November 2015

# PBOC'S TRILEMMA

## RMB Development

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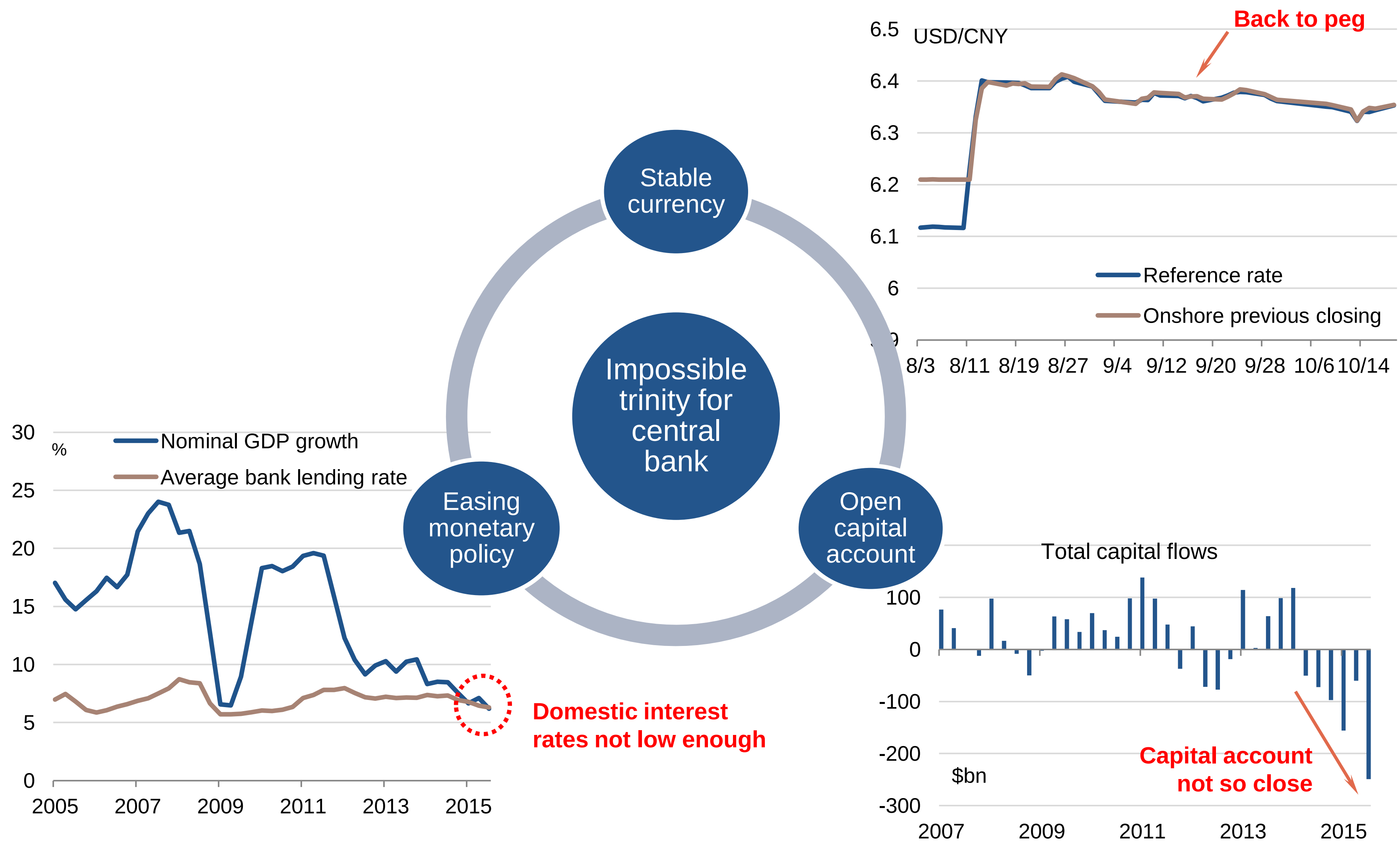
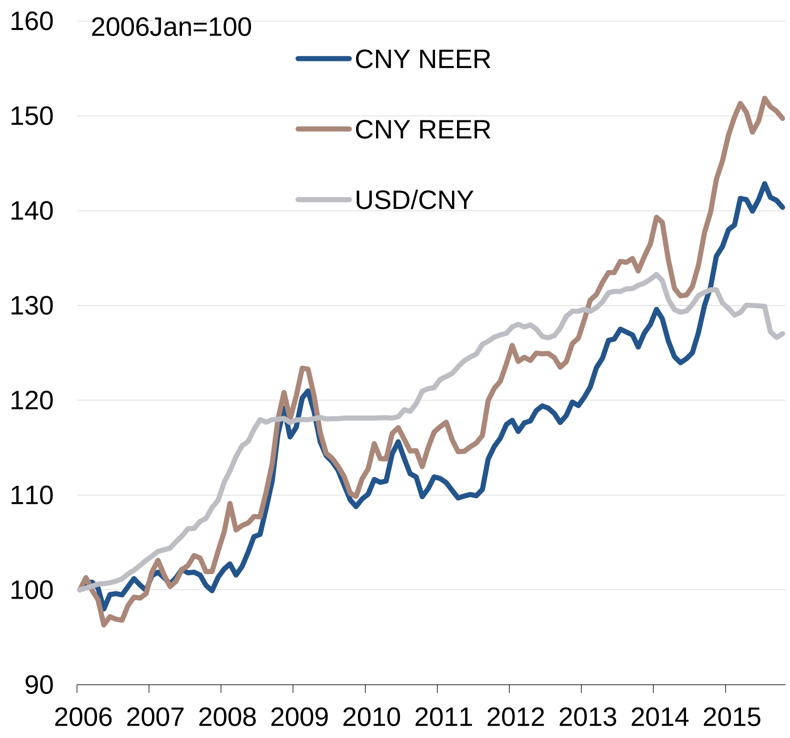
SOCIETE GENERALE
Cross Asset Research

