Business

Volatile Yuan Puts Focus on China's Capital-Control Buffers

By Gregor Stuart Hunter

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- China clamped down on outflows to stem record loss of reserves
- Overseas takeovers were curbed, regulatory scrutiny tightened

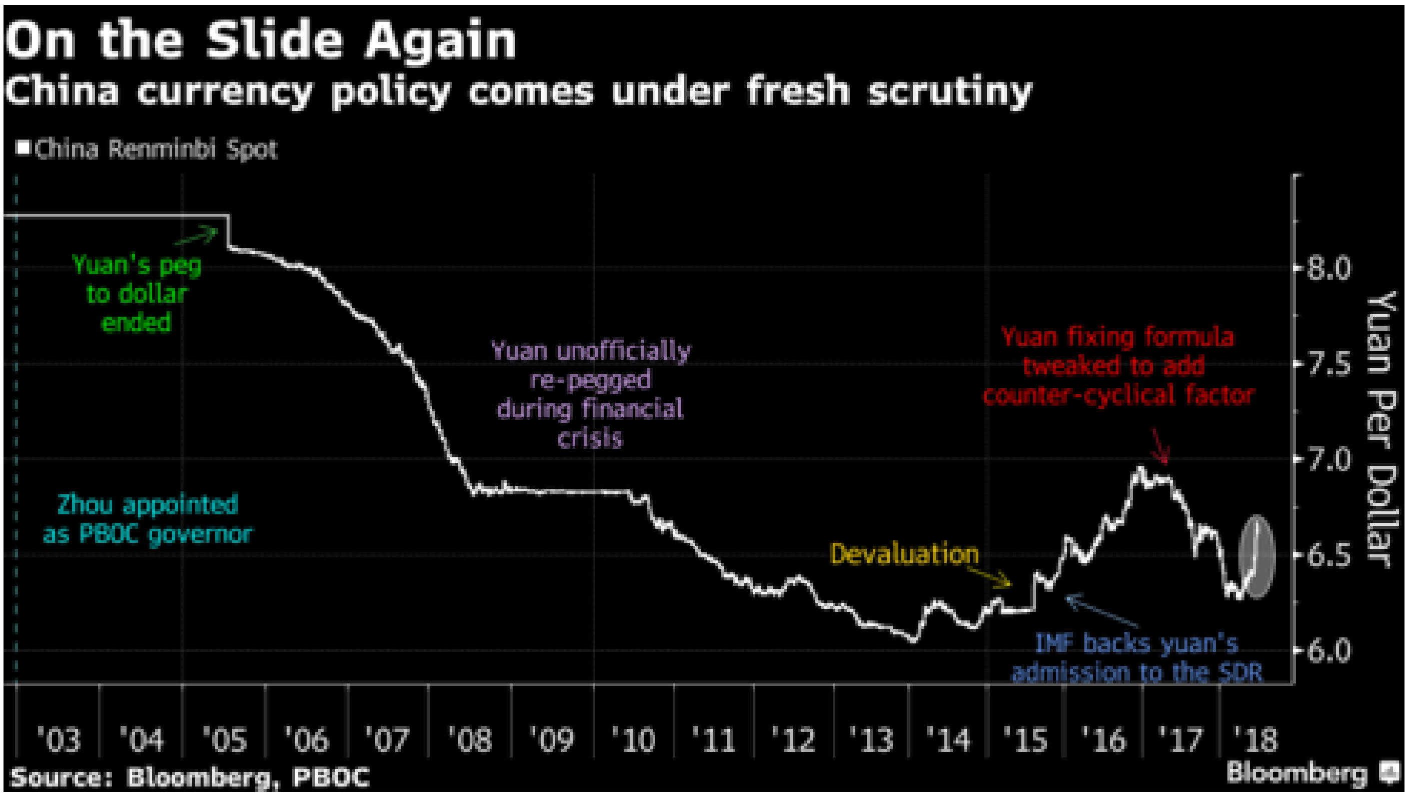
The yuan's plunge has seen little of the capital-flight panic that gripped markets back in 2015. Adam Haigh reports.

The sharpest decline in China's currency since policy makers devalued the yuan in 2015 has seen little of the capital-flight panic that gripped markets back then. How long the calm lasts depends in part on the effectiveness of controls put in place last time.

