BNY MELLON
iFlow
MACRO MORNING BRIEFING

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Currency Trees In China's Easing Wood

Currency weakness not inconsistent with policy objectives

- USDCNY hitting top of trading band should not be seen as renewed outflows
- PBoC acknowledges expectations matter and will push for more stimulus
- Quantitative policy discussions should move up the agenda again

Improving "social expectations" requires comprehensive stimulus

USDCNY on Wednesday traded towards the upper end of its 2% daily trading band. The market bias in favour of a higher USDCNY should not come as a surprise amid domestic growth pressures in China and resilient pricing for the Federal Reserve's rate path. Our iFlow positioning monitor shows that except for the Singapore dollar and Indonesian rupiah, every other Asia-Pacific currency, both developed and emerging, is currently net underheld.

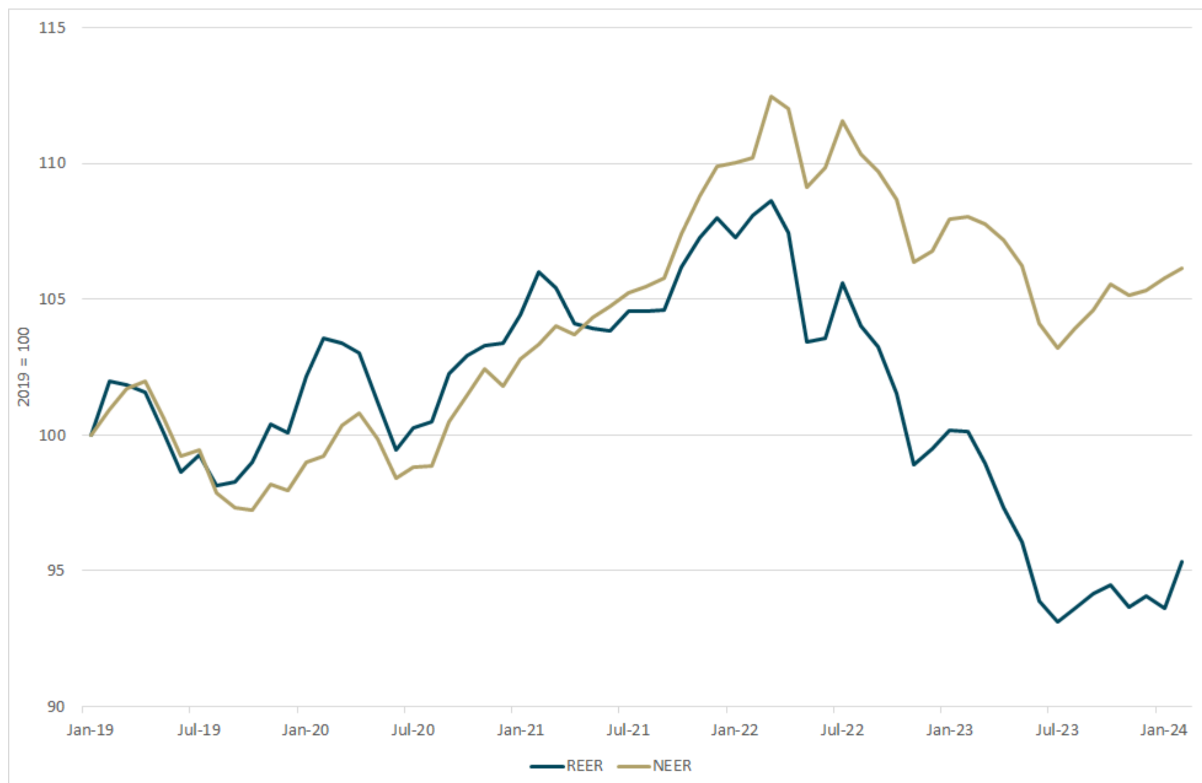
Although we believe there is an increasingly strong valuation case for asset re-allocation back into APAC, we also acknowledge that this will be difficult to realise until there is a clearer easing path signalled by the Fed. However, we also dispute the view that current price action in the renminbi or other Asia currencies is symptomatic of capital outflows and disorderly developments on the region's financial account. Much has been made of the ongoing struggles with foreign direct investment (FDI) in China and the lack of inflows on the portfolio account. Without suggesting these factors will turn around anytime soon, we doubt that they will be a marginal driver for the renminbi, especially relative to ongoing changes in policy differentials. iFlow tracking of China's portfolio account also indicates that the strongest period of asset liquidation is over. While there has been some pressure on equity positions more recently, those are secondary to fixed-income exposures.