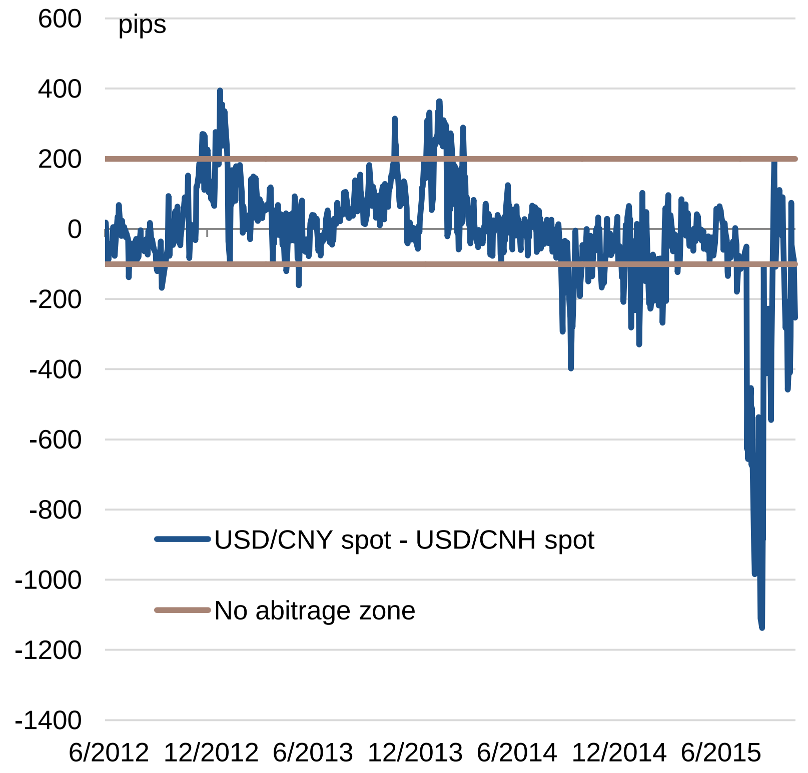
# PBOC STUCK IN THE IMPOSSIBLE TRINITY




*Source: PBoC, CEIC, SG Cross Asset Research/Economics*

# PERSISTENT DEPRECIATION EXPECTATIONS



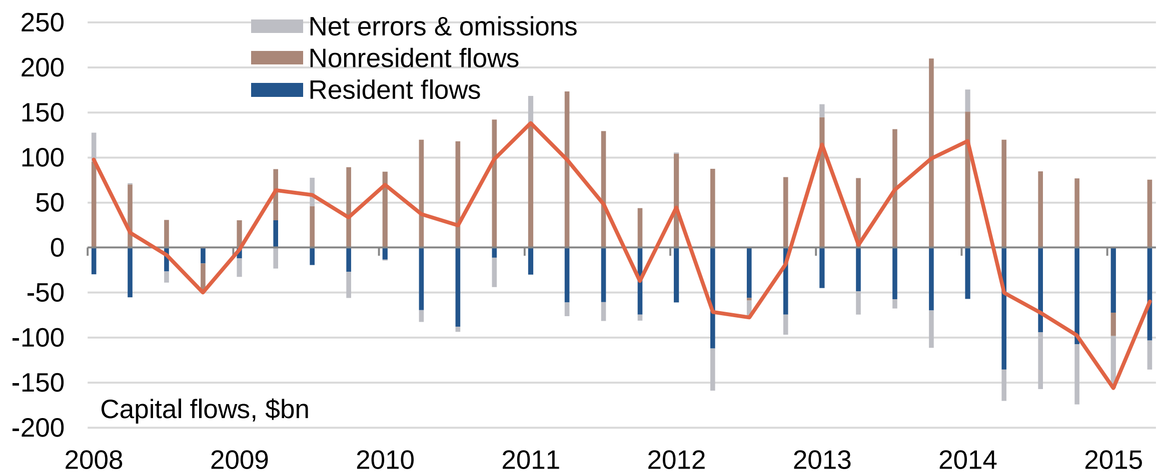




- **RMB barely changed in EER terms**
- **Depreciation pressure still well present**

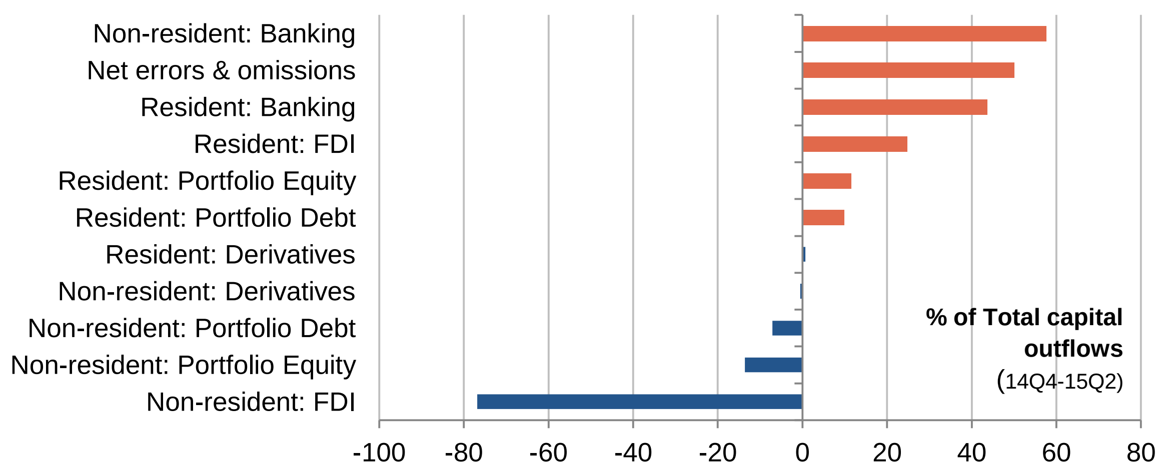
*Source: PBoC, CEIC, Bloomberg, SG Cross Asset Research/Economics*

