

**MONTHLY HIGHLIGHTS**

- Compared with November 2016, TR/HKEX RXY Global CNH Index remained flat at 95.47, while the People's Bank of China (PBOC) USD/CNY Fixing increased by 1.2 per cent to 6.9730 in December 2016.
- Overall for 2016, HKEX's USD/CNH futures contract has again taken a leading position with the best liquidity and distribution in USD/CNH futures among exchanges around the world. The contract had record high open interest (OI) and average daily volume (ADV) in December 2016, with the OI reaching 45,635 contracts (US\$4.6 billion notional) on 30 December 2016, and the ADV rising to a record high of 4,325 contracts (US\$433 million notional).
- Professor Ba Shusong, HKEX's Chief China Economist, examines the current RMB fixing mechanism and how its flexibility enhances China's resilience against international economic shocks.
- In the Expert Corner, Mr. Alexis Garatti, Head of Global Economic Research of Taikang Asset Management (HK), discusses the RMB's fluctuation and its impact in the context of the emerging Asian region.

**RECAP ON HKEX'S EFFORTS IN PROMOTING THE OFFSHORE RMB FIC MARKETS**



HKEX Chief Executive, Mr. Charles Li, discussed the significance of Shenzhen-Hong Kong Stock Connect at its launch ceremony on 5 December 2016.



HKEX held a seminar with the China Banking Association from 5 to 9 December 2016, hosting top management and banking executives from Mainland China, which symbolises the continued cooperation between the Mainland and Hong Kong's financial industry.

**FROM THE CHIEF CHINA ECONOMIST'S VANTAGE POINT**

**A Flexible RMB Fixing Mechanism Significantly Enhances China's Resilience Against International Economic Turbulence**

**Professor Ba Shusong, Chief China Economist, HKEX**

With the strengthening of the US dollar after the end of the US presidential election, the RMB's exchange rate has become remarkably more volatile. While maintaining stability against a basket of currencies, the RMB has somewhat depreciated against the US dollar. In an uncertain international environment, flexibility in the value of the RMB significantly enhances China's resilience against external economic turbulence. It is a positive outcome of the earlier reform of the RMB fixing mechanism.

In perspective, reforming the RMB fixing mechanism is a critical part of China's overall financial structural reform. Since 2005, the reform has been a process of continuous increase in exchange rate flexibility, continuous reduction in PBOC intervention and increasing sensitivity of the RMB's exchange rate to internal and external economic volatility. Given the impacts of the exchange rate on a country's currency policy, external trade and capital market, reform of the RMB fixing mechanism is subject to a variety of domestic and overseas factors. Keeping the value of the RMB basically stable at a reasonable and balanced level and successfully implementing clearing of RMB currency transactions are the policy objectives of China's exchange rate reform.

(to be continued on page 9)

Fig 1: Chart of the Month: China's FX Reserves Movement

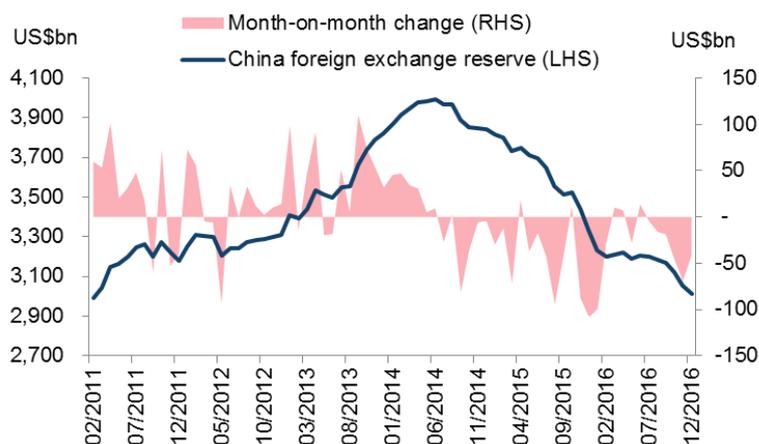
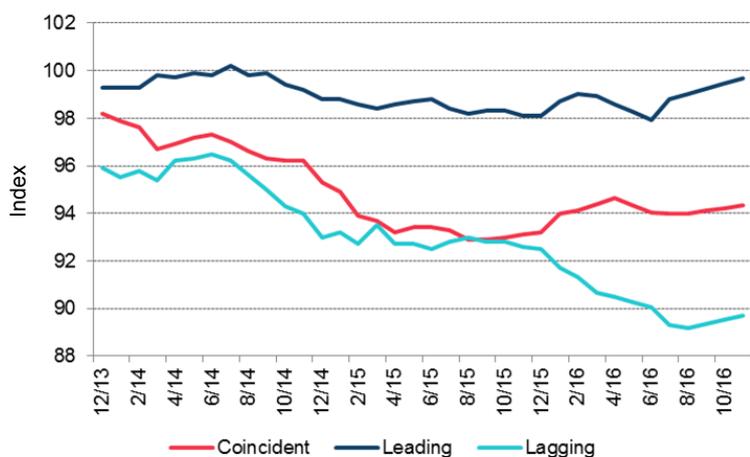


Fig 2: China's Macro-Economic Climate Index



- The coincident index is the index reflecting the current basic trend of the economy, and it is calculated using the following data: (1) industrial production; (2) employment; (3) social demands (including investment, consumption and foreign trade); and (4) social incomes (including the government taxes, profits of enterprises and income of residents).
- The leading index is calculated using a group of leading indicators, which take a lead before the coincident index, and is used for forecasting the future economic trend.
- The lagging index is calculated using the lagging indicators, which lag behind the coincident index, and is mainly used for confirming the peak and trough of the economic cycle.

TABLE 1

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.8	6.7	↑	18/04/2017
CPI (yoy %)	2.1	2.3	↓	14/02/2017
PPI (yoy %)	5.5	3.3	↑	14/02/2017
Industrial Production (yoy %)	6.0	6.2	↓	17/04/2017
FAI (yoy %)	8.1	8.3	↓	14/03/2017
Foreign Investment (yoy %)	5.7	1.2	↑	08/02/2017
CFLP Manufacturing PMI	51.4	51.7	↓	01/02/2017
PBOC Bankers Confidence Index	53.7	46.5	↑	TBC
PBOC Bankers Loan Demand Index	57.5	55.7	↑	TBC
Share of Payments via SWIFT in CNY (%)	2	1.67	↑	27/01/2017
Exports (yoy %)	-6.2	-1.5	↓	10/02/2017
Imports (yoy %)	3.1	5.5	↓	10/02/2017
M2 Money Supply (yoy %)	11.3	11.4	↓	10/02/2017
Retail Sales (yoy %)	10.9	10.8	↑	17/04/2017
Consumer Confidence Index	116.6	114.9	↑	20/02/2017
Regulated Reserve Ratio (%)	17.5	18.0	↓	Infrequent
Official Foreign Exchange Reserves (USD bn)	3010.5	3051.6	↓	07/02/2017
Three-Month SHIBOR (%)	3.86	3.16	↑	Continuous
10-Year Gov't Bond Yield (%)	3.27	3.19	↑	Continuous
USD/CNY Exchange Rate	6.86	6.95	↓	Continuous
TR/HKEX RXY Global CNH Index	95.47	95.47	↔	Continuous

CHART OF THE MONTH

- The China's foreign exchange (FX) reserves fell by US\$41 billion to US\$3.01 trillion in December 2016, a slower decline than the previous month and also less than expected according to a Reuters poll of analysts as of 6 January 2017. According to a statement by the State Administration of Foreign Exchange on 19 December 2016, the PBOC's effort to stabilise the currency was the key reason for the decline of China's FX reserves.

REGULATORY/POLICY DEVELOPMENTS

- The China Foreign Exchange Trade System (CFETS) announced on 9 December 2016 that it would allow direct RMB trading with seven more currencies, bringing the total number to 23. On 29 December 2016, the CFETS announced the addition of a further 11 currencies to the trade-weighted FX basket effective from 1 January 2017. This reduced the weighting of the US dollar to 22.4 percent from 26.4 percent in the basket.