Furthermore, irrespective of the outlook for the Fed, we think there is a case to be made for China's policy framework: there is no need to lean against a weaker renminbi, and the

People's Bank of China (PBoC) will only seek to manage volatility, rather than direction. The bottom line is that avoiding entrenched deflation and disinflation is a policy priority, for which a strengthening currency serves little purpose. Barring any divergence in interest-rate profiles between the PBoC and Fed beyond market expectations, we think markets need to manage expectations on the extent to which CNY valuations can deteriorate further.

Even though on a nominal basis CNY is not materially lower (exhibit #1), this is largely due to weakness across APAC FX, which comprises much of China's Trade Weighted Index; there is limited scope for policy divergence on these legs. However, due to extremely weak inflation dynamics in recent quarters, the REER weakened aggressively in 2022 and through mid-2023 before stabilising. The risk to inflation differentials versus China seems clearly to the downside globally, despite slow progress. This alone would help support the CNY REER. While this doesn't imply improved CNY strength outright, the CNY REER may have found a floor which can also limit strong nominal declines, otherwise domestic inflation risk will lead to changes in interest-rate differentials in the PBoC's favour.

Exhibit #1: CNY Valuations

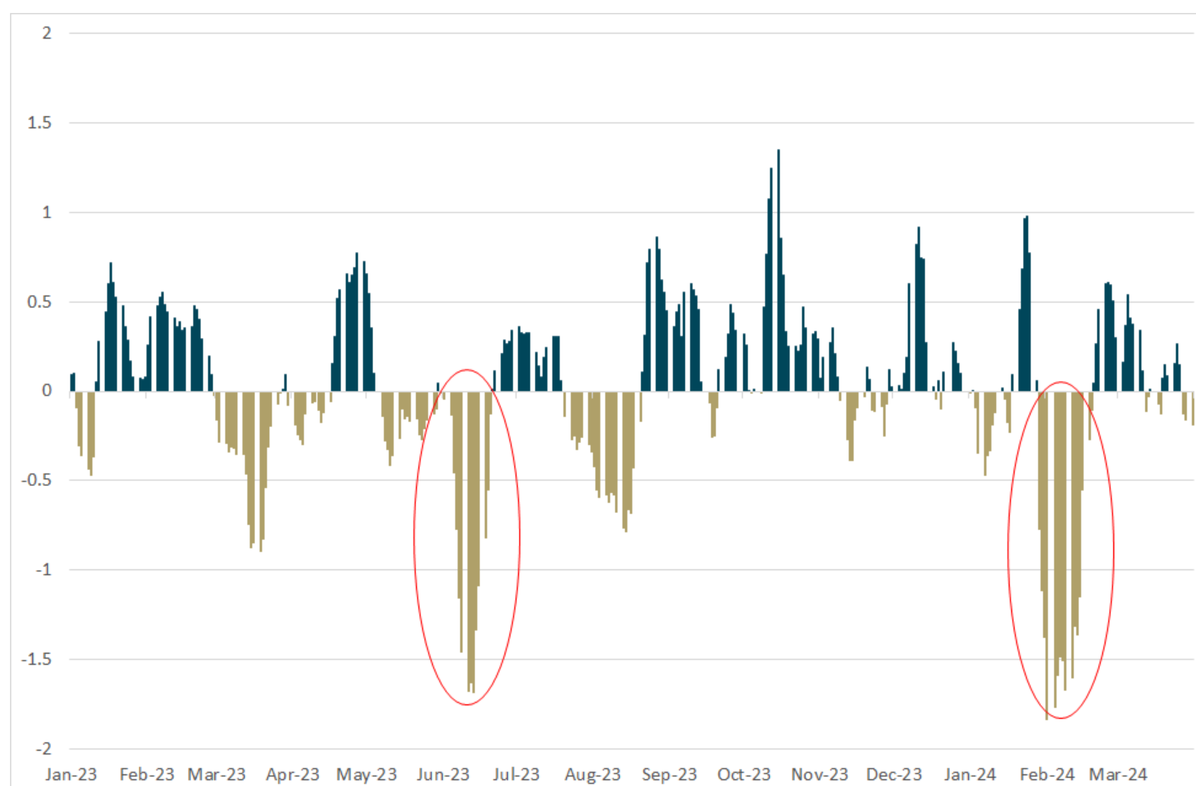


Source:Bloomberg, BNY Mellon

On a flow level, we also question the extent to which additional selling can materialise after the significant round of pre-Lunar New Year liquidation in February (exhibit #2). At the time, we highlighted that the FX sales were accompanied by liquidation across several China-linked asset classes globally. The effects are still clear. For example, the Thai baht is the most underheld currency in iFlow. What's more, APAC equities in general are currently

underperforming: according to our data, on a weekly smoothed flow basis, March-end equity outflows from the region matched the strongest levels seen over the past four years.