# RESIDENT FLOWS DOMINATE THE OUTFLOWS

- **Capital outflows started to intensify since Q4 2014**

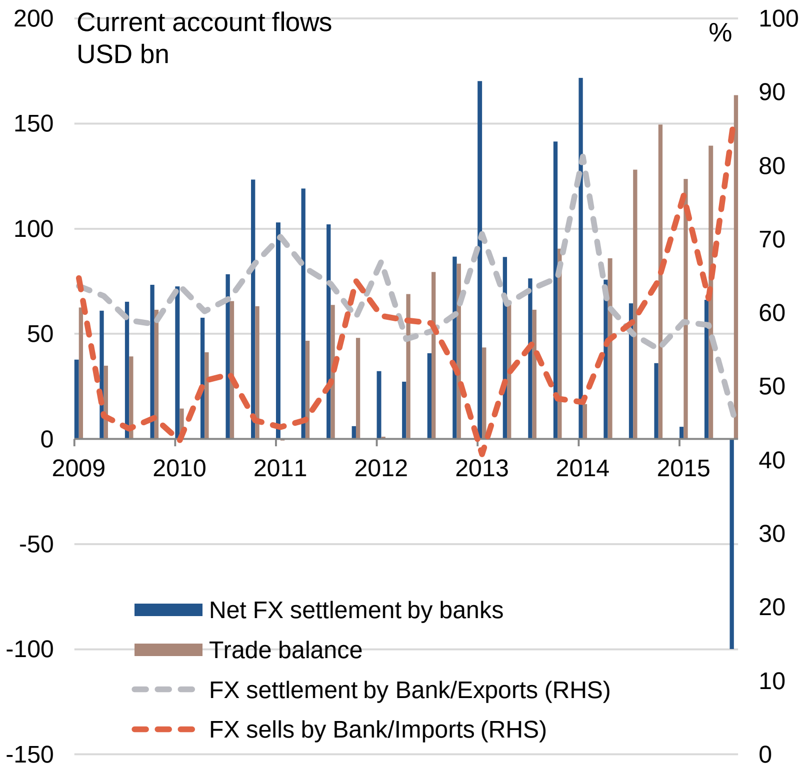


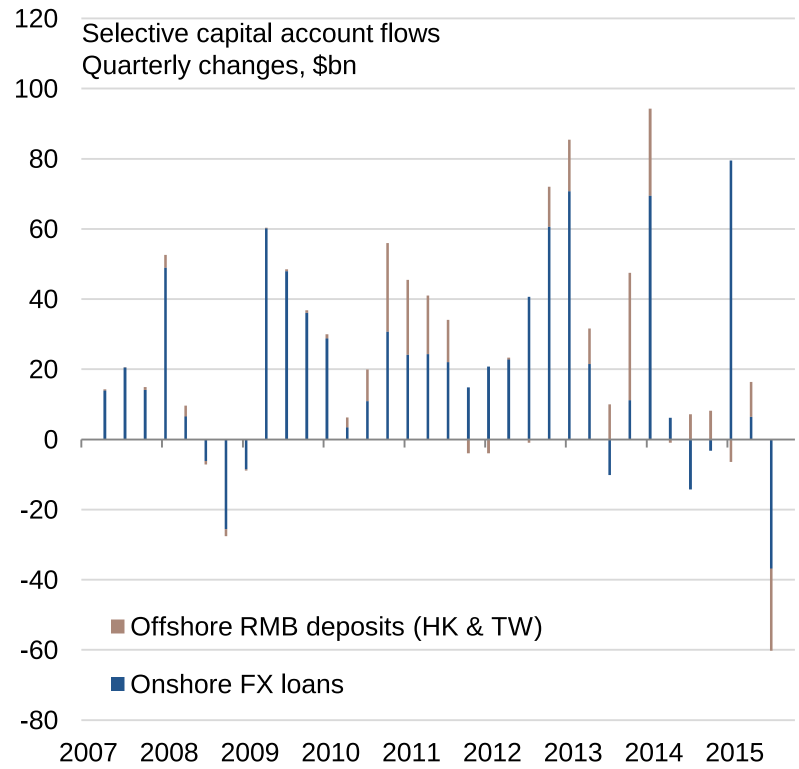

- **Top three outflow accounts: deleveraging, shadow diversification, formal diversification**




*Source: SAFE, CEIC, SG Cross Asset Research/Economics*

# CAPITAL OUTFLOWS OVERWHELM TRADE SURPLUS

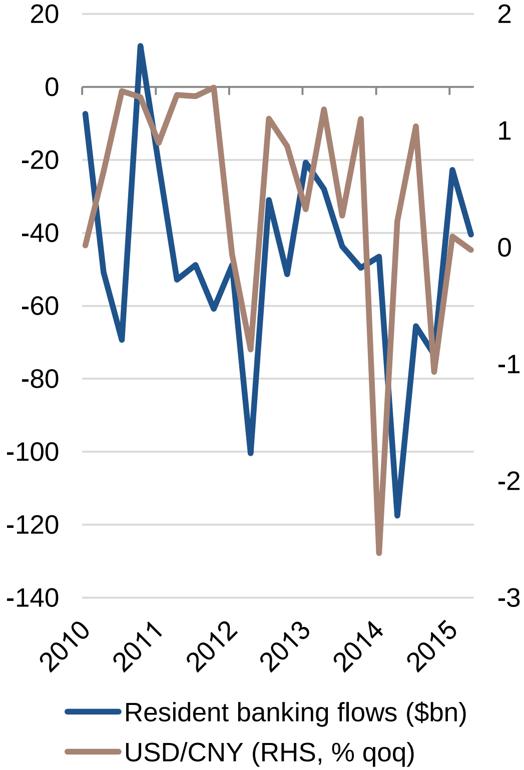


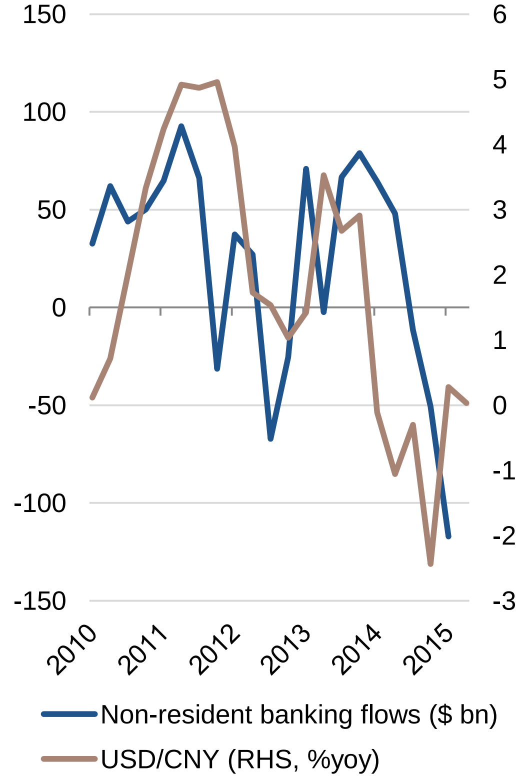



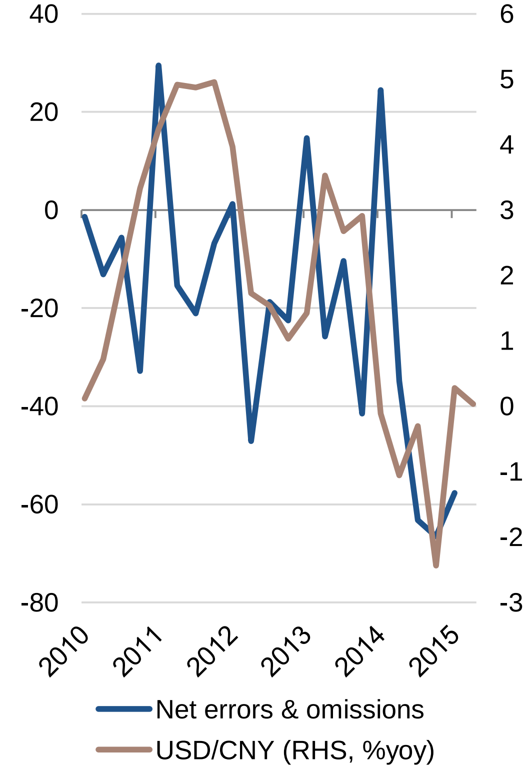

- **Settlement behavior highly sensitive to the currency movement**
- **Banking flows dominate the capital account**

