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The Renminbi Regime

"We're in the process of giving the keys back. There's no money coming out of China."
- Why China Fell out of Love with New York Property (FT, 6/24/19)

Ahead of what should be an interesting summer for USDCNH, let's dissect how China manages the RMB. **Chinese policymakers are controlling both the price and volume of foreign exchange transactions**. Systemic stresses could create an FX scarcity that would impair China's ability to remain globally integrated.

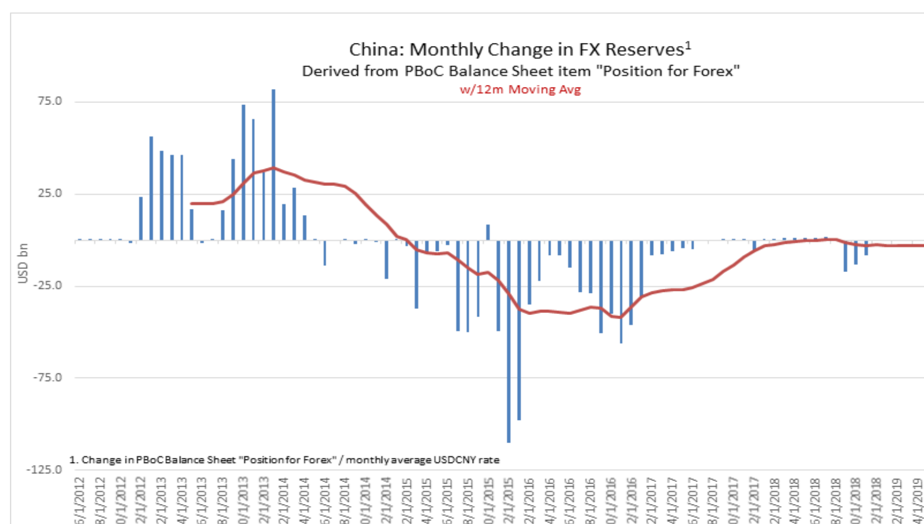
FX Quotas: Forcing Capital Flows into Balance

I first heard chatter of an emerging "quota system" for FX flows in the Spring of 2017. Banks were told that over specified periods – a month or a quarter – they could facilitate client interest to buy FX only to the extent that other clients generated FX supply by selling FX / buying RMB. In other words, on a bank-by-bank basis: **only what comes in goes out**.

On a market-wide level this is also how free-floating FX rates work: in the absence of central bank intervention, market supply and demand must balance. But the RMB is not floating – its value is heavily managed by signaling via the daily USDCNY fixing, as well as via more direct "window guidance."

China's FX reserves are remarkably stable – FX flows are balancing absent intervention – but there has been no discernible uptick in price volatility. **FX flows aren't balancing via free price discovery, but by administrative force.**

This PBoC balance sheet provides the cleanest measure of China's FX reserve activity. With the exception of some small USD-selling to stabilize the RMB late last year, reserve utilization has been minimal.



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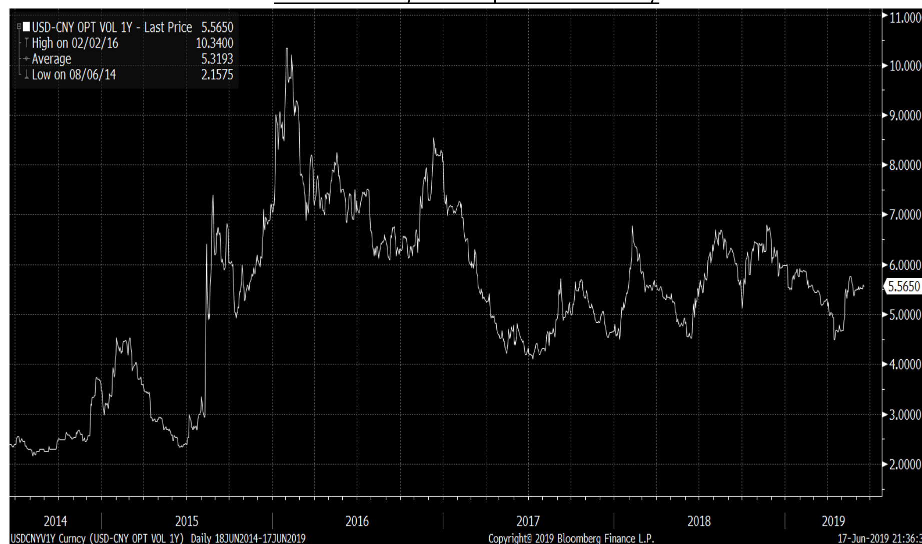
There is no sign in the reserves data of net inflows stemming from the MSCI reweighting or Bloomberg bond index inclusion generating. Despite these supposedly chunky flows in April and May, China's reserves showed nary a ripple. What came in, went out.

