fixing mechanism has a black box component of a "counter-cyclical factor". Each fixing-quoting bank can decide its own methodology for the "counter-cyclical factor". This offers leeway for the central bank on the fixing exchange rate, but it is literally a step backward in reforming the yuan regime. We do not expect the central bank to remove the daily fixing rate, but we expect it to be more transparent on the fixing mechanism.

What we do not expect to happen to the yuan in 2018

Though we expect capital inflows, we expect only a nominal net increase. China has no interest in generating a surge in hot money inflows, which could easily turn into outflows when the yuan is weak. Thus regulators will only cautiously open the door for inflows and we don't expect a completely free flow of capital into China.

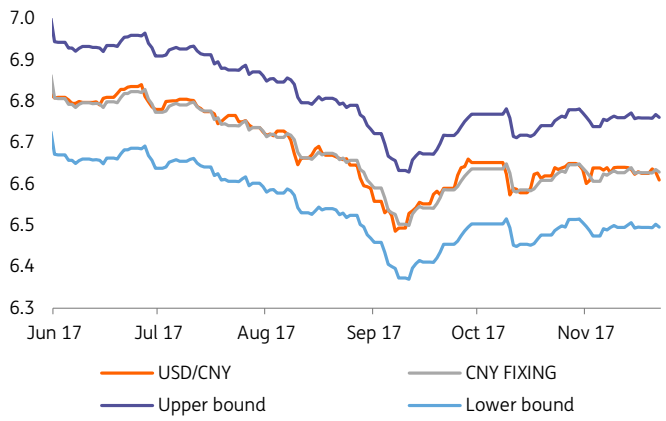
We do not expect the central bank to focus on the yuan index (the RMB CFET Index). The CNY basket index is a passive indicator as it reflects the weighted average of the dollar and other currencies against the yuan via USD/CNY.

On the daily trading band of the USD/CNY, we do not expect any change in 2018 as the central bank governor has told the world that the band is not that relevant in exchange rate policy. We agree. The spot seldom touches the ±2% band and has been trading very close to the daily fixing. The last widening of the daily trading band was in March 2014.

USD/CNY and USD/CNH to nearly become one.

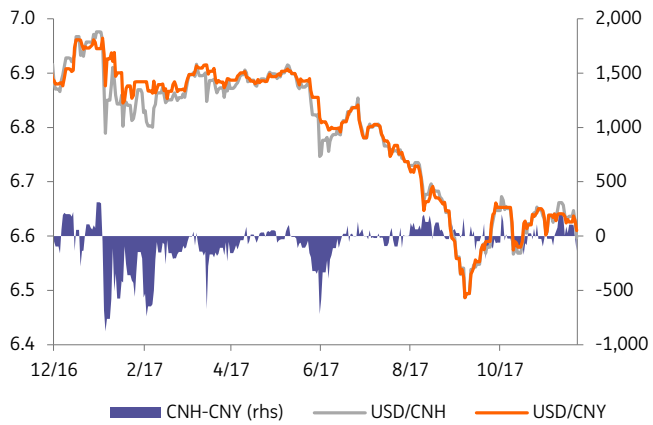
We also do not expect onshore yuan (USD/CNY) and offshore yuan (USD/CNH) to deviate from each other much. Moving yuan liberalisation forwards needs the onshore and offshore yuan to come as close as possible. The central bank can achieve this more readily when an offshore yuan liquidity pool builds up once again as the yuan appreciates.

Spot follows fixing, not touching the bands



Source: Bloomberg, ING

Onshore and offshore yuan will converge



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