China: FX reserves rose $16.5bn, largely as expected

CNY depreciation vs currency swap line

Emerging Markets Asia, Economic and Policy Research

Tingting Ge
(852) 2800-0143
tingting.ge@jpmorgan.com

Haibin Zhu
(852) 2800-7039
haibin.zhu@jpmorgan.com

Grace Ng
(852) 2800-7002
grace.h.ng@jpmorgan.com

Ji Yan
(852) 2800-7673
ji.yan@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch

China's June FX reserves beat market expectations, rising US$16.5bn to $3193bn (J.P. Morgan forecast: $3188bn, market consensus: $3180bn), after the $28.3bn decline in May.

- **Current account surplus likely at similar size to May.** Export orders component under the Caixin manufacturing PMI fell 0.5-pt to 50.1, and that under NBS manufacturing PMI fell further by 0.8-pt to 46.4. Taken together, we expect June exports to inch up 1.0%m/m sa after the 7.6% drop in May, along with an extended 1.0%m/m gain in imports (vs +4.6% in May), leaving the trade surplus to widen marginally to US$71.5bn (vs $65.8bn in May). We expect the current account surplus will be at US$31.5bn, a similar size to May.
- **Implied capital outflow is preliminarily estimated at US$33.1bn.** The US dollar index drifted lower from 104.3 to 102.9 in June, leading to an estimated currency valuation gain of US$18.1bn. We estimate the implied capital outflow at around $33.1bn (vs a revised estimate of $25.4bn for May).

Gold holding up, UST holding stabilizes

Gold reserves have been rising for the eighth consecutive month through June. From November 2022 to June 2023, China increased its gold reserves by 5.31 million oz, or 8.5%. The monthly pace for gold reserves increase this time is more rapid and prolonged than previous rounds. Underlying motivation may include risk mitigation, inflation hedging, economic and financial stability, etc. Despite the elevated gold price, we think gold reserves in China may continue to increase. Alongside the gold reserves increase is the fall in China's UST holding in 2022, despite some stabilization this year. The US Treasury Department recently published foreign holdings of US treasury securities through April. For the first four months as a whole, China's holding of UST inched up by US$1.8bn, ending April at US$868.9bn. However, China's holding share in UST total foreign holding continued to trend down to 11.5%, compared to the peak of 28% in 2021.

Unfavorable macro fundamentals, CNY weakness and PBOC's stronger daily CNY fixing

CNY weakness likely to continue and pressure for USD/CNY is biased to the upside. USD/CNY depreciated 2% in June, along with a 1.8% depreciation in CFETS TWI CNY. As we have flagged, the recent CNY weakness was initially triggered by overreacting pessimism on China's macro outlook, followed by continued disappointment in April and May activity data and downward growth revisions. Meanwhile, the US growth resiliency, and sticky inflation have shifted market expectations for Fed funds rates to stay "higher and longer". While we have penciled in a gradual recovery in confidence among consumers and private entrepreneurs, market concerns about a near-term growth recovery deceleration are hard to abate in the near term, especially if the policy support is not as strong as the markets are hoping for.

See page 5 for analyst certification and important disclosures.

Tingting Ge (852) 2800-0143
tingting.ge@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch
Haibin Zhu (852) 2800-7039
haibin.zhu@jpmorgan.com
Grace Ng (852) 2800-7002
grace.h.ng@jpmorgan.com
Ji Yan (852) 2800-7673
ji.yan@jpmorgan.com

While we think the PBOC's tolerance on CNY depreciation will be relatively higher, considering the low domestic inflation environment and export uncertainty ... Though CNY depreciation tends to increase the competitiveness of export goods, it may not always benefit exports in practice. Soft domestic demand has led to intensifying deflation pressure in China. In addition to lingering PPI deflation, headline CPI may also drift into a modest deflation zone in the coming two to three months. Given regime stickiness and path-dependency of China's policy choices, the policy support, if any to come, will likely still focus on the supply side. It may worsen the demand-supply imbalance and increase the deflation risk. Hence, we don't think the PBOC will actively pursue a weak currency strategy to support exports or mitigate domestic deflationary pressure, in part due to capital outflow concerns.

