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Macro + FX Strategy

China: PBoC Cut Foreign Currency Deposit RRR (FC RRR) For The Second Time This Year

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- In a statement on Mon (5 Sep), the People's Bank of China (PBoC) said the reserve requirement ratio for foreign currency deposits (FC RRR) will be reduced to 6% from the current 8% with effect from 15 Sep. This is the second FC RRR cut this year, following a 100bps reduction that took effect on 15 May.

- Given the outstanding foreign currency deposits of about USD0.95 tn, the 2 percent point cut in the FC RRR is estimated to increase liquidity by around USD19 bn.

- With the increasing headwinds in China, the PBoC will need to maintain an accommodative monetary policy and a proactive fiscal policy to support the recovery. Chinese officials said on Mon (5 Sep) that the government will accelerate its stimulus rollout in 3Q22. Policy priority will remain on stabilising the economy as well as preventing sharp depreciation to the CNY ahead of the 20th Party Congress that starts on 16 Oct. To further stem the depreciation, the PBoC may also increase offshore bill issuance to absorb the CNH liquidity.

- The latest move is unlikely to be a game changer for the current bout of CNY weakness. We reiterate our current set of USD/CNY forecasts which are at 7.00 in 3Q22, 7.05 in 4Q22, 7.08 in 1Q23 and 7.10 in 2Q23.

PBoC Cut Forex Reserve Ratio To Slow CNY Depreciation

In a statement on Mon (5 Sep), the People's Bank of China (PBoC) said the reserve requirement ratio for foreign currency deposits (FC RRR) will be reduced to 6% from the current 8% with effect from 15 Sep. This is the second FC RRR cut this year, following a 100bps reduction that took effect on 15 May.

Similar to the previous move in May, this was triggered by rapid USD/CNY gains on the back of stronger dollar, diverging monetary policies driving deepening negative yield gap against CNY and weakening recovery outlook in China's economy. Negative growth factors including the drought and power crunch in Aug and spreading COVID lockdowns, are seen adding to concerns over the prolonged downturn in the domestic property market and waning external demand. Our GDP growth forecast for China has since been revised lowered to 3.3% for 2022 (from 4.1%) and 4.8% for 2023 (from 5.0%). (Manufacturing PMI Stayed Weak, Revising Down Our GDP Forecasts, 31 Aug 2022)

Prior to the FC RRR cut, the PBoC has been setting the daily USD/CNY central parity lower than market's expectation in the last two weeks to slow the rise in the pair. The FC RRR cut will release more foreign currency liquidity into the onshore market and ease pressure on the CNY depreciation. Given the outstanding foreign currency deposits of about USD0.95 tn, the 2 percent point cut in the FC RRR is estimated to increase liquidity by around USD19 bn.

Capital Outflows Has Continued Since Feb

The diverging monetary policy between China and the US has driven the yield spread between China government bonds and US Treasuries, to negative since Apr. Coupled with increasing downside risks to China's outlook, this has led to capital outflows from China since Feb and reaching a record monthly outflows in Mar.

As new growth challenges emerged, the PBoC has resumed cutting its1Y medium-term lending facility (MLF) rate by 10 bps to 2.75% in Aug, the first since Jan when the 1Y MLF was also reduced by 10 bps. As a result, the 1Y and 5Y Loan Prime Rates (LPR) were fixed lower in Aug. Conversely, the Fed has been explicit that interest rates in the US will have to be raised more aggressively to fight the inflation surge.

With the increasing headwinds in China, the PBoC will need to maintain an accommodative monetary policy and a proactive fiscal policy to support the recovery. Chinese officials said on Mon (5 Sep) that the government will accelerate its stimulus rollout in 3Q22. Policy priority will remain on stabilising the economy as well as preventing sharp depreciation to the CNY ahead of the 20th Party Congress that starts on 16 Oct. To further stem the depreciation, the PBoC may also increase offshore bill issuance to absorb the CNH liquidity.