MACRO ECONOMIC UPDATE

- According a survey conducted by Bloomberg on 16 December 2016, economists raised growth estimates for China in December 2016 after China's Central Economic Work Conference, where policy makers indicated plans for prudent and neutral monetary policy and proactive fiscal policy next year, and also pledged to prevent and control financial risks to avoid bubbles.
- China's new credit expanded faster than expected, with new RMB loans standing at RMB1.04 trillion in December 2016, exceeding all 37 estimates in a survey conducted by Bloomberg on 12 January 2017. Aggregate financing was RMB1.63 trillion in December, comparable with RMB1.74 trillion in the prior month.
- China's economy showed improvement in the fourth quarter across all industries, according to the quarterly survey published on 27 December 2016 by the China Beige Book, a New York-based research group. Revenues, profits, employment and capital expenditures improved from the third quarter while new orders were stable.

MARKET/PRODUCT DEVELOPMENTS

- Two incidents of alleged fraud in China's bond market were reported in December 2016 involving Sealand Securities Co. and China Guangfa Bank Co., which spurred the market's call for tougher regulatory oversight.
- Hong Kong is in preliminary talks with Mainland authorities in a potential bond market connect scheme to deepen the link between the two sides after the launch of the Shenzhen-Hong Kong stock connect, according to Norman Chan, Chief Executive of the Hong Kong Monetary Authority, during a visit to Beijing on 20 December 2016.

## RMB FX MARKET DYNAMICS

### OFFSHORE USD/RMB

- In December 2016, USD/CNY fixings moved between 6.8575 and 6.9508, and CNH was trading 0.9 per cent lower versus the USD from a month ago.
- On 14 December 2016, the US Federal Reserve raised the interest rate target range by 0.25 per cent, the second time in a decade. The US dollar strengthened against major currencies in December 2016, with market expectations of further rate hikes and fiscal expansion policies in the near term.
- According to its statement on 6 January 2017, the PBOC reiterated that it will keep the RMB basically stable against a basket of currencies while continuing to improve the exchange-rate formation mechanism. It also reaffirmed that it will implement a prudent and neutral monetary policy in 2017.

Fig 3: Onshore/Offshore RMB Price Range



Fig 4: Implied Volatilities of OTC USD/CNH ATM Options

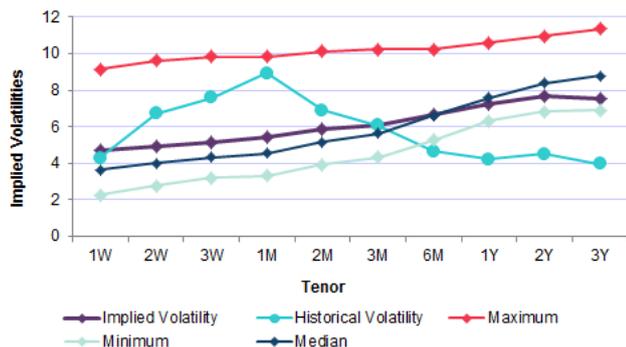


Fig 5: Market Forecasts for the Level of USD/CNH



## HKEX'S USD/CNH FUTURES

### PRODUCT HIGHLIGHTS

- Overall for 2016, HKEX's USD/CNH futures have again taken a leading position with the best liquidity and distribution in USD/CNH futures among global exchanges. Both the turnover and open interest almost doubled year-on-year (YoY) in 2016.
- The OI was 45,635 contracts (US\$4.6 billion notional) on 30 December 2016, an all-time high and a 98 per cent increase from last year. The ADV of December 2016 also rose to a record high of 4,325 contracts (US\$433 million notional).
- The volume and open interest distribution is diversified at HKEX, reflecting a well-balanced investor base. Trading volume was highest in the Dec-16, Jan-17 and Mar-17 contracts, which accounted for 51 per cent of total volume. Open interest concentrated in the Mar-17, Sep-17 and Dec-17 contracts, accounting for 63 per cent of total amount.

Fig 6: Turnover & Open Interest Almost Doubled YoY in 2016

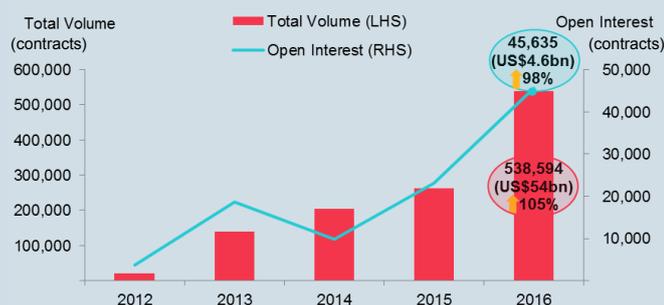


Fig 7: USD/CNH Futures Turnover and Open Interest



Fig 8: Breakdown of Turnover by Contract Month (12/2016)

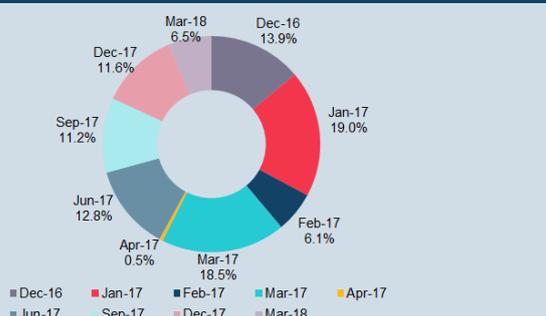
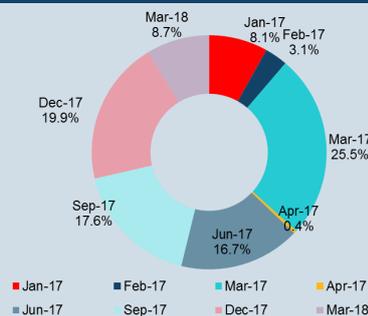


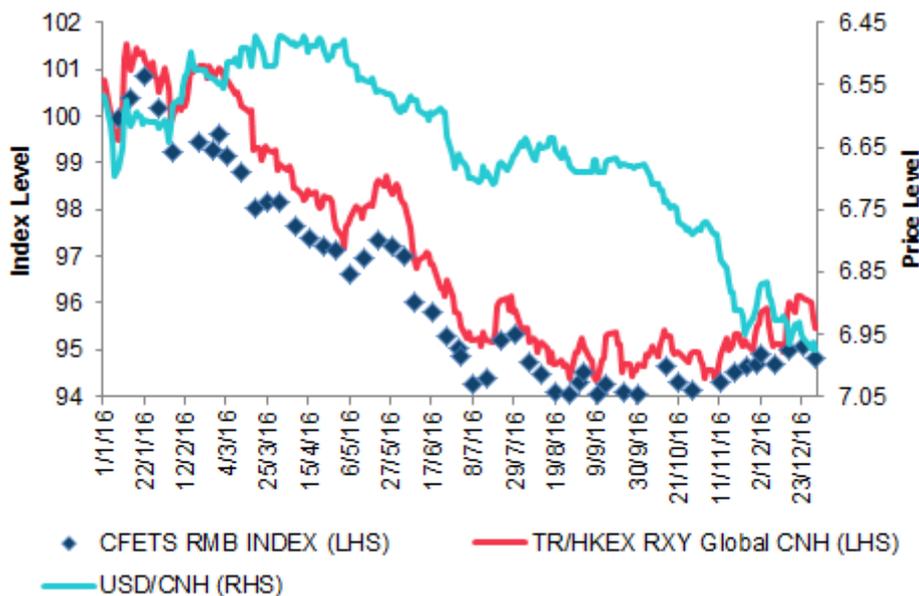
Fig 9: Breakdown of OI by Contract Month (30/12/2016)



## TR/HKEX RMB CURRENCY INDICES (RXY)

- Compared with November 2016, TR/HKEX RXY Global CNH Index remained flat at 95.47, while the PBOC's USD/CNY Fixing increased by 1.2 per cent to 6.9730 in December 2016.
- Consistent with PBOC's exchange rate regime, the TR/HKEX RXY Global CNH Index and CFETS RMB Index remained relatively stable compared with the bilateral exchange rate against US dollar

Fig 10: Performance: TR/HKEX RXY Global CNH, CFETS RMB Index and USD/CNH



## PRODUCT HIGHLIGHTS

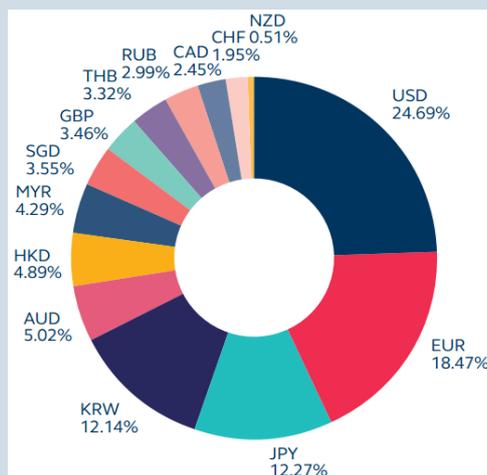
- The RXY indices offer independent, transparent and timely benchmarks for RMB against Mainland China's most important trade partners' currencies.
- The indices are calculated based on WM/Reuters foreign exchange rates (WM/Reuters FX Rates) and managed in accordance with the IOSCO (International Organisation of Securities Commissions) principles for financial benchmarks.
- The RXY indices are designed to be the basis for investment and trading products such as futures, options and exchange traded funds.