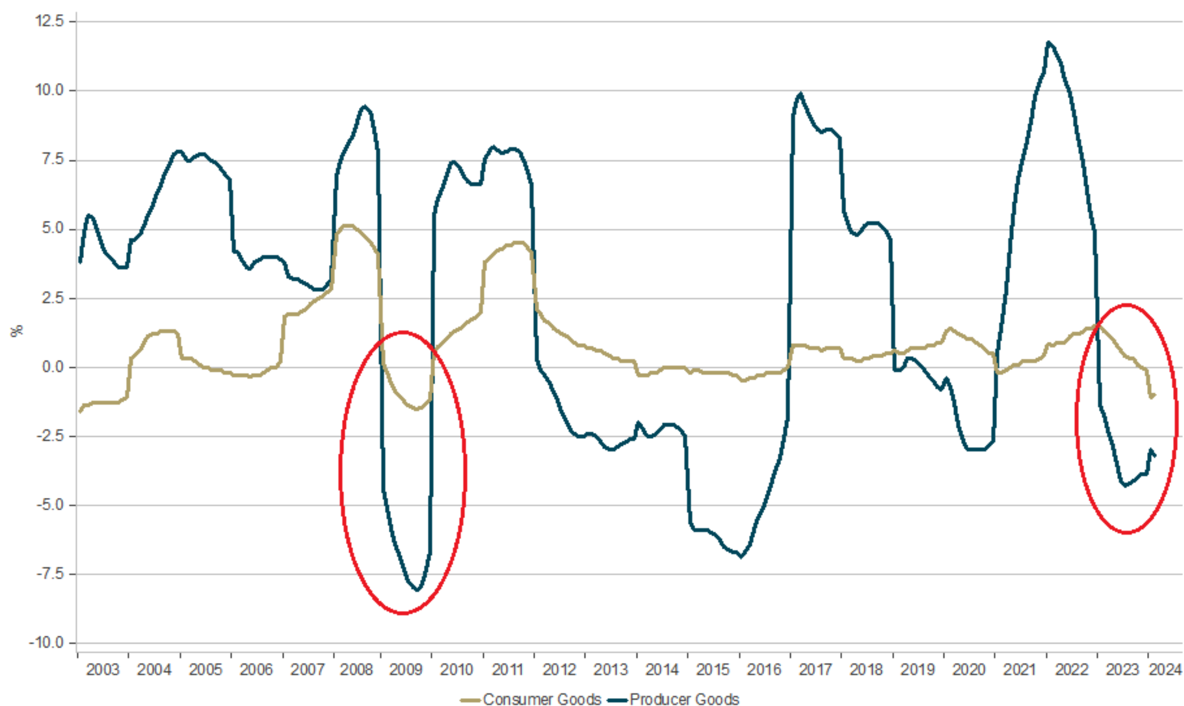
Exhibit #2: CNY Flows, Last Five Quarters



Source:BNY Mellon; smoothed weekly flows

Returning to China's policy outlook, the PBoC is presently very candid about the challenges and requisite measures. It noted in its quarterly Monetary Policy Committee (MPC) meeting statement, "insufficient effective demand and relatively weak social expectations". The central bank also listed "improving social expectations" as one of its key policy objectives. Without directly inferring the PBoC intends to use stimulus to reverse falls in price expectations, avoiding deflation is a priority. The scale of the challenge will underpin the central bank's policy response. Exhibit #3 shows the current annualised change in producer prices in both consumer and producer goods. Both remain in contraction on an annualised basis, though there are signs of recovery in the latter. Without taking a view on the direction of travel, we note that the last time both components were at such negative levels was during the aftermath of the Global Financial Crisis. Fearing a domestic demand collapse due to the Great Recession hitting China's export industry, China engaged in large-scale credit stimulus which reflated the economy. Unfortunately, the scale of the measures led to serious domestic distortions, to which many of China's debt problems today can be traced.