Reluctance to rapid CNY depreciation, especially in CFETS TWI CNY is apparent, triggering stronger daily CNY fixing, lower US$ deposit rate and likely followed by additional macro-prudential measures. While we share the view that 7.30 is by no means a line in the sand, the PBOC's resistance for the 7.30 threshold seems strong. 7.30 is the peak level in 2022, also the peak level since 2008. There have been only two trading days with USD/CNY above 7.3 since 2015. The PBOC has been setting stronger CNY daily fixing for 10 consecutive days, compared to the Bloomberg consensus estimates. As a result, the USD/CNY has largely stayed range-bound around 7.24 since then. Stronger CNY daily fixing aims to slow the pace of CNY depreciation, but is usually not able to alter the direction. We also note that the PBOC's attitude towards further CNY deprecation may depend on the drivers of CNY depreciation. If it is driven by USD strength but basket exchange rate remains stable, the PBOC may not step in. By contrast, if the TWI CNY also depreciates rapidly, the PBOC may step in to manage depreciation expectations. Other than stronger CNY fixing, several SOE banks were reported to have cut their US dollar deposit rates, aiming to reduce onshore USD holding incentive, and unwind more onshore USD supply liquidity. Other macro-prudential policy instruments include: 1) FX deposit RRR cut, 2) increase of risk reserve ratio for FX forward transactions, 3) re-introduction of the counter-cyclical factor, 4) guidance on FX settlement and sales, and 5) intervention on offshore CNY liquidity or other capital control measures etc.

Is CNY depreciation driven by RMB currency swap line?

In addition to the macro fundamental drivers, there is another line of view that RMB currency swap line has attributed to CNY depreciation. In particular, counterpart central banks may have drawn RMB from the currency swap arrangements, convert into USD to take advantage of higher interest rate. Such carry trade has led to CNY weakness against the USD.

We think this storyline has no factual basis.

Total amount for China's currency swap line reached 4.02 trillion. A currency swap line is an agreement between two central banks to exchange currencies. In a typical currency swap line agreement, the two parties agree on the amount of the currency to swap, the maturity and interest rates (either floating or fixed) for the currency swap arrangement. During the period of the agreement, either party can exercise the swap. At the end of the agreement, principal is returned and interests are paid (no currency risk because the borrow and repayment are in the same currency). The PBOC started to introduce bilateral currency swap line in 2009. By end-2021, the PBOC signed bilateral currency swap arrangements with central banks or monetary authorities of 40 countries and regions, with the total amount of 4.02 trillion yuan, and effective amount at around 3.6 trillion.

From a hypothetical perspective, there is no specified use for the withdrawn currency under the swap arrangement, hence the above-mentioned risk may arise. But in practice, the risk is very limited for the following reasons.

Tingting Ge (852) 2800-0143
tingting.ge@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch
Haibin Zhu (852) 2800-7039
haibin.zhu@jpmorgan.com
Grace Ng (852) 2800-7002
grace.h.ng@jpmorgan.com
Ji Yan (852) 2800-7673
ji.yan@jpmorgan.com

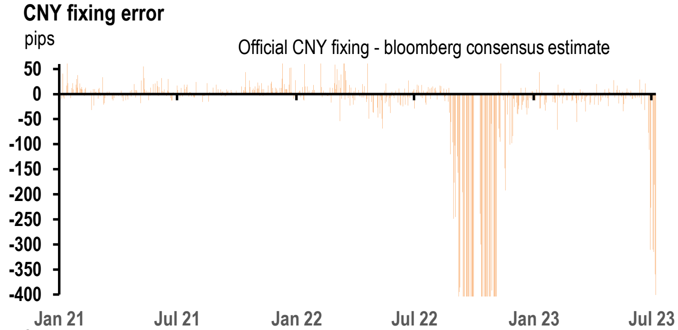
First, **the initial objective of RMB currency swap line is to mainly promote the use of RMB** (or local currency of counterpart central bank) in cross-border trade settlements. Given that most swap arrangement has a maturity (usually three years) with a notable exception in Hong Kong SAR (for which it became a long-standing arrangement with no need for renewal in July 2022 and the size was expanded to RMB 800bn), there is little incentive for central banks to chase for carry trade yields and face the risk of being suspended after the maturity date.