## METHODOLOGY

- Calculation Method:** Geometric Average
- Weighting Method:** Bilateral trade weighted with adjustment for Hong Kong re-exports
- Trade Data Source:** UN Comtrade, Hong Kong Census and Statistics Department
- Weighting Rebalance:** Annual review. Announcement in June, Implementation on the first business day of Q4
- Calculation Frequency:** Hourly
- FX Rate Data Source:** WM/Reuters FX Rates
- Base Date:** 100 as of 31 December 2014

Fig 11: TR/HKEX RXY Global CNH Currency Index

## Index Weights: Valid Until 29 September 2017



For more details, a complete methodology document is available at: [financial.thomsonreuters.com/fxindices](http://financial.thomsonreuters.com/fxindices)

TABLE 2: Index Weights

Currency	RXY Global Currency Indices	RXY Reference Currency Indices
USD	24.69%	28.09%
EUR	18.47%	21.03%
JPY	12.27%	13.97%
KRW	12.14%	0.00%
AUD	5.02%	5.72%
HKD	4.89%	5.56%
MYR	4.29%	4.88%
SGD	3.55%	4.04%
GBP	3.46%	3.93%
THB	3.32%	3.78%
RUB	2.99%	3.41%
CAD	2.45%	2.79%
CHF	1.95%	2.22%
NZD	0.51%	0.58%



## OFFSHORE RMB AGAINST OTHER CURRENCIES

### EUR/CNH

- As the second largest constituent in the CFETS RMB trade-weighted index, the EUR-RMB exchange rate is of particular interest to the market.
- The CNH was trading 0.14 per cent lower against the EUR in December 2016 from a month ago, and remained in a range of 7.21 to 7.39. The implied volatility of 3M OTC options edged higher to around 10 per cent in December 2016.
- On the FX radar, the valuation and fundamental factors were well above their historical average, while the risk, carry, momentum, and sentiment factors were below their historical average.

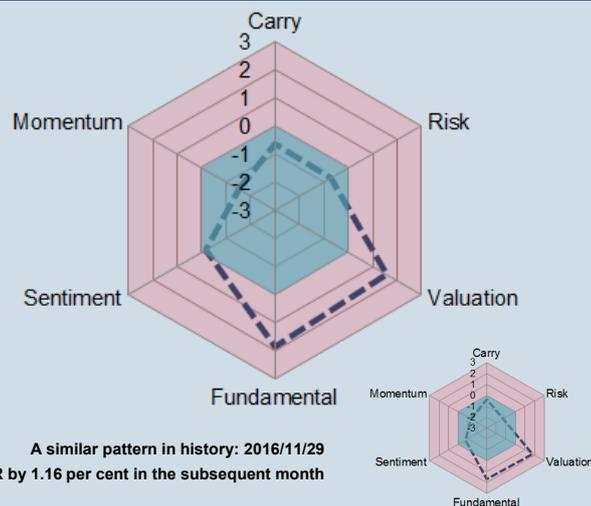
**Monthly CNH Performance vs EUR**

↓ -0.14%

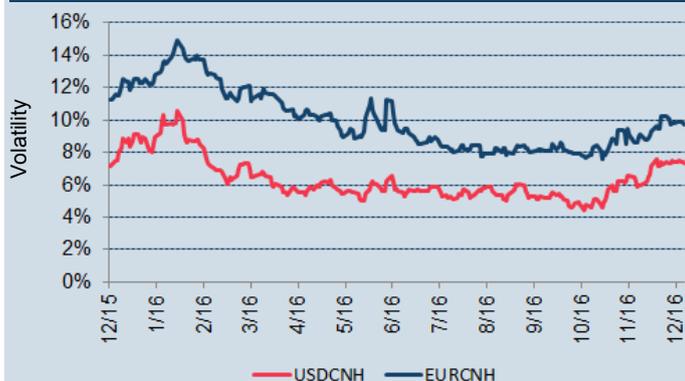
**Implied Volatility**

9.7%

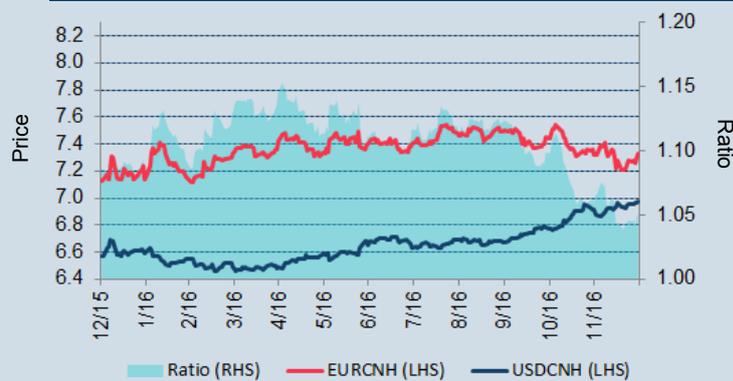
**Fig 12: FX Radar\***



**Fig 13: FX Volatility (3M Implied)**



**Fig 14: Price Ratio: EURCNH / USDCNH**



### AUD/CNH

- The CNH was trading 1.52 per cent higher against the Australian dollar (AUD) in December 2016 from a month ago, possibly due to a drop in iron ore spot prices during the period.
- The implied volatility rebounded to near 11 per cent in December 2016.
- On the FX radar, the risk and momentum factors were below their historical average, while the valuation, carry, fundamental and sentiment factors were above their historical average.