*Source: PBoC, CEIC, Bloomberg, SG Cross Asset Research/Economics*

# MAJOR OUTFLOWS ALL FROM CHINESE AND SENSITIVE TO FX



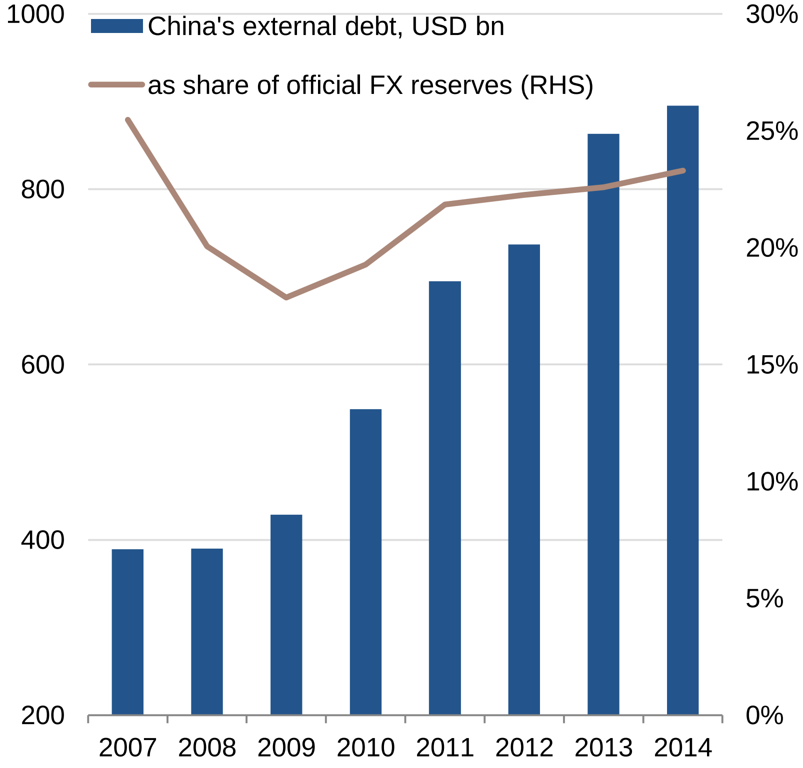



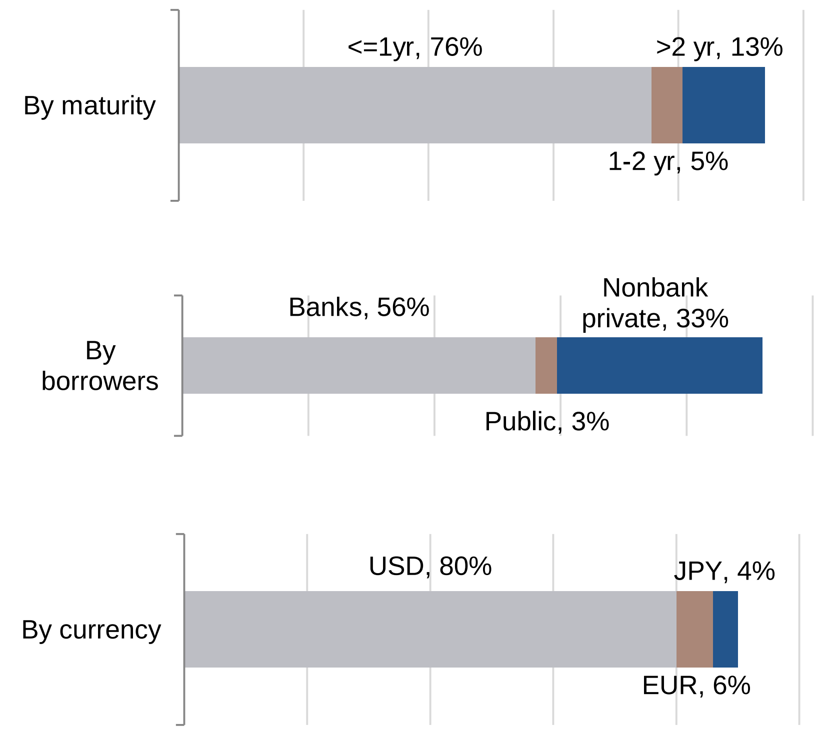




- **Capital controls introduced after RMB regime change:**
  - A limit of RMB100k per year introduced for individual's overseas cash withdraw via UnionPay
  - Banks must keep the equivalent of 20% dollar reserves for clients' FX derivative positions
  - Closer monitoring of individual FX conversion under the $50k annual quota

*Source: SAFE, CEIC, SG Cross Asset Research/Economics*

# EXTERNAL DEBT OVERALL MANAGEABLE



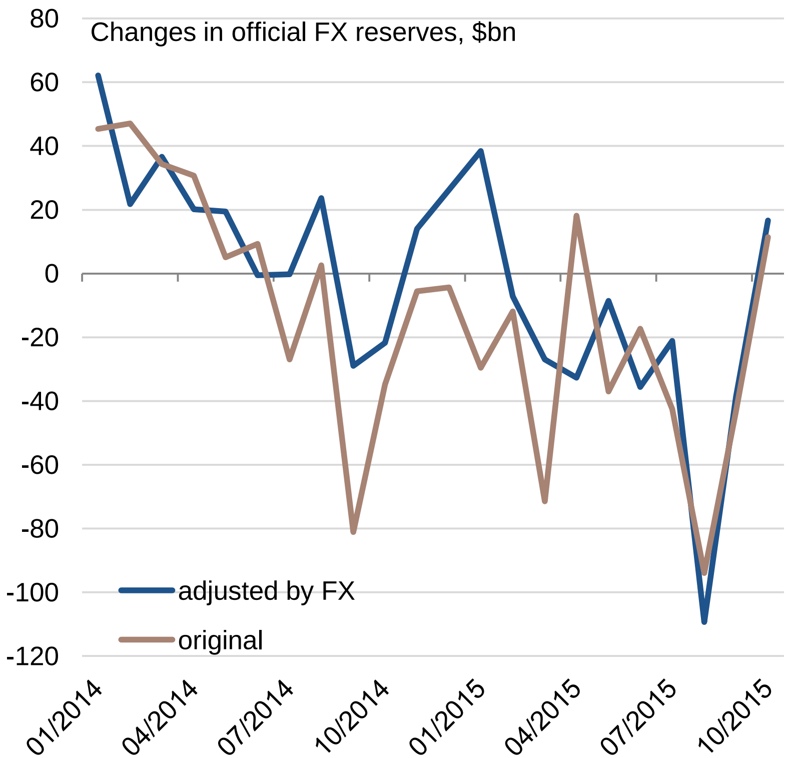



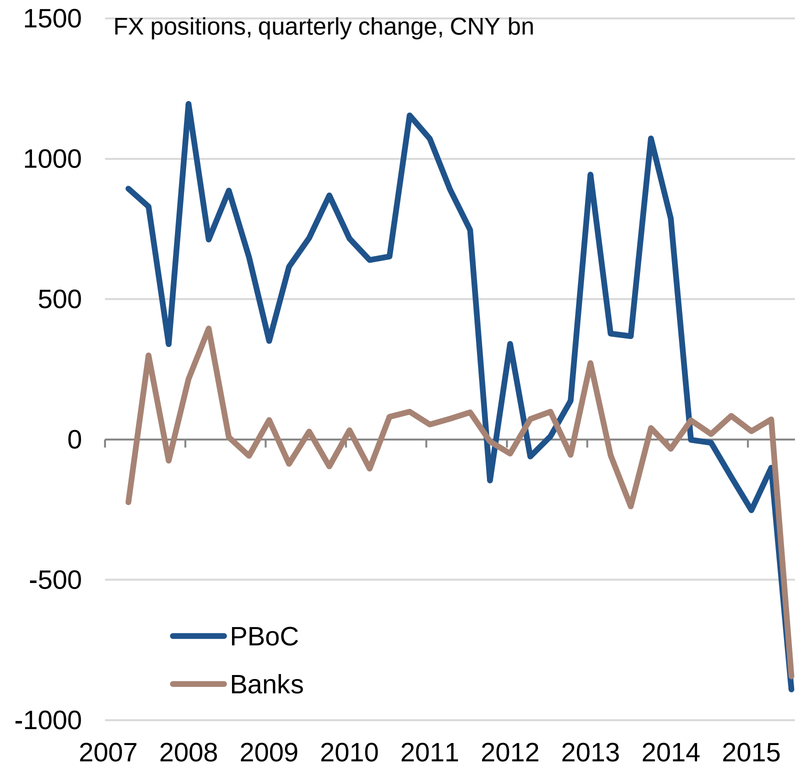

- **Total size of external debt still manageable**
  - <10% of GDP
  - 1/4 of official reserves

- **Short duration => roll-over risk**
- **Unhedged => FX mismatch**
- **Developers' debt small in size but may have outsized impact**

*Source: SAFE, CEIC, BIS, SG Cross Asset Research.*

# MORE INTERVENTIONS THAN MEETS THE EYE




- **Q3 2014-Q3 2015: China's official reserves declined by $230bn**
- **The actual amount of interventions could be twice the size**