Second, actual usage of swap arrangement has been low. According to the PBOC, the usage of RMB under the swap arrangement increased by 20bn yuan to 109.085bn yuan in 1Q23, only 2.7% of total swap line agreements. The PBOC only used US$ 417million foreign currency under the swap arrangement. This is also an indirect evidence that central banks mainly access the swap lines for real business purposes (e.g. trade or liquidity need), not to seek investment return.

Third, for some countries that are facing currency risk (e.g. Russia and Argentina), they have increased RMB holdings in their FX reserves (probably via the swap arrangement). In these cases, our understanding is that it is mainly an accounting transaction, i.e. **RMB holding to boost FX reserve holding but the RMB cannot be used to repay foreign debt directly or be converted into other major currencies**. Hence, it will not add to the CNY depreciation pressure.

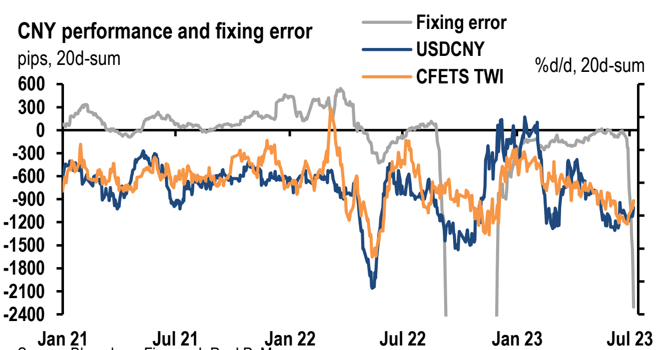
Lastly, the RMB swap arrangement is similar to the various Connect Schemes introduced during the RMB internationalization process, i.e. they are **convertible only under a closed-loop arrangement**. The expansion of RMB use under the closed-loop arrangement may lead to near-term CNY volatility, but has little impact on the medium-term fundamental value of CNY.

CNY fixing error



Source: Bloomberg Finance L.P., J.P. Morgan

CNY performance and fixing error



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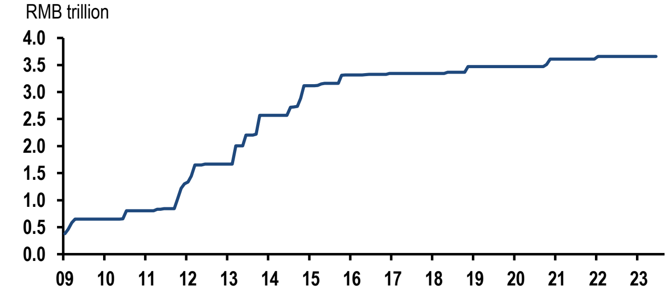
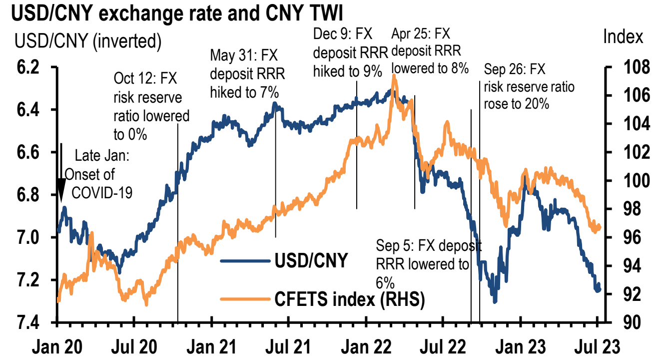
China RMB currency swap line



Source: PBOC, J.P. Morgan

USD/CNY exchange rate and CNY TWI

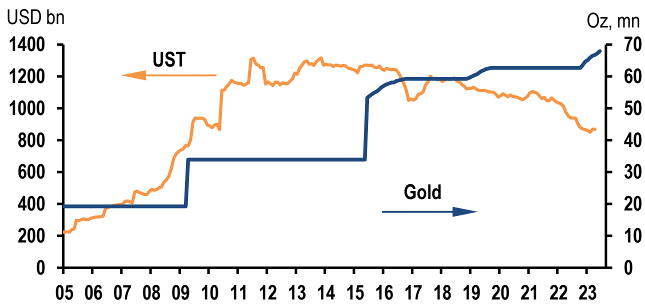


Source: Bloomberg Finance L.P., J.P. Morgan

Tingting Ge (852) 2800-0143
tingting.ge@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch
Haibin Zhu (852) 2800-7039
haibin.zhu@jpmorgan.com