Thus, we continue to see scope for further monetary policy easing, with the 1Y LPR to move lower to 3.55% by end-4Q22 (from current 3.65%). After 35 bps cut YTD, the 5Y rate is still poised to fall further (from current 4.30%) as PBoC extends support to the property market. Having said that, we reiterate our view that real yields in China are still supported by more subdued inflation that averaged just 1.8% y/y in Jan-Jul and much lower than in the US where headline inflation had been above 8% in the last five months. (LPRs Fixed Lower As PBoC Extends Support To The Property Market, 22 Aug 2022)

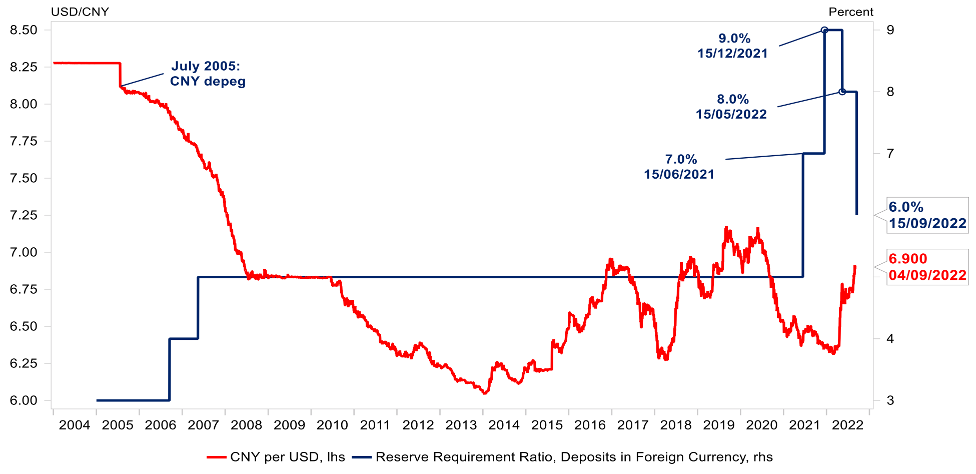
Not A Game Changer For USD/CNY

As with the last FC RRR cut in late Apr, the latest move is unlikely to be a game changer for the current bout of CNY weakness. Growth headwinds and widening monetary divergence between the PBoC and Fed continues to drive a sustained rally in USD/CNY. Externally, expectations of further front-loading of Fed rate hikes and global recession fears underpin broad-based strength of the USD as well.

While it is not expected to reverse the CNY weakening trend, we see the latest FC RRR cut as an effort by PBoC to keep CNY devaluation pressures in check and to reintroduce two-way trading in the CNY. That said, it is inevitable that USD/CNY will test the psychological 7.00 handle soon. Overall, we reiterate our current set of USD/CNY forecasts which are at 7.00 in 3Q22, 7.05 in 4Q22, 7.08 in 1Q23 and 7.10 in 2Q23. (Not Yet Time To Pivot Away From Higher Rates And Stronger USD, 31 Aug 2022)

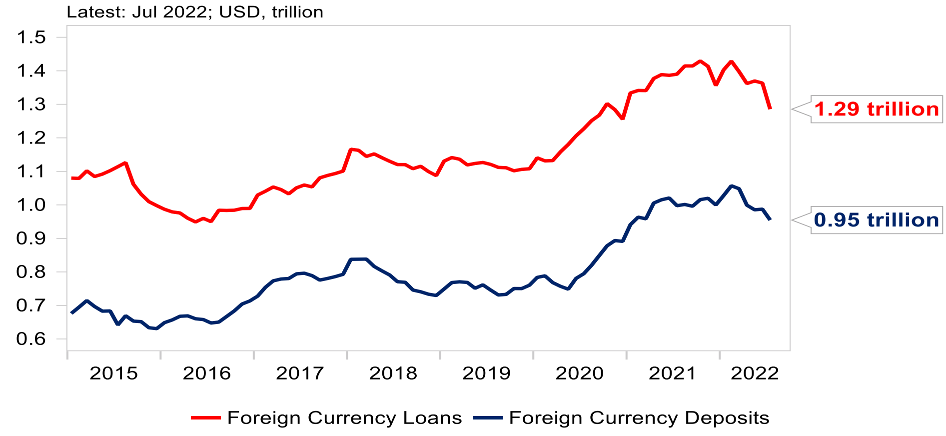
Reserve Requirement Ratio - Deposits in Foreign Currency