*Source: PBoC, CEIC, Bloomberg, SG Cross Asset Research/Economics*

# LIBERALISATION SEQUENCING ISSUES

**Financial market liberalisation sequence**

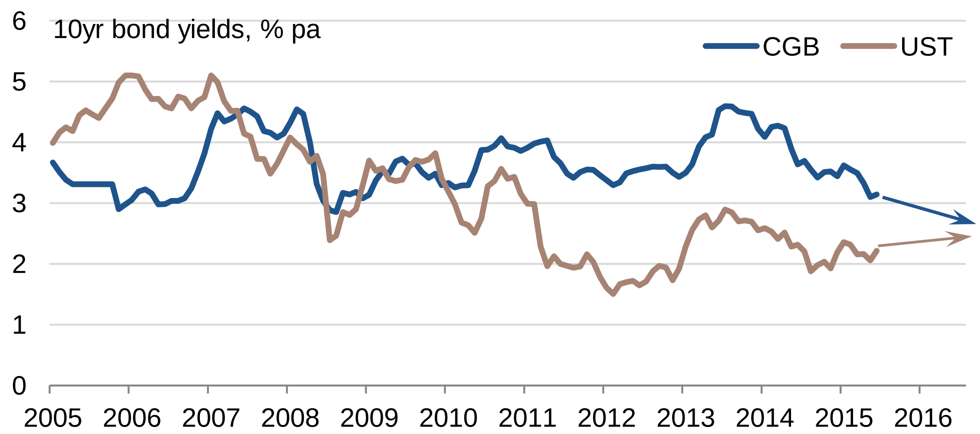
- **IMF recommendation:**
  Currency flexibility >>
  Capital market deepening >>
  Capital account liberalisation
- **China's practice:**
  Capital account liberalisation >>
  Capital market deepening >>
  Currency flexibility

**Capital account liberalisation sequence**

- **IMF recommendation:**
  Inflows >> outflows
  Long-term >> short-term
  Direct>credit >> portfolio
- **China's practice:**
  Follow the text book, but much slower on outflows liberalisation

**Now the problem is … not ideal timing for increasing currency flexibility**

- **Currency no longer undervalued**
- **Structural deceleration**
- **Interest rate differential to vanish**
- **Official FX reserves not unlimited**




*Source: SAFE, CEIC, IMF, SG Cross Asset Research/Economics*

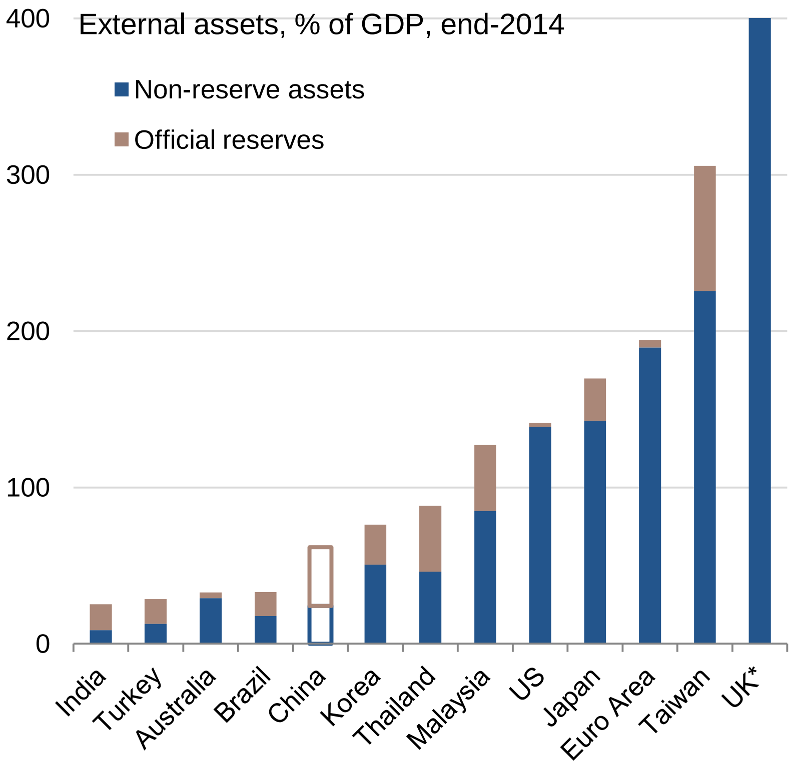
# PROGRESS OF CAPITAL ACCOUNT LIBERALISATION

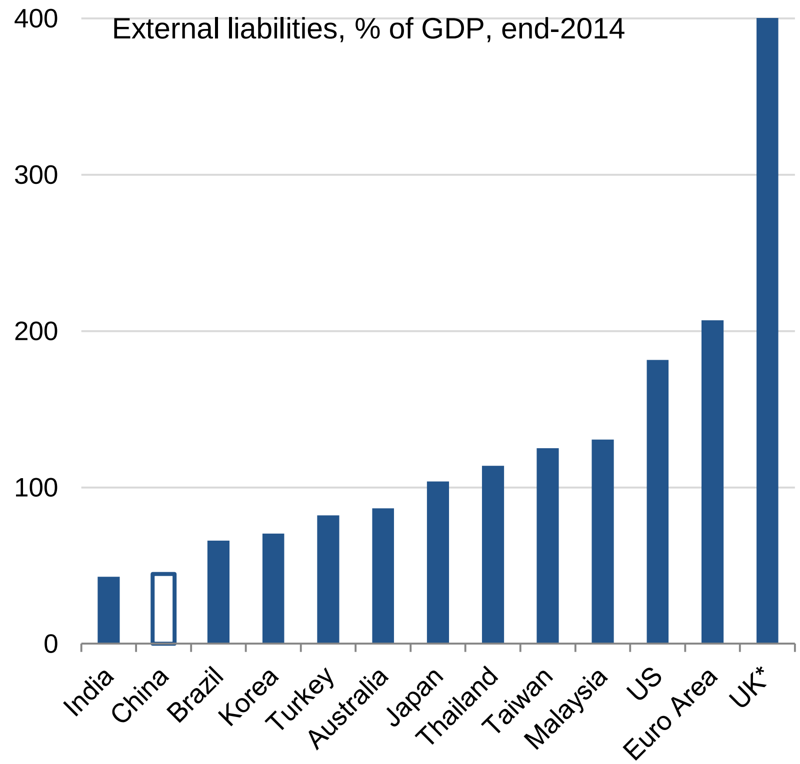
-- Nonresident; -- Resident; -- Two-way

| | Current account | Capital account | | |
|---|---|---|---|---|
| | | Direct | Banking | Portfolio |
| 2000-2012 | Aug 11: RMB settle-ment for trade nation-wide | Oct 11: Eased controls on RMB settle-ment for FDI & ODI | | Nov 02: Launched QFII: allow foreign institutional investors (IIs)in exchanges<br>Apr 06: Launched QDII: allow domestic IIs to invest in overseas securities<br>Aug 10: Launched PBoC Channel: allow foreign CBs, RMB clearing /participating banks in interbank bond market, subject to quotas |
| 2013-2015 | | | Jan 13: Initiated cross-border loans<br>Feb 14: Launched the pilot on cross-border RMB cash pooling in the Shanghai FTZ, enabling MNCs to centralize RMB treasury management;<br>Jun 14: expanded nationwide<br>Feb 15: Allowed companies in the Shanghai FTZ to freely borrow offshore under a macro-prudential risk management framework<br>Oct 15: Launched Cross-border Interbank Payment System (CIPS) | Mar 13: Allowed QFII investors in interbank bond&FX market<br>Nov 14: Launched SH-HK Stock Connect<br>Jun 15: Allowed offshore RMB clearing/participating banks to source liquidity from interbank bond market<br>Jul 15: Launched Mutual Fund Recognition w. HK<br>Jul 15: Switched to registration-based access for foreign CBs, SWFs and international financial organizations in interbank bond market, including IRS & FRA; Sep 15: in interbank FX market |
| Next | | | To achieve full RMB convertibility in Shanghai FTZ | To set up SZ-HK Stock Connect<br>To expand (R)QFIIs and eventually phase out quota management for nonresident long-term portfolio flows<br>To launch QDII2: allow domestic individual investor to invest overseas securities |