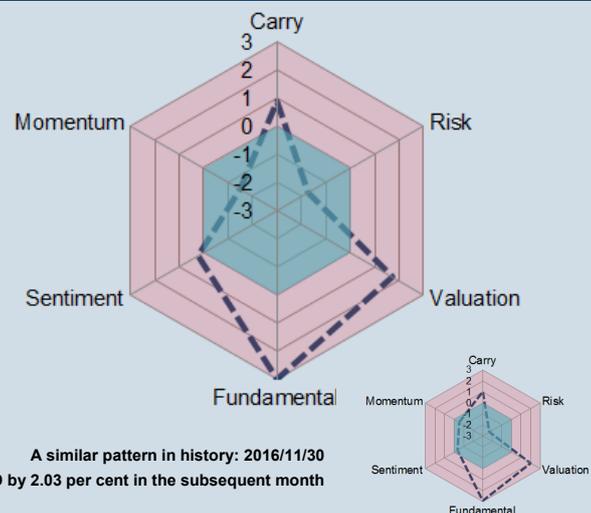
**Monthly CNH Performance vs AUD**

↑ 1.52%

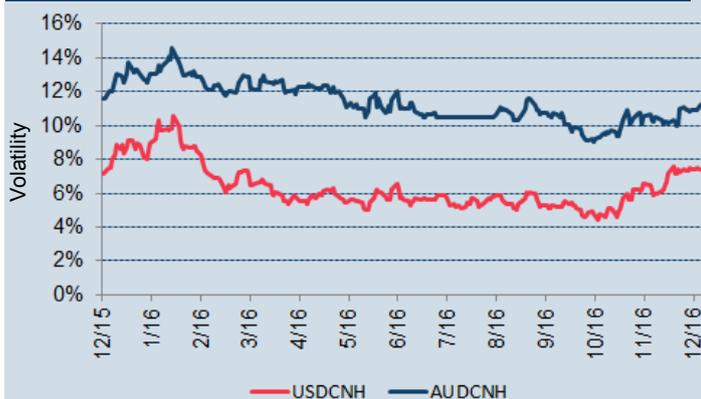
**Implied Volatility**

11.2%

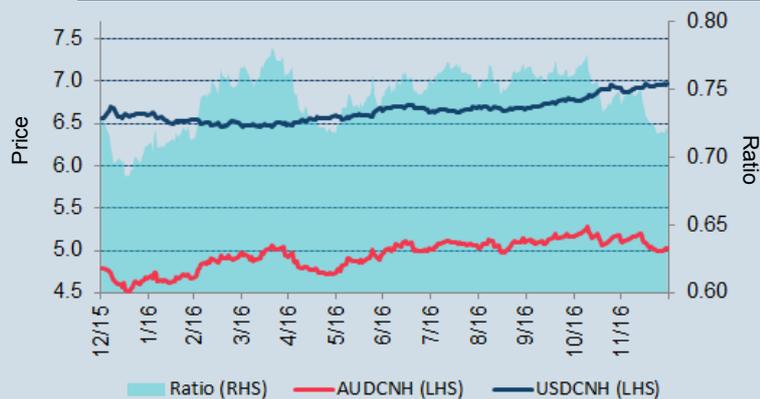
**Fig 15: FX Radar\***



**Fig 16: FX Volatility (3M Implied)**



**Fig 17: Price Ratio: AUDCNH / USDCNH**



- The CNH was trading 1.35 per cent higher against the JPY in December 2016 from a month ago, as the Bank of Japan's continued 'yield-curve control' policy has contributed to Yen weakness by dampening upward pressure on yields in Japan.
- The 3-month implied volatility edged to near 13 per cent in December 2016.
- On the FX radar, the sentiment and fundamental factors were above their historical average, while the valuation, risk, carry and momentum factors were below their historical average.

**Monthly CNH Performance vs JPY**

↑ 1.35%  
**Implied Volatility**  
 12.9%

Fig 18: FX Radar\*

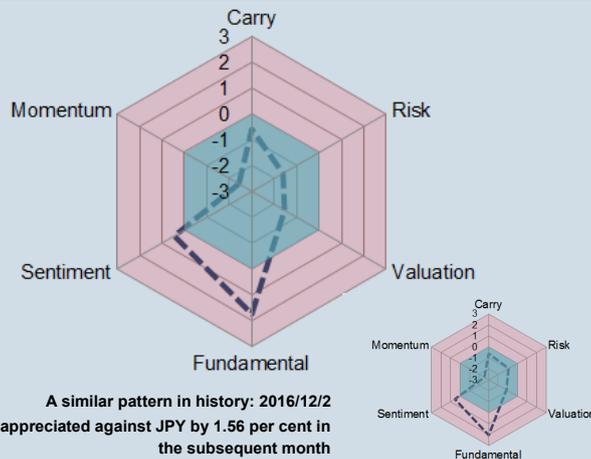


Fig 19: FX Volatility (3M Implied)

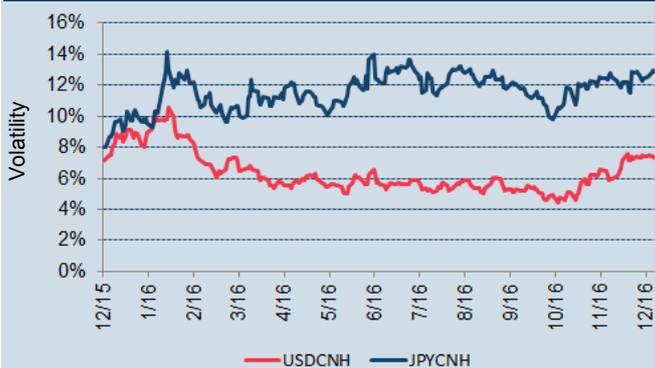


Fig 20: Price Ratio: JPYCNH / USDCNH

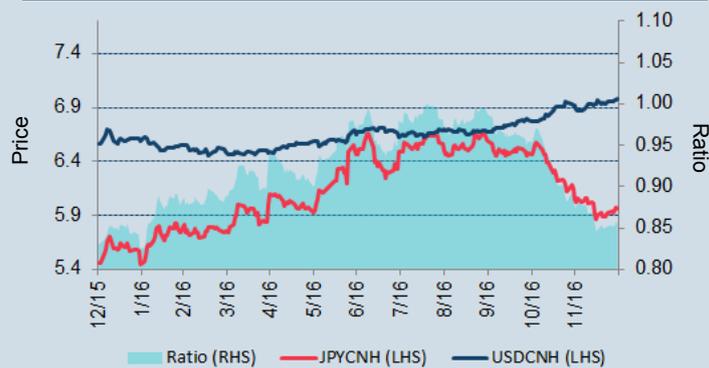


TABLE 3: Summary Table for RMB Currency Pairs

	Performance					Volatility					
	Dec	Nov	Chg	Prior 3 Month	YTD	Implied	Prior	Chg	Historical	Prior	Chg
USDCNH	-0.87%	-2.04%	↑	-4.48%	-5.46%	7.3%	5.9%	↑	3.1%	3.0%	↑
EURCNH	-0.14%	1.60%	↓	2.26%	-1.34%	9.7%	8.6%	↑	6.3%	5.3%	↑
AUDCNH	1.52%	0.97%	↑	1.68%	-7.36%	11.2%	10.3%	↑	8.4%	8.3%	↑
JPYCNH	1.35%	6.54%	↓	9.51%	-7.07%	12.9%	12.6%	↑	8.8%	10.3%	↓

OFFSHORE BOND MARKET DYNAMICS

OFFSHORE RMB BOND MARKET COMMENTS

- RMB deposits in Hong Kong rebounded by 4.8 per cent month-on-month to RMB627.6 billion in November 2016.
- The total remittances of RMB for cross-border trade settlement amounted to RMB390.6 billion in November 2016, compared with RMB309.4 billion in the prior month.

Fig 21: Offshore RMB Deposits vs Dim Sum Bonds

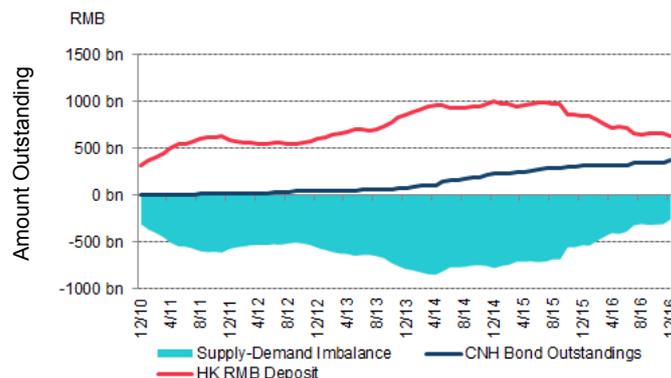


Fig 22: Offshore RMB Bond Issuances by Issuer Type

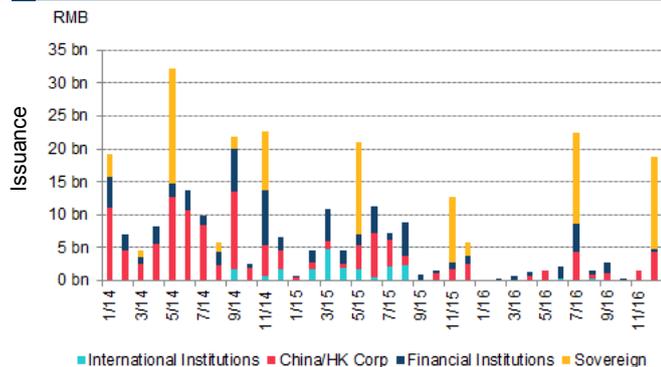
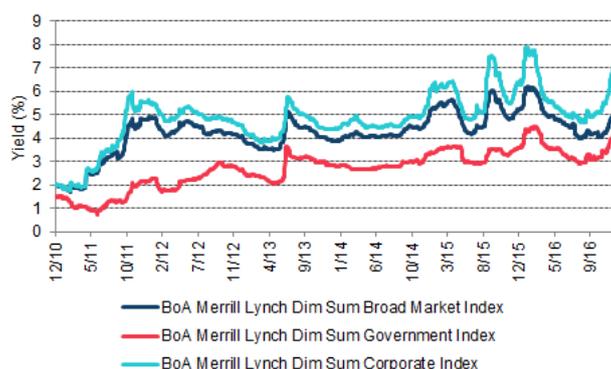


