Matthews Asia

# Matthews Asia Perspective:
## China Currency Update
### Q&A with Teresa Kong, CFA, Portfolio Manager

Q **What happened this week with China's currency?**

A Since 2005, China's currency, the renminbi, has had a de facto soft peg to the U.S. dollar (USD). While its central bank, the People's Bank of China, never explicitly stated how it determines the official daily exchange rate, also known as "fixing," it was clear that it was largely based on the USD. The intra-day band around which the RMB was allowed to float against this fixing had widened from +/- 0.5% to +/- 2% in March of this year. On August 11, the central bank announced that the fixing, going forward, would be based on the close on the prior day. With one stroke of the pen, the driver of the renminbi fundamentally changed. Its compass changed from that of the U.S. dollar to a more market-driven equilibrium rate.

Q **How does Matthews Asia interpret this change in currency regime?**

A We view this RMB change, from a soft USD peg to a managed float, as first and foremost a big step forward in the government's stated objective to liberalize its capital account. This is a logical next step in line with China's reform agenda, its desire to be included as part of the International Monetary Fund's basket currencies of Special Drawing Rights (SDR), and its more gradual growth path and easy monetary stance.

Q **Why now?**

A We think that the timing is a reflection of several factors, including the potential lifting of interest rates by the U.S. Federal Reserve, its candidacy to be part of IMF's SDR, and a slowing economy—all of which converged to make this change take place earlier, rather than later.

First, monetary policy between the United States and China has clearly diverged since the end of 2013 as it became increasingly clear that the U.S. recovery was on track, while China's growth was slowing. As interest rates in the U.S. drifted higher and China lowered rates, the once attractive 4% pickup in yield collapsed to less than 2%. The economics of the long RMB–short USD carry trade* was no longer attractive. The same economics that squeezed the juice out of the carry trade had real effects on corporates and consumers as well. Given the choice, Chinese corporates increasingly held USD-denominated assets over RMB-denominated assets. In order to manage the USD, in the first half of 2015, China's central bank engineered the highest sale of its reserves in the last two decades. Any rate hike by the Fed would only exacerbate the selling pressure on the RMB, and would result in further use of currency reserves.

At the same time, China has been vocal about its wish to become part of IMF's SDR basket. The controversy surrounding the RMB's inclusion has always centered around the "freely usable currency" criterion. Instituting a managed float now would arguably provide three months of data to support China's argument that it is serious about adopting a more freely usable currency. Furthermore, a little noticed but important part of liberalization has been the further opening of the interbank market to foreign institutions.

Last but not least, adapting a more market-driven exchange rate—and the resulting short-term depreciation of the RMB—should help China's slowing economy. It provides a boost to Chinese exports, exerts an inflationary affect onshore and helps accelerate the economy.

Q **Is China purposefully depreciating its currency?**

A The fact that the RMB *depreciated*, not appreciated is a reflection of the fact that the currency had appreciated beyond its equilibrium exchange rate. According to the Bank for International Settlements, in 1H15, the RMB's nominal effective exchange rate appreciated by 3.62% and the real effective rate appreciated by 2.95% (and by more than 50% over the past decade). Moreover, the RMB appreciated by almost 8% against the euro and more than 2% against the yen during the first six

*Carry trade is a strategy that involves selling a certain currency, with a relatively low interest rate, in order to purchase a different currency that yields a higher interest rate.

months of the year. In fact, we expect the RMB to overshoot on the down side before appreciating in the long run.

Our long-term appreciation view is based on our belief that this change in currency regime removes the biggest hurdle to China's inclusion in the SDR and the major global equity and bond indices. When China's weight becomes commiserate with that of a more freely accessible market, the demand for Chinese assets should materially increase in the long run.

In summary, the adoption of this mechanism and the resulting short-term depreciation in the renminbi will benefit China's exports and its economy in both the short run and the long run. But to give too much credence to the "currency war" or "mercantilism" narrative misses the big picture.

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### How does this affect Chinese corporates?

Over the long run, a more flexible exchange rate is going to instill a great deal more discipline and risk management on the part of Chinese corporates.

In the short run, losers will be those companies with large USD liabilities that are not covered by USD assets or revenues. The lack of RMB volatility, and the perceived one-way appreciation of the RMB created moral hazard where corporate chief financial officers were incentivized to profit from having assets in RMB and liabilities in U.S. dollars. Those companies with the biggest currency mismatch between their assets/revenues versus their liabilities can experience the most pain. These include portions of Chinese property and large industrials that import commodities for domestic consumption. Short-term gainers could obviously include exporters.

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### What is the effect on Matthews's portfolios?

Over the short term, we expect a weaker RMB to exert depreciation pressure on other Asian currencies as well. So we expect a short-term impact to Asia's markets. Over the long run, however, this development is a major step toward the investability of China. In fact, this single change in currency regime arguably removes the main obstacle for China's inclusion in the SDR and also in major equity and bond indices globally. When the weights of the global equity and bond indices include China, we expect supply and demand dynamics to be highly favorable to China and Asia as a region.

We have been vigilant about the quality of the balance sheets across all portfolios.

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### Is the Hong Kong dollar (HKD) the next to fall?

We know from economic history that countries can only do no more than two of the following three things over the long run: maintain a fixed exchange rate, have an independent monetary policy and allow free capital flows. Since the early 1980s, Hong Kong has successfully maintained a fixed exchange rate, free capital flows, and monetary policy directly linked to the U.S. As a small entrepot whose economy has become increasingly more linked to China in the last decade, Hong Kong has found that having its monetary policy linked to that of the U.S. has been suboptimal at times. With this change of RMB regime to a more market-driven one, the re-pegging of the HKD to the RMB needs to be more fully explored as a possibility in the foreseeable future.