*Source: Chinese government, SG Cross Asset Research/Economics*

# DE FACTO OPENNESS STILL LIMITED



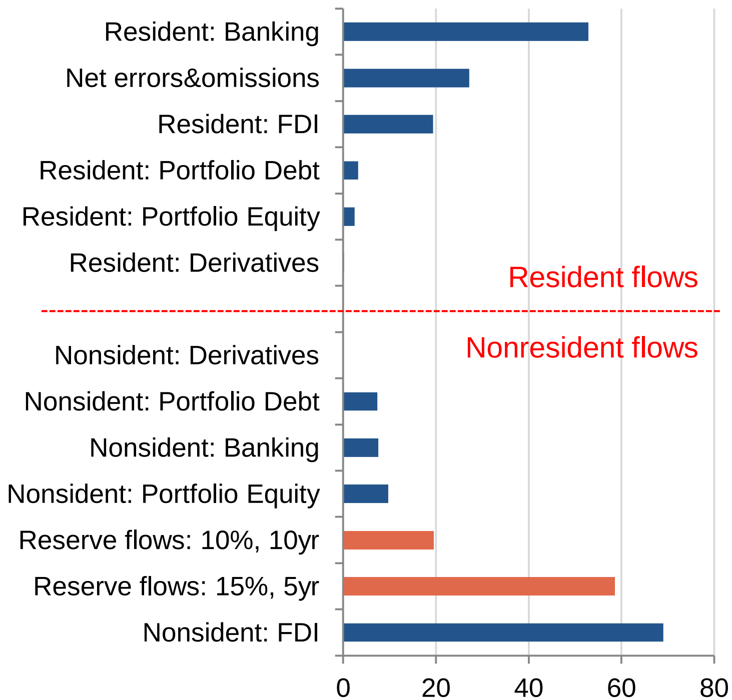




- **Non-reserve assets only 25% of GDP**
- **Future trend: non-official outflows to replace official outflows**
- **External liabilities less than 50% of GDP**
- **Future trend: expansion of long-term portfolio inflows**

** UK's external assets and liabilities both around 550% of GDP. Source: SAFE, CEIC, IMF, SG Cross Asset Research/Economics*

# SDR INCLUSION NO GUARANTEE FOR RESERVE CURRENCY STATUS

Average size of quaterly flows, since 2010, $bn




- **Limited inflows in the short-term**
- **Long-term impact subject to China's liberalisation progress**

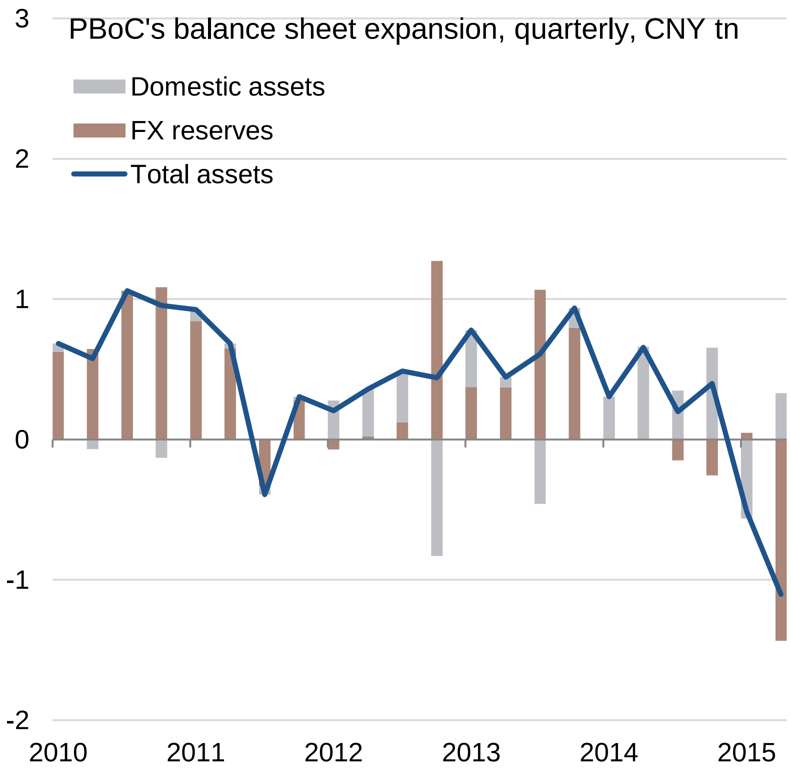
## Implication of further liberalisation

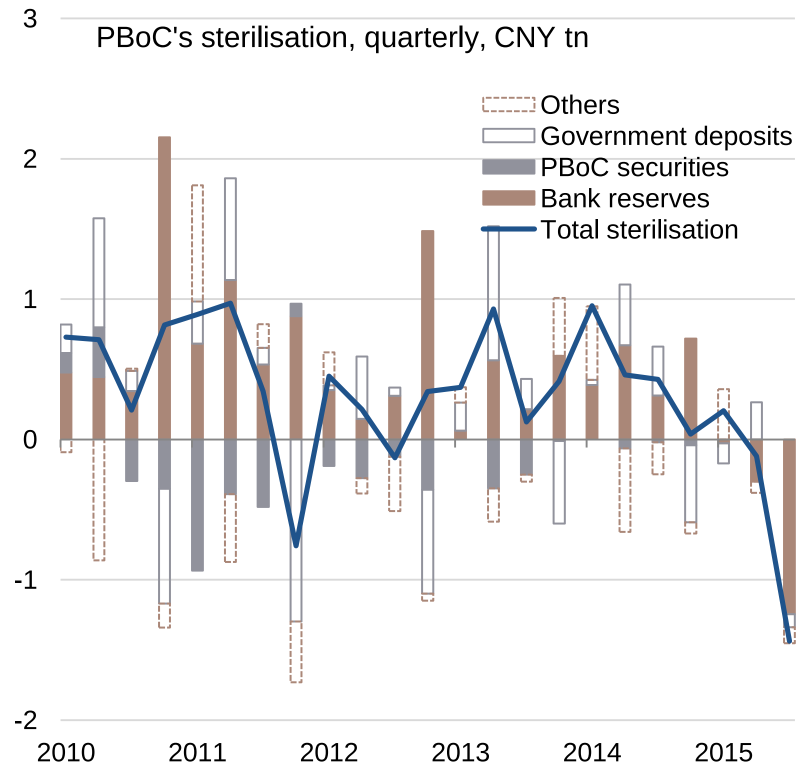
- **If no change in official reserves,**
  **Current account surplus = Capital account deficit**
- **If China doesn't run current account deficit, China will be a capital exports and RMB a funding currency on balance**
- **That is, Resident outflow > Nonresident inflows**
- **For the currency, the short-term question is how fast Chinese FX diversification will take place.**

| | FDI | Portfolio: Equity | Portfolio: Debt | Credit: Loans |
|---|---|---|---|---|
| External Assets, excl. official reserves (% of GDP) | | | | |
| China | 7.2 | 2.5 | 1.6 | 3.6 |
| G4 average | 50.9 | 37.4 | 42.9 | 25.3 |
| External Liability (% of GDP) | | | | |
| China | 25.9 | 3.6 | 1.4 | 5.5 |
| G4 average | 42.2 | 41.6 | 52.8 | 28.0 |

