Macro Research

Macro Comment China

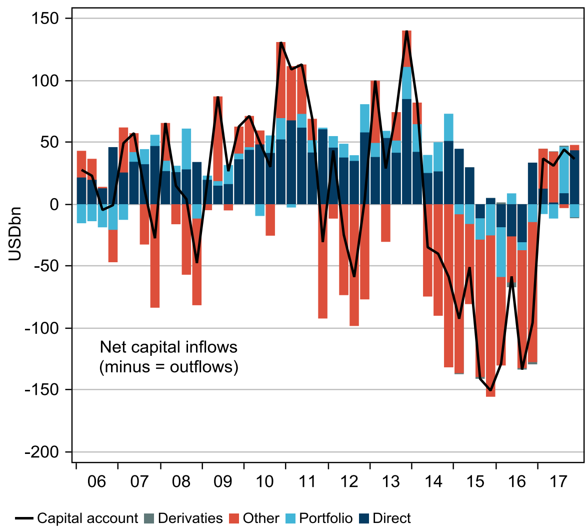
How will looser capital restrictions impact the CNY?

Capital restrictions are once again being loosened in China, with domestic stock and bond markets being opened up for foreigners. This is part of China's strategy to integrate its financial markets with the rest of the world, and ultimately to make the CNY a new global reserve currency. Opening up does not necessarily imply net capital inflows and give a stronger currency; we continue to expect a slightly weaker CNY versus the USD in the short run amid general USD strength.

Looser capital restrictions

China has re-entered the path of gradual loosening of capital restrictions. The overall trend has been for looser restrictions over several decades, but there have been bumps in the road. The most recent setback was following the badly communicated changes to the FX regime in the summer of 2015. The changes were perceived by markets as a 'devaluation' and spurred expectations of further CNY weakness and thus strong capital outflows. That led the authorities to halt the liberalisation process and tighten control of outflows. But following fairly balanced flows in 2017 and so far this year, China seems ready to once again make it easier to send capital in and out of (mainland) China.

Fairly balanced flows in 2017 following outflows



Source: Macrobond

Bond and stock markets opening up

The most interesting area of opening up seen from a foreign investor's point of view is the China Hong Kong stock and bond connect schemes, which grant foreign investors much easier access to domestic equities and bonds via clearing banks in Hong Kong. The stock connect is not new anymore, but the daily quotas for the amount of investments in and out have recently been nearly quadrupled, emphasising that the direction is for fewer and not more restrictions. The bond connect opened as recently as last summer, and also here, daily quotas are likely to be lifted gradually. When we visited Hong Kong on an investor trip in early April, the bond connect (and of course the US China trade tensions) were on everyone's lips.

The connect schemes and especially the bond connect could well prove attractive for foreign institutional investors, including foreign central banks. Persuading foreign central banks to hold CNY bonds as part of their reserves would rhyme well with China's ambitions to make the CNY a global reserve currency alongside or even replacing the USD. Getting there would take a long time though, and requires more than just setting up a scheme for accessing the domestic bonds.

Index inclusion will attract capital inflows

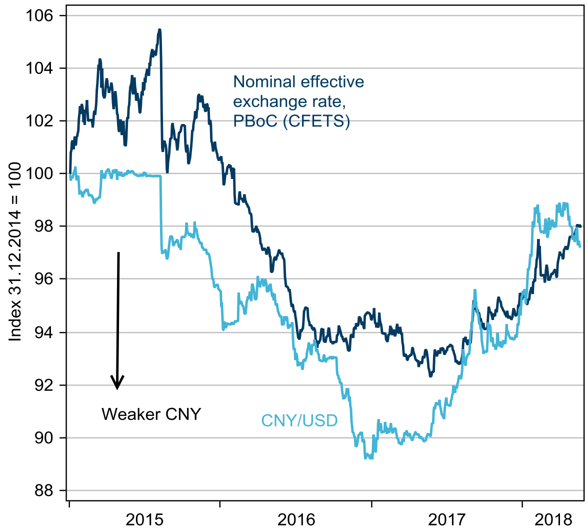
As the market is being opened up, so are index providers looking to include Chinese bonds and stocks in their Emerging Markets indices. Index inclusion will in itself attract foreign money to China, as passive funds tracking the indices will have to invest and as active fund managers might see their mandate and scope widened to also include China.

The stronger capital inflow seen in isolation adds strengthening pressure on the CNY. But to conclude that the CNY would indeed strengthen as a consequence is probably false as one has to take into account the other side of opening up the capital account. The stock and bond connect also make it much easier for domestic investors to invest abroad. There is no guarantee per se that the extra inflow will balance the extra outflow. But the authorities will likely make sure that this will be the case by adjusting controls of inflows and/or outflows.

We expect a weaker CNY versus the USD

More generally speaking, the authorities will despite gradual liberalisations continue their firm grip of the exchange rate, in our view. We also expect the authorities to stick to their policy of keeping the effective exchange rate "basically stable". Since autumn last year, the effective or trade-weighted exchange rate has strengthened somewhat as the authorities have allowed the CNY to strengthen more versus the USD than the USD has weakened versus most other currencies.

CNY is set to weaken in the short term



Source: Macrobond

Recently, the USD has started to strengthen generally again, and we expect the CNY to be weakened versus the USD to ensure that the effective CNY also weakens and moves back down into the 'basically stable' interval. For 2019 and 2020, we forecast renewed CNY strength amid general USD weakness. We expect the USD/CNY to increase toward 6.6 in late 2018 and decrease toward 6.2 in late 2020.

Handelsbanken Capital Market FX forecast

	22/05/2018	Q2 2018	Q3 2018	End 2018	Q1 2019	End 2019	End 2020
USD/CNY	6.37	6.50	6.60	6.60	6.50	6.40	6.20
EUR/USD	1.18	1.17	1.15	1.15	1.17	1.20	1.25
EUR/CNY	7.50	7.61	7.59	7.59	7.61	7.68	7.75
EUR/SEK	10.20	10.25	10.00	9.80	9.70	9.50	9.40
CNY/SEK	1.36	1.35	1.32	1.29	1.28	1.24	1.21
EUR/NOK	9.49	9.50	9.50	9.40	9.30	9.30	9.30
CNY/NOK	1.27	1.25	1.25	1.24	1.22	1.21	1.20
EUR/DKK	7.45	7.46	7.46	7.46	7.46	7.46	7.46
CNY/DKK	0.99	0.98	0.98	0.98	0.98	0.97	0.96
EUR/GBP	0.88	0.88	0.88	0.90	0.91	0.92	0.92
GBP/CNY	8.55	8.64	8.63	8.43	8.36	8.35	8.42

Source: Handelsbanken Capital Markets

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