Source: Macrobond, UOB Global Economics & Markets Research



Foreign Currency Loans And Deposits

Source: Macrobond, UOB Global Economics & Markets Research

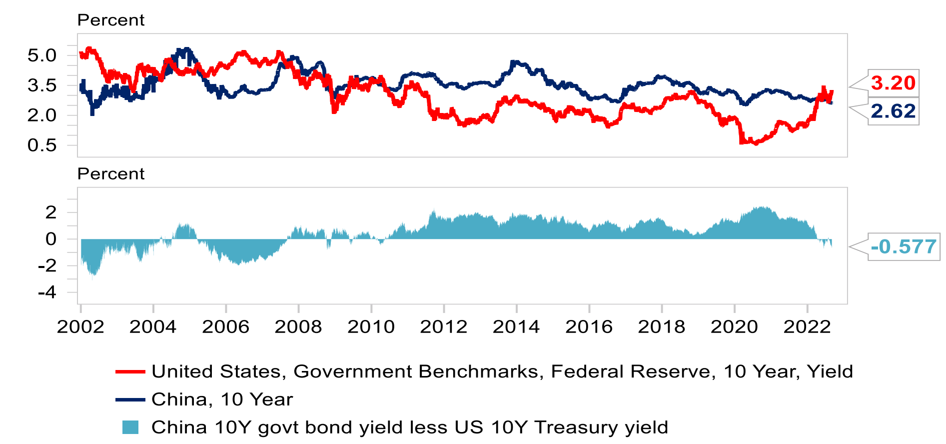


CFETS RMB Index

Source: Macrobond, UOB Global Economics & Markets Research

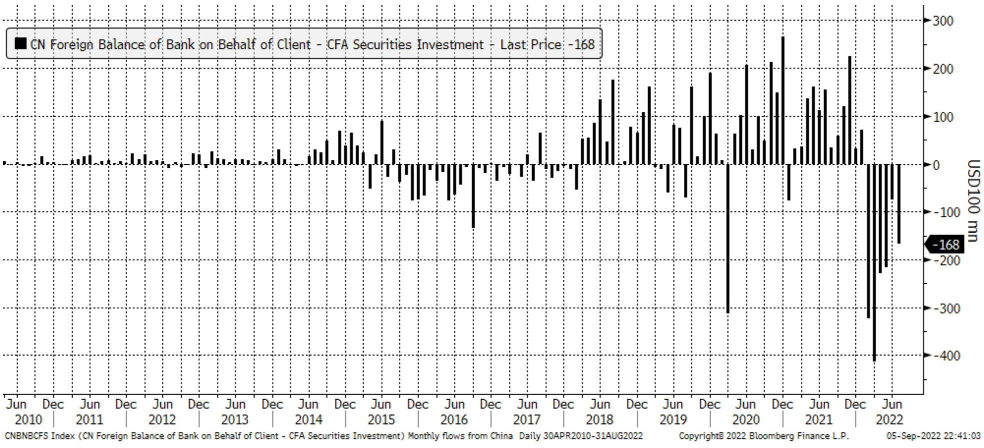
Negative China-US Bond Spreads Weigh On CNY

Source: Macrobond, UOB Global Economics & Markets Research



Outflows From China's Capital Market Continued

Source: SAFE, Bloomberg



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