*Source: PBoC, CEIC, Bloomberg, SG Cross Asset Research/Economics*

# SELF-INFLICTED QUANTITATIVE TIGHTENING

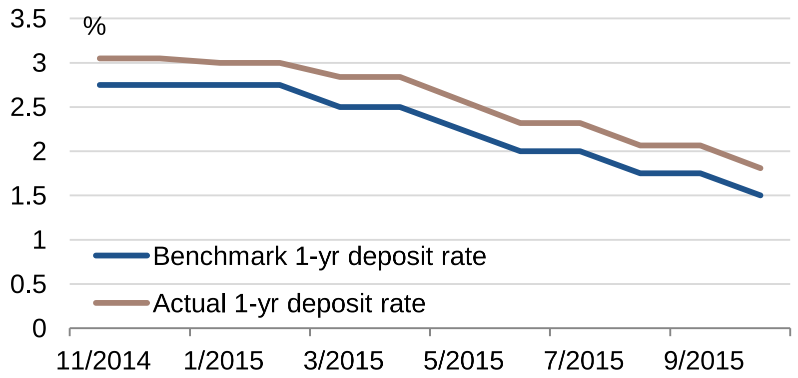


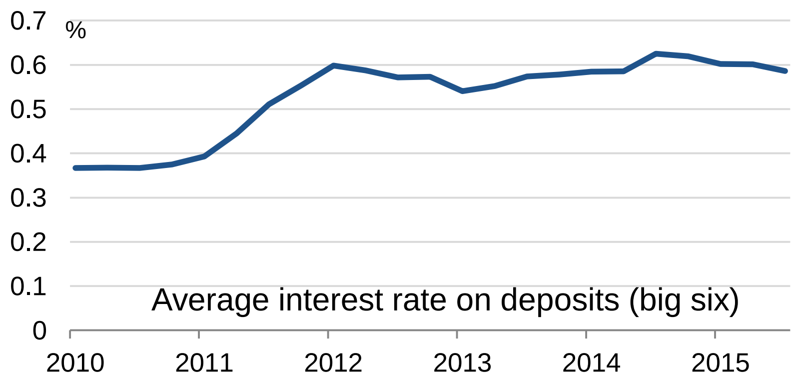



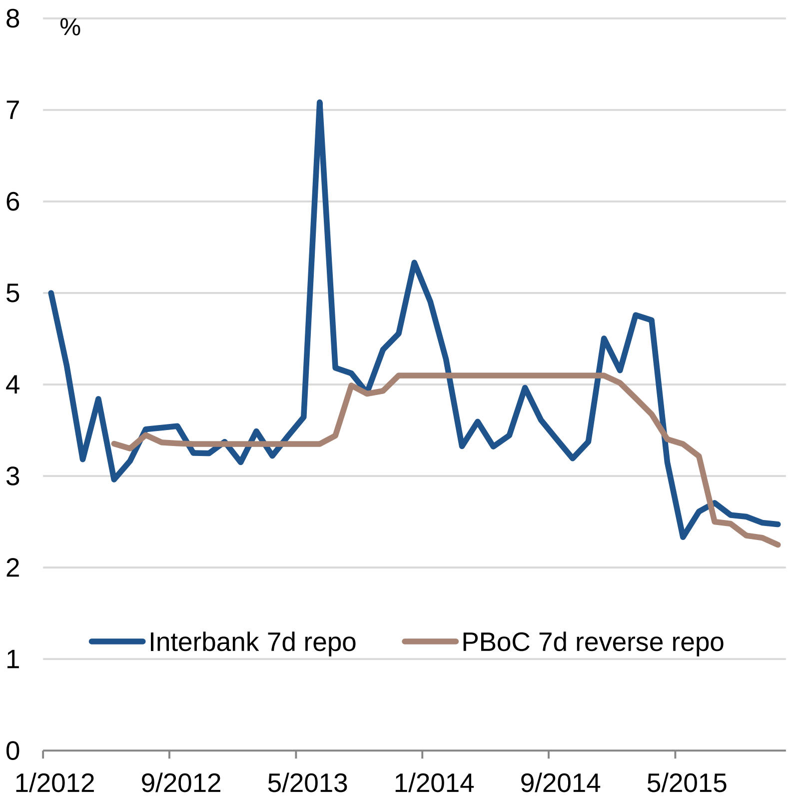

- **PBoC's balance sheet is now shrinking**
- **RRR cuts are barely keeping up**

*Source: PBoC, CEIC, SG Cross Asset Research/Economics*

# FEWER RATE CUTS CAN MEET THE EYE




- **Benchmark deposit rate cuts have not brought down banks' interest rate expenses much**
- **And the interbank rates barely changed since mid-2015**

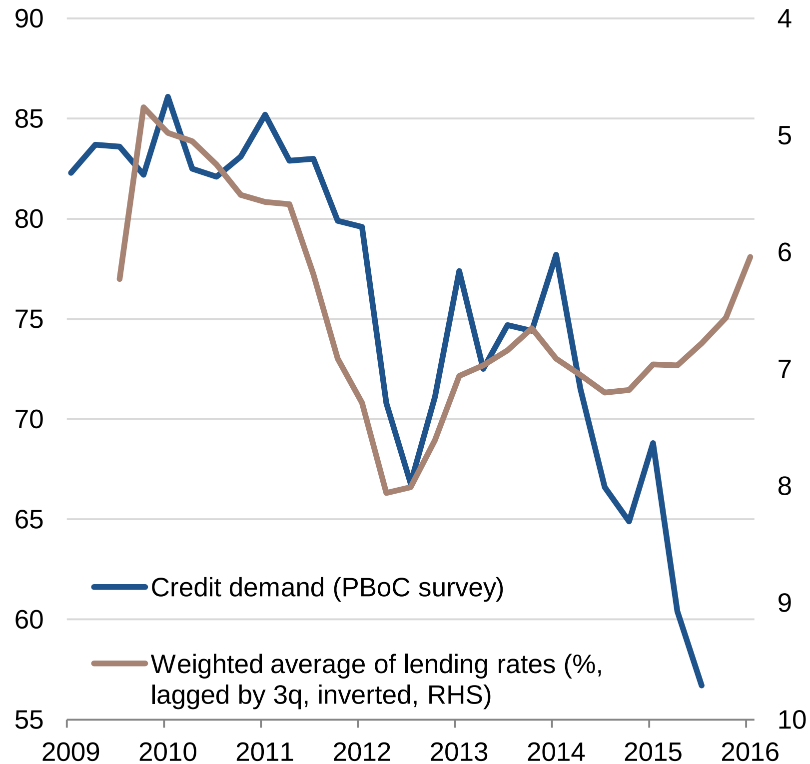
*Source: PBoC, Bloomberg, SG Cross Asset Research/Economics.*

