The renminbi conundrum: the external surplus and the exchange rate

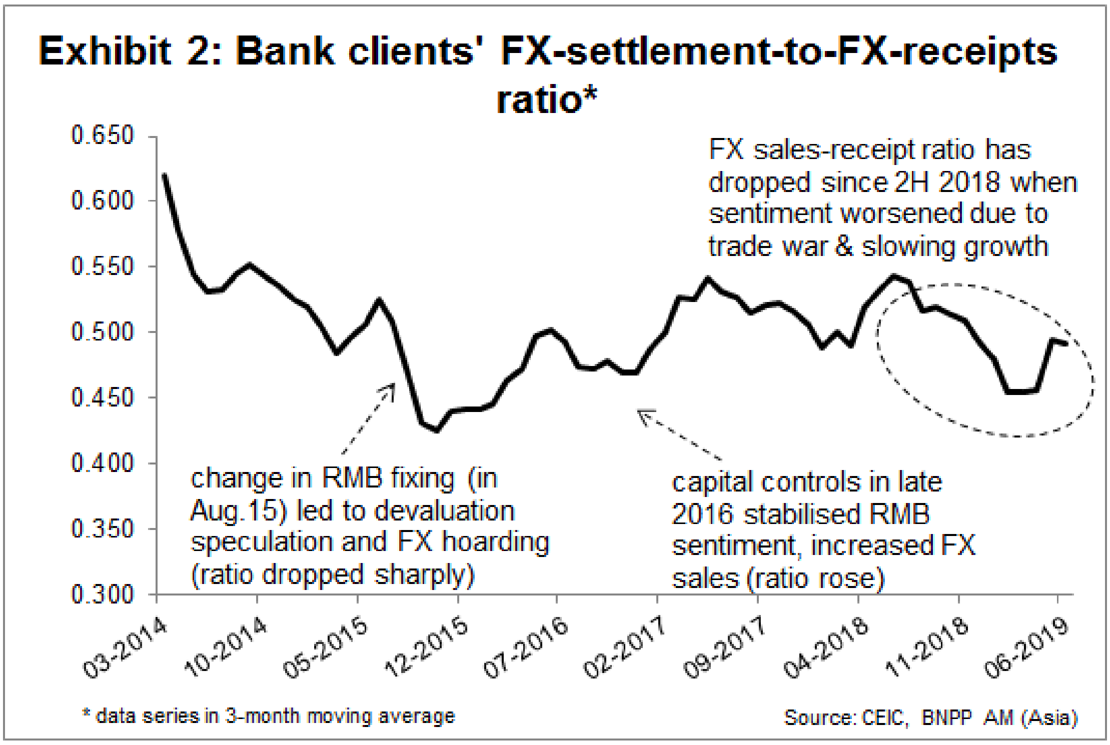
Here is the conundrum: Why is the renminbi-US dollar exchange rate still under pressure when China's external surplus has risen?

- **Current account surplus: wider in the second quarter**
- **Corporate currency hoarding is an important factor**
- **Renminbi fall: a scare tactic in trade fight with the US**
- **Base case: tensions stabilise, RMB-USD could hover at around 7.0**

China's current account has defied consensus (https://china.bnpparibas-am.com/the-fuss-about-chinas-current-account-deficit-and-global-cost-of-capital/) , and recorded a surplus of 1.6% of GDP in Q2 2019, up from a 1.5% surplus in Q1. How can that be? The answer must lie in the financial and capital accounts, where outflows overwhelm inflows from the basic surplus (the sum of current account flows and net foreign direct investment (FDI) flows). This rose to 1.8% of GDP in Q2 2019 from 1.6% in Q1.

At the time of writing, financial and capital account data for Q2 2019 is not available (these accounts had a combined deficit of USD 57.1 billion in Q1 2019, or 0.4% of GDP). The swing factor is corporate hedging. This is reflected by the FX-settlement-to-FX-receipt ratio (Exhibit 1).

When demand for the renminbi drops, Chinese firms sell less FX than they receive (i.e. they hoard FX), so the ratio drops; and vice versa.



Currently, Chinese companies are bearish and are hoarding US dollars, thus adding downward pressure on the renminbi.

How low will the renminbi drop against the dollar?

There is no certain answer to this since the People's Bank of China (PBoC) does not have a target exchange rate. While the central bank has greater tolerance now for a weak currency driven by market forces, it is unlikely to let the renminbi fall sharply or quickly for the well-known reasons of risking capital flight and increasing China's foreign debt burden.

The debt burden is estimated at between USD 1.2 trillion (or 8.6% of GDP, using BIS data of foreign bank claims on China) and USD 3.3 trillion (or 23.6% of GDP, using Chinese balance of payments data of total foreign liabilities under the "other investments" category).

A sharp drop in the renminbi would also sharply inflate import prices. Since the bulk of China's imports are for local usage, that would boost inflation, erode domestic purchasing power and thus frustrate government efforts to rebalance the economy towards consumption.

A tactical tool

While it would not be in China's best economic interest to "weaponise" the renminbi, it could – as a scare tactic in fighting the trade war – let the currency nudge down under market forces for a prolonged period. While President Trump faces re-election pressure in the coming year, President Xi does not. And as they did recently, financial markets react quite negatively and violently to the tail risk of renminbi devaluation.

So, China has time to play it slowly, but Mr. Trump does not. If China lets the renminbi slide very slowly, keeping alive the devaluation fear, for several months, say towards 7.3-7.5 per USD, which is 4%-7% down from today's rate, it could inflict much bigger declines in the US stock market to hurt Mr. Trump's election effort, and probably force him back to the negotiation table. However, this is not my base case.

China's policymakers have been relatively unfazed by large moves in domestic stock prices. Stock ownership in China is not as prevalent as in the US. China's is predominately a debt-financed system, so the equity market is not as important as it is in the US for corporate funding.

The bottom line

- If the trade tensions escalate, the PBoC could nudge the renminbi towards 7.5/USD in the coming months (probability 20%)
- If the tensions stabilise, RMB-USD could hover at around 7.0, which is my base case at this point (probability 60%)
- If the tensions subside (probability 20%), RMB-USD could easily move back below 7.0 on fundamental support.

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