Exhibit #3: China PPI Annualised Change



Source: Macrobond, BNY Mellon

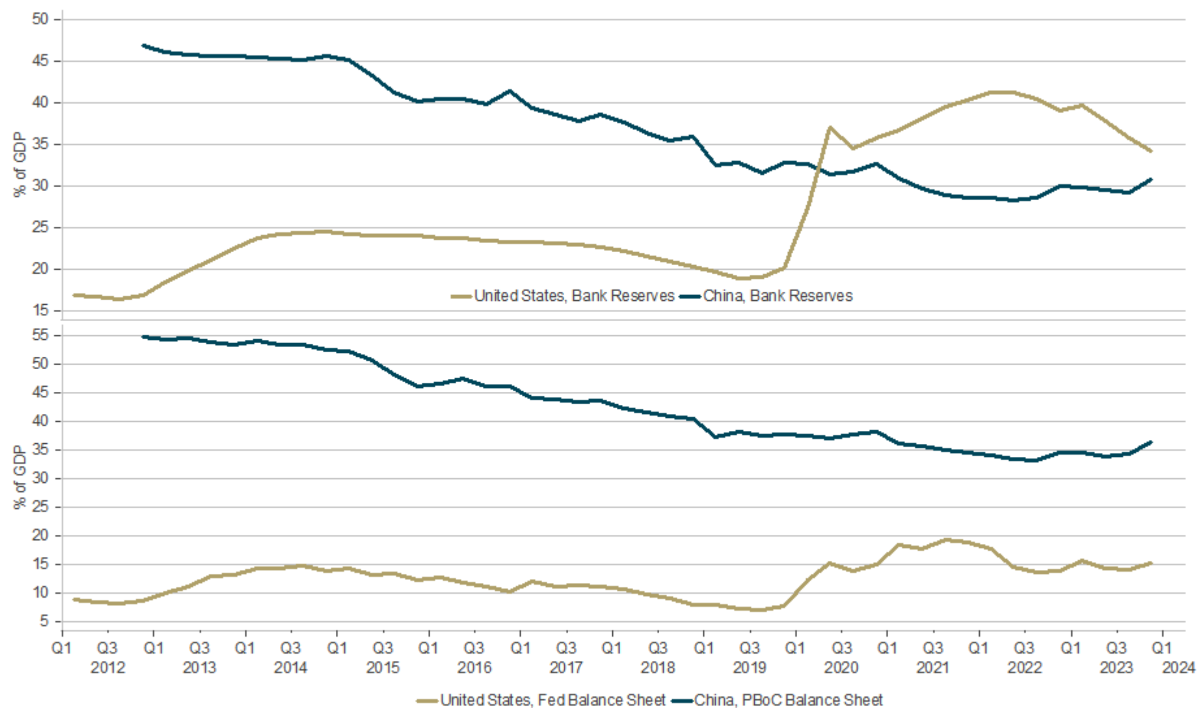
While the experience of 2009 explains strong reluctance to repeat large-scale stimulus, we think current challenges should mean that nothing is off the table. Slowly but surely, conversations are ongoing in China regarding policies which could be construed as quantitative easing, or with the effect of using the PBoC's balance sheet to further ease financial conditions. For example, in yesterday's MPC statement, the PBoC clearly stated intent to "strengthen its implementation of policy…maintain total social financing and money supply at a level consistent with the target for economic growth price expectations". We interpret this as a sign that if economic growth and price expectations are veering off target, then the PBoC will need to resort to measures which would directly increase liquidity.

There are no hard rules regarding the scale of balance-sheet expansion needed for any economy to boost growth, as monetary velocities and price transmissions vary greatly. Relative to the US and measured by percentage of nominal GDP (exhibit #4), we can see that the PBoC's total balance sheet is far larger, although its holdings are dominated by foreign assets, which reflects conventional transmission to financial conditions through foreign exchange purchase positions, rather than directly through ownership of government bonds or domestic assets. However, on the liabilities side, bank reserves serve similar purposes. We can see not only that China's bank reserve share of GDP is lower than the US equivalent (even after Fed quantitative tightening), but also that the share has declined by around a third over the past decade. By this measure, China has been tightening on a quantitative basis throughout the entire period while growth has slowed on a secular basis. Much of this is likely deliberate due to fears over the financial system's debt overhang.

Yet, the extent of disinflation/deflation risk seen presently is unprecedented and requires a commensurate response. Large-scale asset purchases are not imminent – a tail risk. But

based on the PBoC's own statements, continued deterioration in "social expectations" and "price expectations" requires a liquidity (quantitative) response. Required reserve ratio (RRR) cuts are in the price, so shifting expectations requires something that isn't. We think quantitative easing – with Chinese characteristics – is the best possible candidate.

Exhibit #4: Balance Sheet Comparisons, PBoC vs. Fed



Source: Macrobond, BNY Mellon

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