Fig 23: Dim Sum Bond Performance



Sources: Bloomberg, WIND (31 December 2016)

Past performance is not a guide to the future  
 \* For detailed information, please see appendix

## ONSHORE RMB BOND MARKET COMMENTS

### ONSHORE BOND MARKET DYNAMICS

- Onshore bond issuance decreased by 2 per cent to RMB 2.35 trillion in December 2016 from RMB 2.40 trillion in December 2015.
- Further to PBOC's announcement of detailed China interbank bond market (CIBM) access procedures in May 2016, the foreign participation has increased to record levels, representing 2.52 per cent in bond holding in the CIBM, an all time high.
- Two incidents of alleged fraud in China's bond market were reported in December 2016 involving Sealand Securities Co and China Guangfa Bank Co. The market awaits tighter regulations in this regard.

Fig 24: MoF T-Bonds Yield 5Y: Onshore vs Offshore (%)

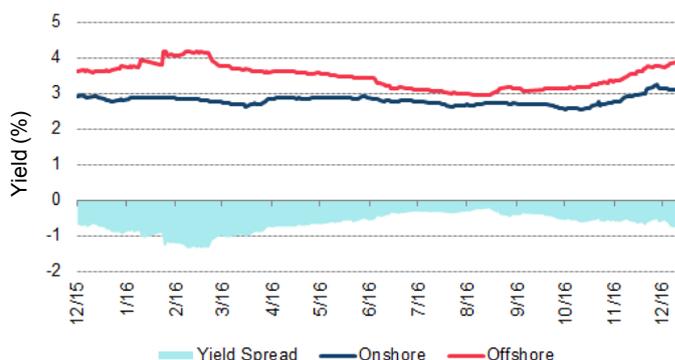


TABLE 4

Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types, for December 2016)

Bond Type	Number of Deals	Trading Value(RMB 100M)	Yield to Maturity(%)
Policy Financial Bond	24,466	18,675.88	3.5899
Treasury Bond	5,222	4,981.91	2.8646
Medium-term Note	8,198	4,041.20	5.1050
Corporate Bond	5,819	2,647.47	5.0791
CDs	9,785	16,691.86	4.0909
Commercial Paper	8,559	4,457.15	4.1209
Others	2,372	2,334.25	4.1302
<b>Total</b>	<b>64,421</b>	<b>53,829.72</b>	<b>3.9670</b>

Fig 25: MoF T-Bond Outstanding Split by Tenor

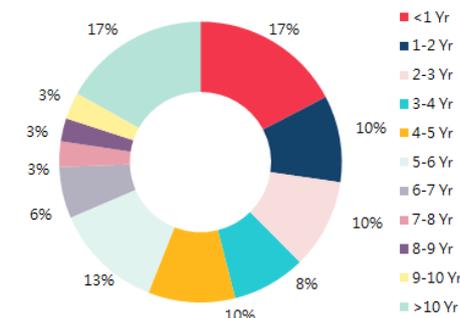


TABLE 5

	NAFMII Guidance for Non Fixed Income Debt Issuing (as of 2016/12/28)															
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.72	↑	3.95	↑	4.06	↑	4.29	↑	4.55	↑	5.10	↑	5.26	↑	5.52	↑
AAA	3.86	↑	4.05	↑	4.24	↑	4.65	↑	4.86	↑	5.37	↑	5.68	↑	5.98	↑
AA+	4.07	↑	4.36	↑	4.57	↑	5.09	↑	5.43	↑	6.02	↑	6.37	↑	6.71	↑
AA	4.42	↑	4.80	↑	5.08	↑	5.74	↑	5.96	↑	6.73	↑	7.08	↑	7.57	↑
AA-	5.39	↑	5.99	↑	6.35	↑	7.40	↑	7.78	↑	8.39	↑	8.76	↑	9.06	↑

NAFMII – National Association of Financial Market Institutional Investors

Fig 26: Foreign Participation in the CIBM Market

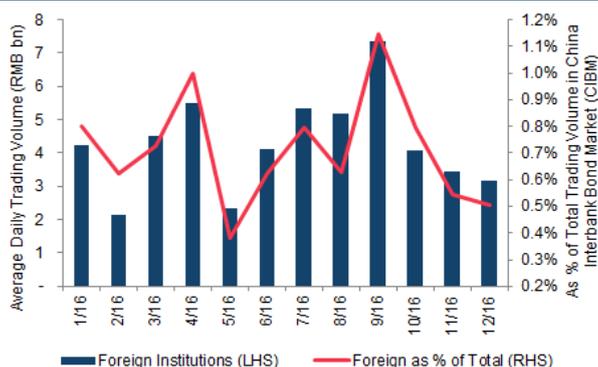


Fig 27: Onshore Bond Holdings by Foreign Institutions

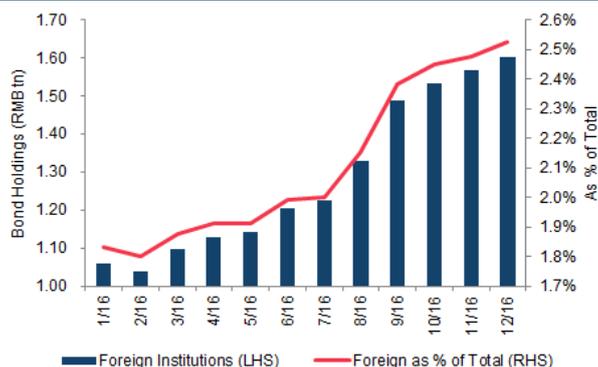


Fig 28: Bond Holdings Composition by Foreign Institutions

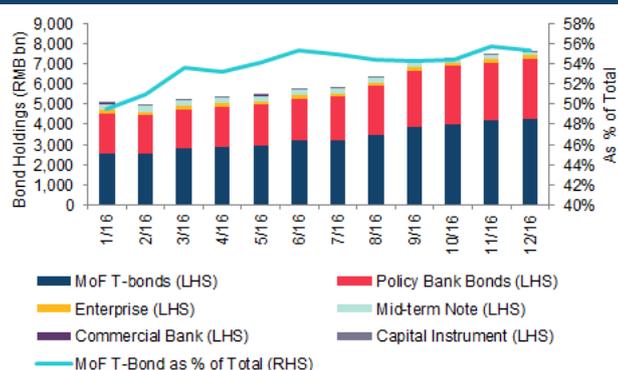


Fig 29: MoF T-Bond Futures Trading Volumes



## ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

### ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- The China interbank market liquidity remained tight due to the US dollar strengthening trend. The benchmark SHIBOR rate, a key barometer of money market liquidity and a measure of the interbank funding cost, generally rose across tenors during December 2016. The 7-day SHIBOR rate increased to 2.5470 per cent on 27 December 2016, a 15-month high since August 2015
- The offshore CNH liquidity also remained tight. The CNH HIBOR overnight loan rate continued to surge in December 2016, ending at 12.81 per cent on 30 December, 9.9 per cent increase from the end of November.