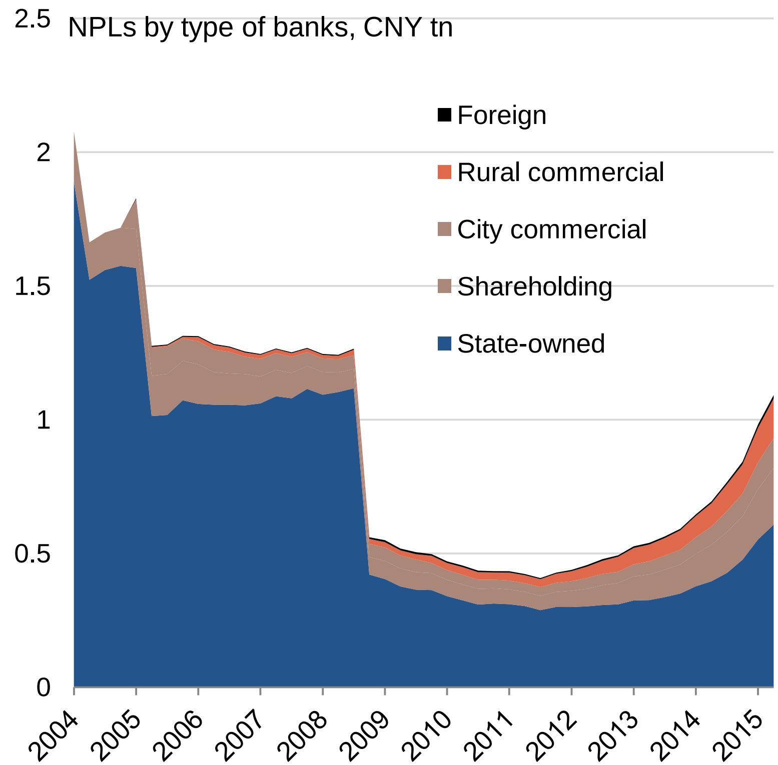
# PBOC'S NEW POLICY TOOLBOX

| Instruments | Duration | Frequency | Latest implementation |
|---|---|---|---|
| ***Short-dated*** | | | |
| Regular Open Market Operation (OMO) | most frequent: 7-, 14-day<br>others: 21-, 28-, 91-day | Auction usually held on Tuesdays and Thursdays. PBoC usually gauges demand one day before an auction. | Latest injection: 7-day reverse repo, late Oct 2015, 2.25%; 14-day reverse repo, 29 Sep 2015, 2.70%<br>Latest withdrawal: 14-day repo, 25 Nov 2014, 3.2% |
| Short-term Liquidity Operation (SLO)<br>- OMOs with shorter durations to supplement the regular OMOs | O/N to 7-day | Irregular | Latest injection: 6-day reverse repo, 31 Aug 2015, 2.35%<br>Latest withdrawal: 5-day repo, 27 Feb 2014, 3.40% |
| Standing Lending Facility (SLF)<br>- short-term liquidity offered by the central bank at the request of financial institutions | O/N and 7d for small- and medium- sized financial institutions<br>1m to 3m for policy banks & big commercial banks | Irregular, upon request | Latest injection: Mar15, for those institutions that meet certain macro-prudential criterion: o/n 4.5%, 7-day 5.5%; or 100bp higher for those which fall short. |
| Bank reserves<br>- depository institutions' required or excess reserves at the central bank | N/A | N/A | Injection: required reserve ratio cuts on 23 Oct<br>Rate on required reserves: 1.62%<br>Rate on excess reserves: 0.72% |
| ***Longer-dated*** | | | |
| Medium-term Lending Facility (MLF)<br>- medium-term liquidity offered to qualified commercial banks and policy banks at below-market rates | 3- and 6-month | Irregular; upon request, can be granted via auctions | Latest injection: 6-month MLF of CNY 105.5bn, Oct 2015, 3.35%<br>Injection in Q2: 3-month MLF of CNY 384.5bn, Apr 2015, 3.50% |
| Pledged Supplemental Lending (PSL)<br>- long-term liquidity provided for development projects such as shanty town renovation | 3-year | Irregular | Injection: PSL of CNY 52.1bn to China Development Bank, Sep 2015, 2.85% |
| Relending with credit asset collaterals<br>- similar to PSL but allows local banks to use high-quality loans as collateral, thus aimed at smaller banks without enough bonds to apply for PSL | Less than two years | Irregular | Amount granted in the two pilot provinces in 2014:<br>PBoC Guangdong branch provided CNY1.68bn in 2014, with one-year interest rate 3.5%<br>PBoC Shandong branch provided CNY0.85bn |
| Other forms of relending<br>- targeted at small banks without enough bonds to apply for PSL; some programmes required no collateral | Less than two years | Irregular | N/A |

*Source: PBoC, SG Cross Asset Research/Economics*

# MONETARY POLICY TRANSMISSION IMPAIRED




- **Lack of credit demand, despite lower borrowing cost**
- **NPL cycle continues to burden banks**

*Source: PBoC, CEIC, SG Cross Asset Research / Economics*

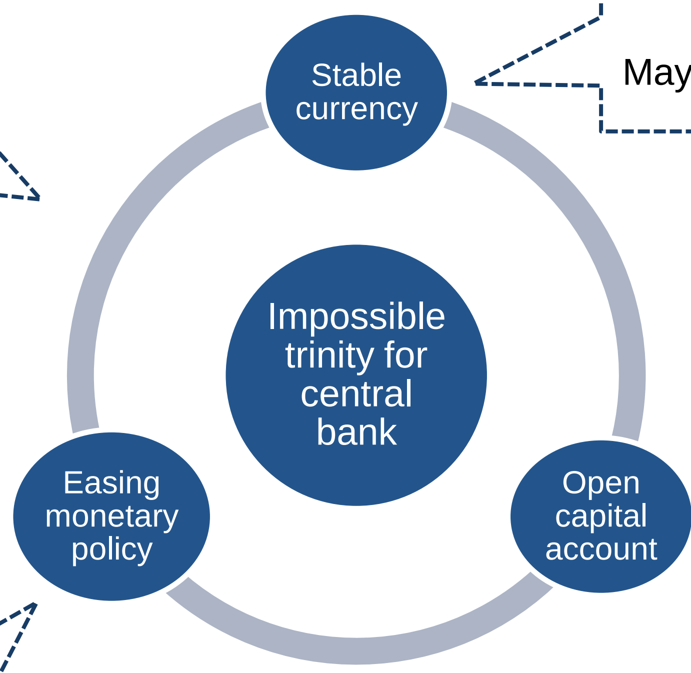
# PBOC WAY OUT OF THE IMPOSSIBLE TRINITY

Therefore,

PBoC has to let go the currency

Maybe not in one go, but step by step

Official reserves are not unlimited




PBoC needs to keep interest rates low or lower for smoothing structural deceleration, whereas the Fed is seen to raise rates

RMB inter-nationalisation & reserve currency status seems as a national strategy. Outflows liberalisation cannot be deferred indefinitely

*Source: PBoC, CEIC, SG Cross Asset Research/Economics*

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