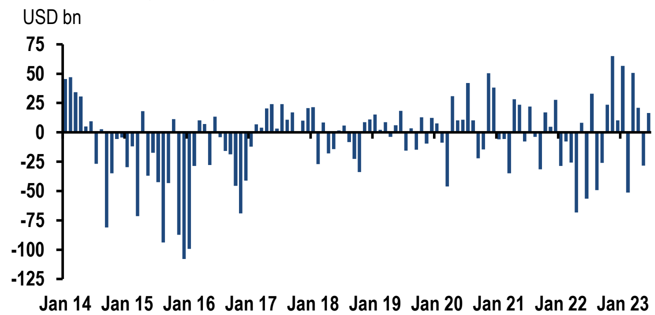
Grace Ng (852) 2800-7002
grace.h.ng@jpmorgan.com
Ji Yan (852) 2800-7673
ji.yan@jpmorgan.com

China's offcial reserve asset components



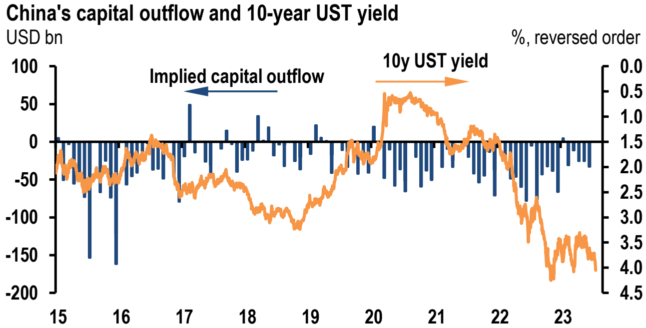
Source: PBOC, U.S. Department of the Treasury, J.P. Morgan

China: Monthly change in FX reserves



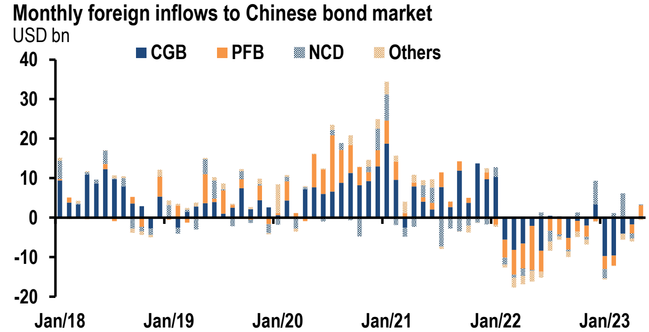
Source: SAFE

China's capital outflow and 10-year UST yield



Source: SAFE, Federal Reserve, J.P. Morgan

Monthly foreign inflows to Chinese bond market



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Tingting Ge (852) 2800-0143
tingting.ge@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch
Haibin Zhu (852) 2800-7039
haibin.zhu@jpmorgan.com
Grace Ng (852) 2800-7002
grace.h.ng@jpmorgan.com
Ji Yan (852) 2800-7673
ji.yan@jpmorgan.com

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Tingting Ge (852) 2800-0143
tingting.ge@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch
Haibin Zhu (852) 2800-7039
haibin.zhu@jpmorgan.com
Grace Ng (852) 2800-7002
grace.h.ng@jpmorgan.com
Ji Yan (852) 2800-7673
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Tingting Ge (852) 2800-0143
tingting.ge@jpmorgan.com
JPMorgan Chase Bank, N.A., Hong Kong Branch
Haibin Zhu (852) 2800-7039
haibin.zhu@jpmorgan.com

Grace Ng (852) 2800-7002
grace.h.ng@jpmorgan.com

Ji Yan (852) 2800-7673
ji.yan@jpmorgan.com

Completed 07 Jul 2023 07:36 PM HKT

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