This time around, the yuan's 3.6 percent slide since mid-June has been accompanied mainly by an outflow of cash from foreign, rather than domestic, investors, analysts say. Overseas funds took out almost 4 billion yuan ($610 million) from Hong Kong's Stock Connect with mainland exchanges in that period, reversing inflows the prior two weeks.

Chinese operators face tight constraints -- ranging from official scrutiny of trade invoices to detailed justification for certain overseas transactions -- put in place years ago to stem an exodus of funds. The cost of the 2015-16 shore-up-the-yuan campaign was high: the central bank burned through $1 trillion of foreign-exchange reserves, and took some criticism <https://www.bloomberg.com/news/articles/2016-01-21/lagarde-panelists-say-china-transition-challenge-is-manageable> in international forums for how it managed the exchange rate.

Fears of fresh domestic jitters might have contributed to verbal intervention on Tuesday, when the People's Bank of China assured the yuan will remain "basically stable."



"They're concerned about any vicious cycles that might develop with the weaker currency spilling over," to local stocks and "more worryingly to capital outflows," said Adarsh Sinha, co-head of Asia currency and rates strategy at Bank of America Merrill Lynch in Hong Kong. "We haven't really seen signs of big capital outflows yet, but if that did happen, that would be a bit of a problem."

Sinha, whose team cut its forecasts for the yuan this week, said "I'd be watching the balance of payments data quite closely to get a sense of are capital outflows accelerating."

Bank of America Merrill Lynch now sees the yuan dropping to 6.95 per dollar by year-end, versus a previous forecast of 6.80. It was at 6.6259 as of 5 p.m. in Shanghai. On Tuesday, it slid through 6.7 for the first time since August 2017.

With President Donald Trump's administration scheduled to start collecting tariffs on a swathe of Chinese imports July 6, speculation had risen that China was guiding the yuan lower as a weapon in the trade battle, helping maintain the competitiveness of its exports. The danger of reigniting capital outflows argues against such a policy, the idea of which was rejected by the PBOC Tuesday.

"The currency is certainly not a weapon that the Chinese want to use as part of the arsenal in the trade war, because it's a weapon that could pretty badly backfire," Eswar Prasad, a trade policy professor at Cornell University and former head of the IMF's China unit, said on Bloomberg Television.

Back in 2015 and 2016, it took much more than verbal intervention to quell the capital-outflow pressure. One school of thought even says it took an unpublished agreement among Group of 20 policy makers meeting in Shanghai to calm currency markets, in part through less-aggressive expectations of Federal Reserve monetary tightening.

Read about the theory behind the 2016 Shanghai agreement here. <https://www.bloomberg.com/news/articles/2016-03-17/shades-of-plaza-accord-seen-in-barrage-of-stimulus-after-g-20>

Such a deal might be tough to envision this time around, given the U.S.-China trade tensions. That increases the importance of China's capital controls as a brake, alongside outright intervention to sell dollars against the yuan.

Morgan Stanley, for one, sees the controls as proving their worth. "China's more regulated capital account suggests that a repeat of 2015/16 is unlikely," the bank's currency strategists, led by Hans Redeker in London, wrote Tuesday.

If Chinese companies and individuals, fearing a loss of purchasing power, again desert the yuan for the safety of dollars, some metrics to monitor include the following:

- The monthly foreign-exchange reserves release; next due July 7
- The PBOC's monthly foreign-exchange positions data; next due around July 15
- The PBOC's monthly data on foreign-exchange settlements on behalf of clients, due July 19
- Quarterly current-account data, especially the "net errors and omissions" column that can include money outflows; next due late September

The PBOC has also sent signals it will let the market have a greater role in determining the exchange rate, as opposed to the opaque "counter-cyclical" factor introduced to steady the yuan last year, according to Cliff Tan, head of global markets research at MUFG Bank Ltd.

PBOC Governor Yi Gang's endorsement of a "floating currency exchange-rate mechanism" indicated that "the reformers are fighting back" in China, Tan said.

Capital controls might make them all the more confident if traders start testing the yuan's downside again.

– With assistance by David Ingles, Ramy Inocencio, and Xiaoqing Pi

(Updates yuan trading in third paragraph after first chart.)

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CNY
China Renminbi Spot
6.6370 CNY ▲ +0.0045 +0.0678%

BAC
BANK OF AMERICA
27.89 USD ▲ +0.10 +0.38%

MS
MORGAN STANLEY
46.55 USD ▼ -0.47 -1.00%