Fig 30: CNH Implied Yield vs. USD/CNH



Fig 31: CNY SHIBOR Yield Curves

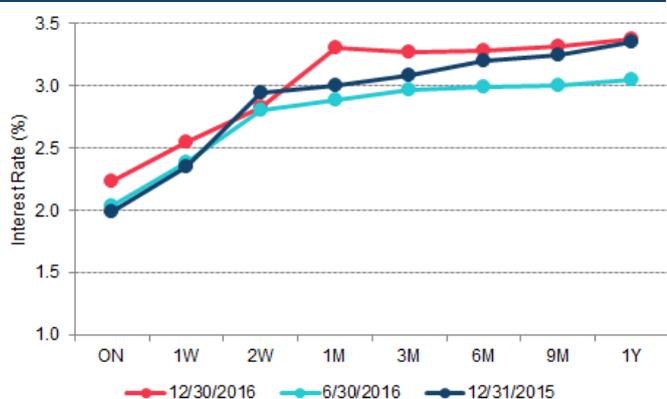


Fig 32: CNH HIBOR Yield Curves

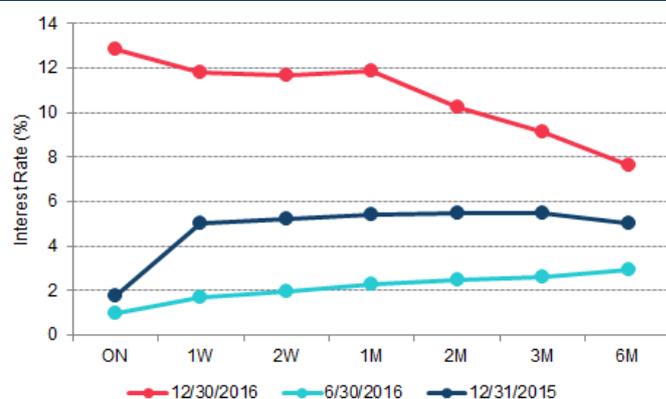


Fig 33: Onshore IRS (7D Repo) Yield Curves

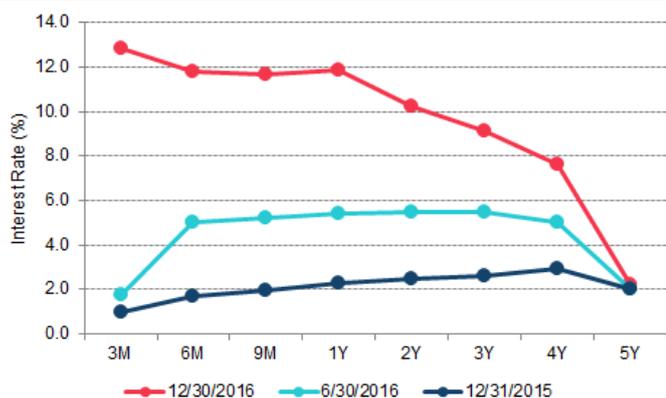


Fig 34: Onshore IRS Trading Notional Principal

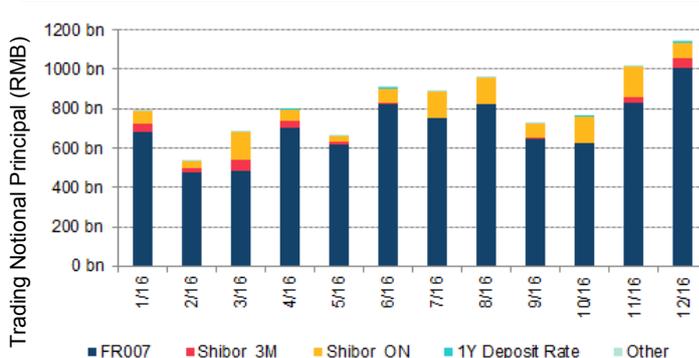


Fig 35: CNY SHIBOR vs CNH HIBOR

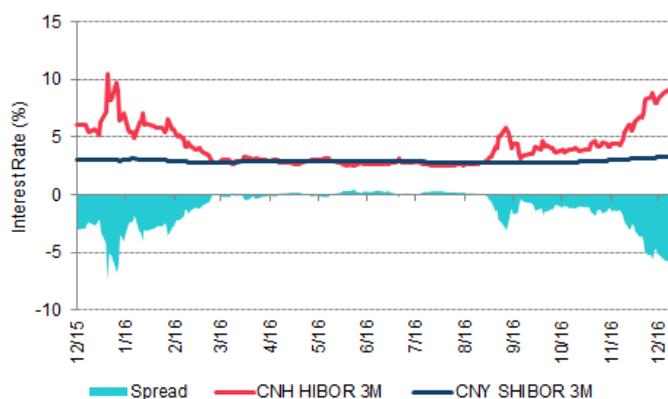
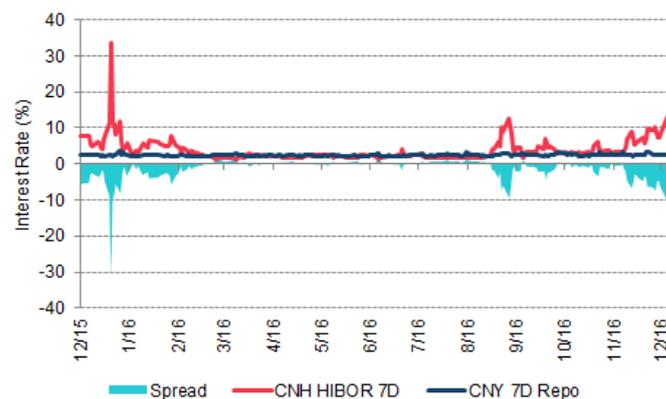


Fig 36: CNY 7D Repo vs CNH HIBOR



(Continued from page 1)

How to address the relationship between exchange rate volatility and stability is a real problem in the reform of the RMB fixing mechanism. The range within which the RMB moved against the USD had been widening as permitted by the PBOC even before the currency reform of 11 August 2015, but in RMB fixing, stability is still seen as a relatively more important policy objective. For example, in the daily fixing of the CNY/USD mid-price, whenever the value of the RMB comes under pressure, there was a tendency for the PBOC to adjust the speed and extent of exchange rate volatility through intervening in the fixing of the mid-price, an action that often incurred a high cost. Passive intervention in the FX market not only depletes the FX reserve and restricts the room of manoeuvre of the currency policy, but also hinders the FX market's truthful and timely reflection of changes in capital flows and economic fundamentals.

The new round of currency reform launched on 11 August 2015 demonstrates a change in the PBOC's thinking about currency reform. The central bank now supports a gradual loosening of the government's grip on the FX market and an open and transparent market-based fixing mechanism in pursuit of a stable balance in the midst of market volatility. Under the new mechanism, the CNY/USD rate is based on the previous close and CFETS' RMB exchange rate index. The former reflects the currency reform's adoption of market forces to correct long-time pricing distortions in the FX market. The latter reflects the philosophy behind the mid-price fixing, which is to reduce the impact of exchange rate changes on foreign trade. Evidently, the purpose of the new mechanism is to coordinate and unify the two goals: two-way movements in the exchange rate and relative stability. It is worthwhile to note that under such market-based fixing mechanism, market expectations have a crucial impact on FX demand and supply and the movements of the exchange rate. The use of expectation management in the current round of currency reform reflects innovation in the way the PBOC manages the FX market. A shift from direct intervention to indirect steering of expectations to accept changes in a gradual manner helps investors understand the new system and enhance investors' confidence.

In terms of effects, an RMB exchange rate that is flexible promptly takes into account pressures brought by changes in capital flows and economic fundamentals, thereby enhancing China's resilience against unfavourable external economic shocks. Maintaining the exchange rate at a relatively fixed level amid rapid changes in external economic and financial factors will lead to a build-up of pressure on exchange rate adjustment. The sharp reduction of the FX reserve caused by central bank intervention may undermine market confidence. Lessons from emerging markets show that when a country that adopts a fixed exchange rate mechanism encounters external economic turbulence, its current account, capital account and FX reserve may influence each other and negative feedback will emerge, thus magnifying the spillover effect of the external incident on the country and causing internal crises. Taking Russia as an example, in 2014, the plunge of international oil prices led to deterioration in the country's current account and massive capital outflow. Russia's FX reserve fell as a result of central bank intervention in the exchange rate of the ruble. Investors' fears about the stability of the ruble's value increased more serious capital outflow which eventually led to a crisis.

