8 February 2016

Flash Comment

Chinese FX reserves down again in January but calm has been restored

Chinese currency reserve data for January showed another big decline of USD107.9bn, to USD3.230trn (released over the weekend).

Adjusted for valuation (reflecting changes in exchange rates versus the USD), the decline was slightly smaller at approximately USD92bn. It is still a big decline but smaller than the declines in December and August 2015.

The majority of the reduction in the reserves is likely to have taken place in the first two weeks of January, as there was significant depreciation pressure versus the USD following increased expectations of a devaluation. However, China managed to calm markets down by indirectly pushing up offshore money-market rates by draining liquidity and imposing reserve requirements on offshore banks (see *FX Strategy: PBoC draws a line in the sand*, 12 January, and *FX Strategy: PBoC pulls out another weapon to defend CNY*, 18 January).

We expect intervention to have calmed down and we believe China has managed to reduce capital outflows in February. Hence, we look for a smaller decline in FX reserves this month. China has found a new way to fight pressure on outflows by squeezing up money-market rates in the offshore market when pressure intensifies. This reduces the need for large-scale intervention. The smart thing about using higher offshore rates is that it does not hurt the Chinese economy much, as only limited funding is taking place in this market.

USD/CNY moving lower but CNY basket weakest level in over a year

Since the turmoil in early January, the CNY has strengthened slightly against the USD. That the CNH-CNY spread is also back to zero suggests that the big pressure on the currency is fading for now. Most of the hedging and big positions taken by the hedge funds for a devaluation are being done in the offshore market and the CNH-CNY spread is thus a good indicator for the extend of pressure on the yuan.

The USD/CNY fixing has also moved gradually lower and actually declined a bit more on Friday than in the previous days; maybe as a further signal to the markets ahead of the New Year holiday this week that China means it when it says it does not wish to devalue.

Interestingly, the **Chinese currency actually weakened further over the past week when measured on a trade-weighted basis**. Using the weights China announced in December, the basket is now at its weakest level in over a year. However, the markets still view the Chinese currency strength through the lens of the USD and hence the weakening of the CNY basket has not received any attention from the markets. The CNY is also weaker against the EUR, with EUR/CNY close to the high seen in August 2015.

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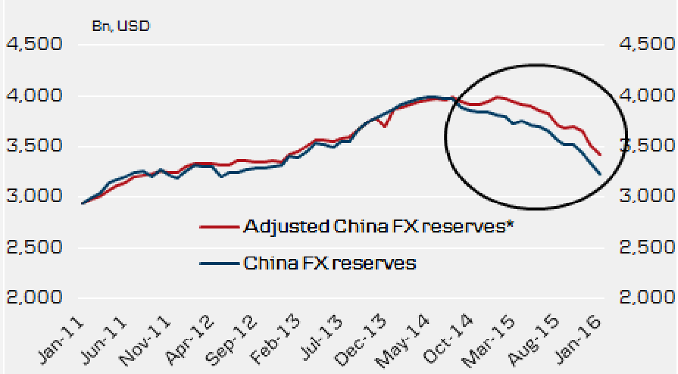
We expect China to keep the CNY fairly stable against the USD in the short term, as it wants a period of stability to keep outflows down. However, in the medium to long term, we still look for a gradual depreciation versus the USD but in a more orderly fashion than we witnessed in early January. If necessary, China will again use higher short-term offshore money market rates in defence of the CNY. Note that the 12-month money-market CNH rate is still high following the introduction of a reserve requirement for offshore banks. This keeps the cost of shorting CNH on a longer term basis fairly expensive. A last line of defence of the CNY for China would be tighter capital controls to stem outflows.

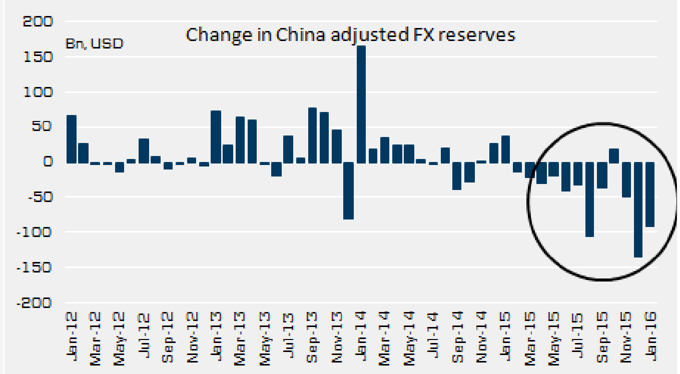
Note that as we expect EUR/USD to move higher on a 12M horizon, **we also look for a depreciation of the CNY of more than 10% against the EUR**. We continue to recommend EUR-based corporates with receivables to hedge their exposure.