The impact of the recent US presidential election on the RMB's exchange rate fully reflects that a flexible exchange rate has the positive function of serving as a buffer against external shocks. In addressing shocks from capital flows, a more flexible exchange rate has taken the place of capital control and effectively eased devaluation pressure on the RMB. Experience of emerging markets shows that for large open economies facing a capital outflow, increased capital control will cause market panic rather than stabilise the home currency, thereby triggering more serious capital outflow and currency crises. A relatively open, transparent and predictable fixing mechanism, supported by policy communication and guidance from the central bank, has enabled investors to quickly adapt to the volatility of the RMB's exchange rate. Objectively speaking, this will help increase the depth and flexibility of the FX market, enhance the RMB's resilience against external shocks and adjustment pressure, and avoid potential problems that may arise from control measures under the capital account. In terms of addressing the shock from changes in fundamentals, a flexible RMB exchange rate can change trade conditions hence effectively reducing the impact of global shocks on China's macro economy. Only with a free floating exchange rate can international balance of payment be adjusted. Excessive emphasis on exchange rate stability turns the exchange rate policy itself into a goal, and represents voluntary abandonment of policy tools that can be used to achieve external equilibrium. An exchange rate system with greater flexibility will give rise to a greater variety of FX derivative products. It will be an effective channel through which Mainland enterprises can hedge exchange rate risks.

The current round of reform is a solid step forward in the market reform scheme of the RMB fixing mechanism and marks a significant turning point. A flexible exchange rate for the RMB remarkably enhances China's resilience against external economic turbulence. It should be noted that during transformation of the RMB fixing mechanism and amid external political and economic changes, increased market volatility is natural. Latest trends show that since last year the RMB's devaluation has remained within a controllable range of 5-10 per cent a year which is acceptable compared internationally, and also compared with the RMB's own historical performances. In the long run, with the gradual release of devaluation expectations, the RMB's exchange rate, benefitting from the market reform of the fixing mechanism, will return to a path driven by fundamentals. Ancillary to the exchange rate reform, a flexible exchange rate system requires a developed FX market to perform price discovery and provide risk management for market entities. Development of sophisticated FX market participants, optimisation of market mechanisms and environments and creation of innovative FX derivative instruments will be important groundwork for the implementation of the next steps of exchange rate reform.

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## EXPERT CORNER

### RMB DEVALUATION IS NOT A BAD NEWS FOR EMERGING ASIA

Contributed by Alexis Garatti, Head of Global Economic Research, Taikang Asset Management (HK)

#### CNY's depreciation is not a source of destabilization for emerging Asia

Between August 2015 and November 2016, CNY's nominal effective exchange rate has registered a 10% decline, with potential devastating impacts on Asian emerging economies. Trade relations with China indeed take on high importance for these countries today confronted to a threefold challenge: an erosion of their competitiveness because of an appreciation of their currency relatively to Japan and China, a tightening of credit conditions alongside USD's recent appreciation and persistently muted trade at a global level. This configuration is reminiscent of times preceding the 1997-98 Asian financial crisis, which saw two successive negative shocks on the CNY and the JPY, an increase of US rates and a too rapid accumulation of (external) debt, another common point with today's environment. We will show that in fact CNY's fluctuations now have a lower influence on trade performances because of three structural factors, i.e. the re-balancing of China's economy, vertical intra-regional integration inside Asia and emergence of a RMB bloc.

#### CNY's fluctuations are less relevant in determining trade performances in Asia

Westpac Nominal Effective Exchange Rate Trade Weighted Chinese Yuan registered a 10% depreciation between August 2015 and November 2016. In order to better capture the impact of RMB's recent depreciation on Asia's emerging economies, we calculate an effective nominal exchange rate of the CNY based on trade relations with India, Indonesia, Malaysia, Thailand and Philippines only. We can observe three periods (see fig 37). In period 1, the CNY appreciated both compared to the USD and currencies of emerging Asia on the back of China's successful integration into world trade and world economy. In period 2, between 2014 and the beginning of 2016, the CNY depreciated against the USD as the market perceived China as suffering from weaker growth induced by a restructuring of its economy, capital outflows and excessive debt. Despite these difficulties, the CNY appreciated compared to emerging Asia's currencies, as a lower exposure to external debt better protects the Chinese economy against an upcoming phase of rate normalization in the US. In phase 3, from the end of 2015 until US elections in November 2016, the CNY depreciated by 8% compared to the currencies of Asian emerging economies, which benefitted from a global thirst for yield and a better alignment between the Fed and the market on the need of gradual rate normalization. In November 2016, the CNY re-appreciated by 1.4% against emerging Asia's currencies, as fears related to the negative impact of a USD-based tightening of monetary conditions were reignited by the perspective of a new US stimulus nurturing inflationary pressures.

The joint evolution of China's real exports toward emerging Asia and CNY's effective exchange rate points toward a distending relation between the two variables since 2014 (see Fig 38). This process is also visible when looking at China's real exports toward developed markets. It suggests that currencies movements now have a lower impact on trade inside Asia and outside Asia. This view is confirmed by an analysis in terms of market shares, which have invariably evolved in favor of China whatever the level of the RMB. The distending link between currency and real exports as well as continuous increase of China's market shares indicate that structural factors, related to competitiveness and the restructuring of the economy, are far more decisive in shaping trade relations between China and emerging Asia.

#### The restructuring of China's economy is more important in determining Asia's trade

Hong, Lee, Liao and Seneviratne (2016, "China and Asia Global Trade Slowdown", IMF Working Paper) demonstrate that China's rebalancing (from export-driven to domestic demand driven, from investment-based to consumption-based and on-shoring) has markedly impacted trade relations in Asia. According to their data, China's consumption is much less intensive in terms of import contents compared to investment and re-export activities. So the demand of China for investment - and re-export - related imports has diminished, whereas consumption - related demand for imports has increased, independently of currency considerations. The change in the size and structure of China's demand has therefore structurally reduced the role of currencies as an element of relative competitiveness or dynamism of trade. Obviously, the ranking-up of China in the value-added ladder, which is part of the transformation operated in China's economic model, has also reduced the elasticity of substitution between Chinese products and the rest of Asian products, therefore reducing the influence of currency movements.

#### Vertical integration, intra-trade and RECP to also reduce CNY's impact on Asian trade

The rise of intra-regional flows and vertical specialization across countries has been the main features of Asia's trade integration after the 2008-2009 global financial crisis. China has been the main engine of these two processes, which give a larger weight to intermediate goods in trade flows. The Asian Development Bank shows that the sensitiveness of trade volumes (both imports and exports) have been halved in the aftermath of the Global Financial crisis (Asia Economic Integration Report 2016: what drives foreign direct investment in Asia and the Pacific?) for a sample of 160 countries including 40 Asian partners. The surge of vertical integration with China has been particularly impressive in Asia, therefore reducing the impact of CNY fluctuations. A depreciation of the CNY may boost Chinese exports (fostering competitiveness) but the net impact is probably lower as it also increases the cost of foreign intermediate goods contained in these products (hampering China's competitiveness and fostering competitiveness of Asian countries using Chinese products as intermediate goods). In terms of trade integration, the RECP (Regional Comprehensive Economic Partnership) is also likely to receive a boost from Trump's protectionist stance and foster inter-regional flows, representing another long-lasting positive shock on Asian trade with no link with currency movements.

#### As an anchor of Asian currencies, the RMB undergoes a "neutralization" of its fluctuations

The emergence of a RMB bloc is the third structural phenomenon, beside China's economic restructuring and vertical regional integration, to significantly reduce the impact of RMB's fluctuations on growth of emerging Asia. Ito ("A new financial Order in

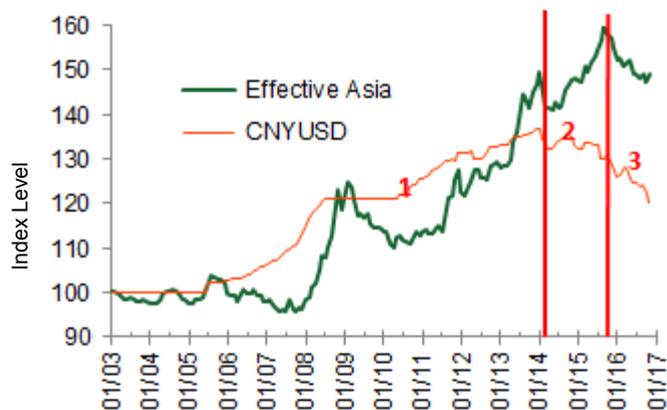
Asia: will a RMB bloc emerge?, NBER working paper 22755) shows that RMB's importance has grown for the six functions of an international currency (i.e. unit of account, medium of exchange and store of value at both a private and public level, see table 7). The emergence of this bloc means that the RMB is now used as an anchor by Asian central banks, instead of the USD, in the determination of their monetary – currency policy. The author demonstrates on the base of a Frankel-Wei regression, that except for Thailand, currencies of emerging Asia co-move in a larger extent with the RMB than with the USD. Said differently, central banks of these countries (except Vietnam, Laos, and Cambodia), despite highly heterogeneous objectives of monetary policy, neutralize between 50% to 90% of RMB fluctuations against the USD, i.e. give more weight to the CNY than the USD in their implicit basket of currencies. Beside the anchor role of the RMB, we can also mention its growing influence as a unit of account, medium of exchange and store of value alongside regional initiatives such as Asian Infrastructure Investment Bank and the One Belt One Road strategy. All these elements slowly reduce Asia's dependency on the USD, therefore offering a better protection against a global shock of liquidity in this currency.

### Perspectives on emerging Asia for 2017

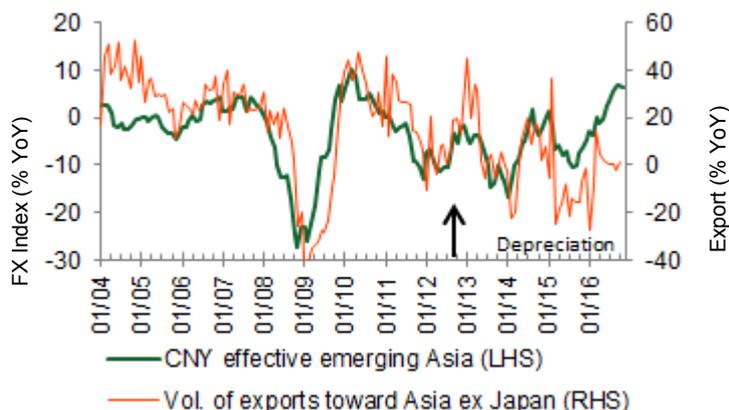
All in all, the CNY is unlikely to represent a source of destabilization for emerging Asia. Self-insurance of these countries has also progressed in the aftermath of the 1997-98 Asian Financial Crisis via the accumulation of foreign exchange reserves, the construction at a regional level of a more solid financial architecture, a lower level of gross external debt (close to an average of 35% of GDP in 2015 compared with 45% before the 1997-98 crisis and 65% of GDP during this crisis). At last, external macroeconomic factors should continue to be supportive for emerging Asia. Indeed, the impact of any stimulus in the US should be limited in 2017 because of the time needed to vote tax cuts and infrastructure projects or because of low multiplier effects (US economy being close to its potential). In addition, the new voting members of the Federal Open Market Committee (FOMC) are likely to give an even more dovish tilt to the Fed, which has recognized its predisposition to accept a higher level of inflation. In this context, a global tightening of monetary and financial conditions, related to a USD appreciation is likely to not be exaggerated or rapid. In an environment of gentle normalization of the US monetary policy and anchoring role of the CNY, emerging Asia is on track to continue performing well.

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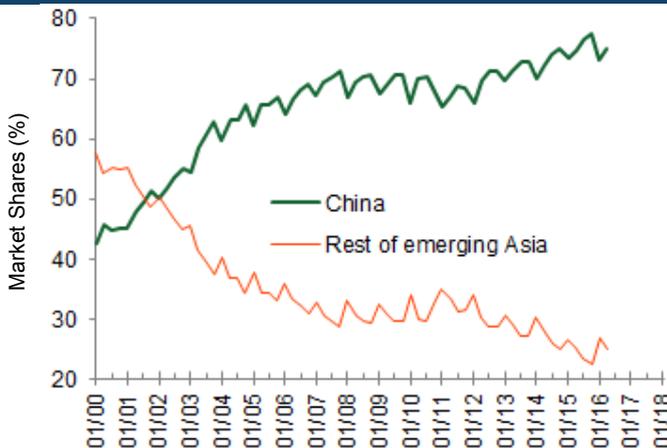
**Fig 37: CNY Indices**



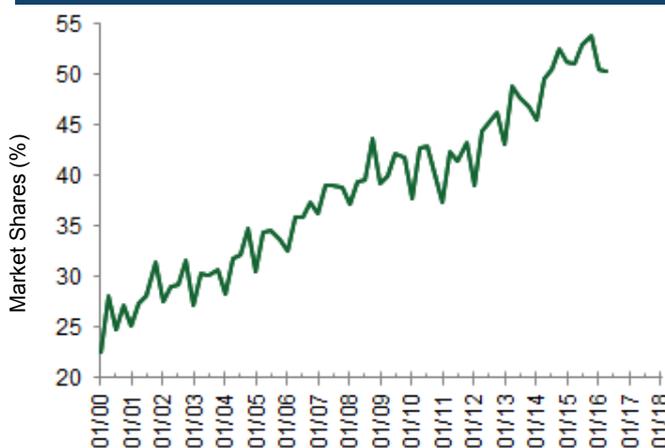
**Fig 38: Exports in Volume of China Toward Asia ex Japan**



**Fig 39: Asian Market Shares in Terms of Exports Toward Advanced Economies Among Asia Emerging (India, Indonesia, China, Vietnam, Thailand, Philippines)**



**Fig 40: Share of China exports in Emerging Asia exports toward Emerging Asia**



**Table 6: China: Import Growth Decomposition (%)**

	2012-2015 over 2006-2011	If No Rebalancing	Effect of Rebalancing
Imports	-6.8		
IAD	-7.2		
Domestic Demand	-5.8		
Consumption	-0.7	-1.3	0.6
Government	-1.2		
Investment	-3.9	-1.3	-2.6
External Demand	-1.5	0.1	-1.6
Onshoring	0.5		
Residual	-0.1		
		Net Effect	-3.6

**Table 7: Dimensions of an International Currency**

	Private Sector	Official Sector
<b>Unit of account</b>	Trade invoicing <RMB trade invoicing>	Being pegged by other countries <China, None>
	Denomination of financial products issued by companies and financial institutions of other countries <China, Panda bonds>	High weights in (official or de facto) currency baskets of foreign central banks <China, Frankel-Wei regression>
	Denomination of offshore financial products by domestic companies <China, Dim Sum bonds>	(IMF) SDR composition currency <China, Oct. 2016>
		Denomination of international bonds issued by other governments or IFIs
<b>Medium of exchange (Settlement)</b>	Trade Settlement <China, RMB trade settlement>	Intervention currency by other momentary authorities
	International financial transaction settlement <China, SWIFT> <China, BIS Triennial Survey>	Government financial transactions (such as ODA) Central Bank swaps currency <China, PBOC Swap lines>
		Currency circulation abroad (e.g., dollarization)
<b>Store of value</b>	Cross-border deposits <China, RMB deposits offshore>	Foreign reserves (of other countries) <China, IMF COFER; & Special Survey>
	Cross-border securities investment	Sovereign Wealth Funds (of other countries)

Note: Author's creation, slightly modified from Ito (2011), which was based on the matrix first proposed by Kenen (1983) and Cohen (1971)



Alexis Garatti holds a PHD on “macroeconomic shocks inside a monetary union”. He started as an economist in the Research Department of Natixis, working three years in Paris and two years in London. He first covered the UK and European Nordic economies and then focused on the US and Euro zone. He published “Why England lost”, a book analyzing the UK’s economic decline. In 2009, he joined Citic securities in Hong Kong as a Senior Global Macroeconomist and worked for Haitong Securities International, with a growing focus on China and Asia Pacific. He joined TKAMCHK in January 2015 as the Head of Global Economic Research, providing multi - asset analysis for Taikang Asset Management.

## APPENDIX: DEFINITION OF THE FX RADAR

We selected a number of factors that drive RMB currency pairs, including carry (yield spread), risk (volatility), valuation (terms of trade), fundamentals (trade balance), sentiment (risk reversal), and momentum (three-month return). Factor values were normalised based on the most recent one-year data and plotted on our FX radar graph. For example, a factor value of 1 for “carry” indicates that the current yield spread is one standard deviation above its mean over the past year.

The black dotted line represents the prevailing factor dynamics of the specific RMB FX pair. Against the current factor dynamics, we identified the most similar patterns in past history by means of optimisation across the six driving factors. The historical price movement of that particular period is shown for reference.

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