Chinese FX reserves reduced by USD800bn from the peak



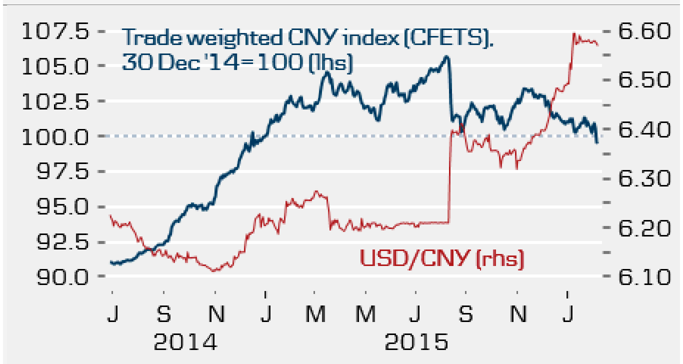
Sources: Macrobond Financial, Bloomberg, Danske Bank

Big decline in January but smaller than in December and August



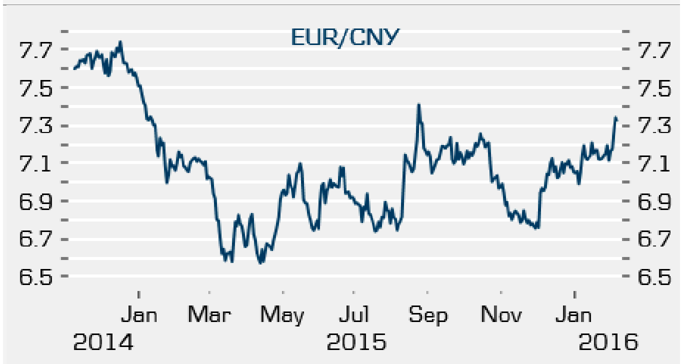
Sources: Macrobond Financial, Bloomberg, Danske Bank

Calm restored vs USD but basket weakest in a year



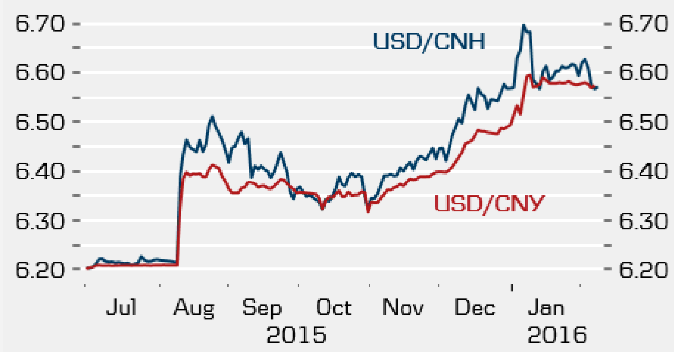
Sources: Macrobond Financial, Bloomberg, Danske Bank

CNY also depreciating against EUR due to USD weakness



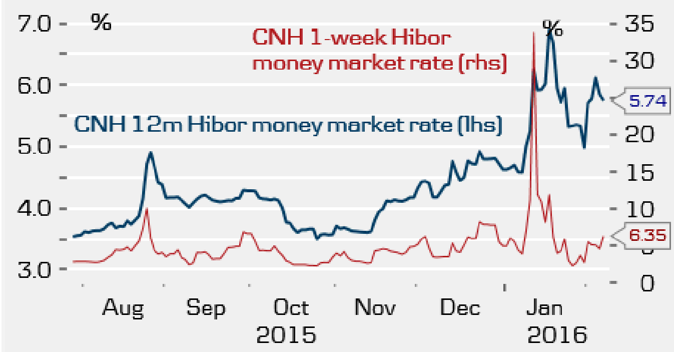
Sources: Macrobond Financial, Bloomberg, Danske Bank

CNH-CNY spread back to zero reflecting reduced selling pressure



Sources: Macrobond Financial, Bloomberg, Danske Bank

1-week CNH MM rate normalised – 12-month rate still high



Sources: Macrobond Financial, Bloomberg, Danske Bank

We look for a weaker CNY longer term, especially against the EUR

	USD/CNY		EUR/CNY	
	Danske	Forward (NDF)	Danske	Forward
08-Feb	6.57		7.33	
+3M	6.70	6.66	7.10	7.44
+6M	6.85	6.73	7.54	7.55
+12M	7.00	6.85	8.12	7.74

	USD/CNH		Spread CNH-CNY	
	Danske	Forward	Danske	Forward
08-Feb	6.57	6.57	6.57	0.00
+3M	6.72	6.65	0.02	0.00
+6M	6.87	6.71	0.02	-0.02
+12M	7.02	6.82	0.02	-0.03

Sources: Macrobond Financial, Bloomberg, Danske Bank

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