At the same time, there is little evidence of increased flexibility in the exchange rate:

USDCNY 30-day Rolling Historical Volatility

USDCNY 1-year Implied Volatility



After operating the FX quota system as a covert op for the past two years, SAFE has surprisingly come clean. From Bloomberg (May 31): "China Quietly Revamps Tools for Controlling Capital Outflows."

> *China has quietly revamped its tools for handling capital flows -- an issue that takes on added importance as the yuan slips near the key 7 a dollar level.*

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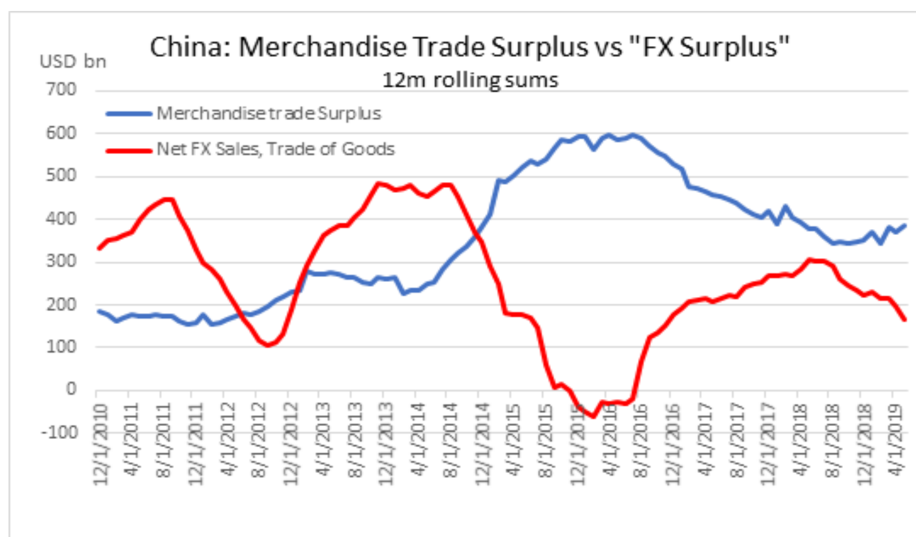
After many years of plugging loopholes in its safety net only in response to an imbalance, the currency regulator has gone on the offensive. ***The State Administration of Foreign Exchange has now put the onus on banks*** *to more closely monitor and balance their foreign exchange businesses in line with the government's views.*

The Myth of Efficient Capital Controls

The dirty little secret of China's "capital controls" is that **banks have never had the requisite infrastructure to comply with capital account regulations as written**. There are over one million corporate entities licensed to engage in international trade in China. I'd be surprised if Chinese banks even meet cursory "know your customer" standards on all of them, let alone possess the ability to decipher what they're actually doing with the proceeds of each and every FX trade.

Historically there has little connection between China's merchandise trade surplus and the FX flows that Chinese banks book under the regulatory heading "trade of goods." **Disguised capital flows abound**.



Efficient enforcement of China's capital account regulations has always been impossible. When SAFE says they've "*put the onus on banks to more closely monitor and balance their foreign exchange businesses*" they're talking about net-balance quotas on FX trading. More from Bloomberg:

"This is a standardized way for banks to see how to balance currency flows *against the backdrop of China's shrinking current account surplus and the macro prudential framework," said Tommy Xie, an economist at Oversea-Chinese Banking Corp. "By tightening the banks' compliance, this will indirectly limit the capital outflows, which will reduce pressure for the renminbi to weaken further."*

Chinese lenders will have to make changes to how they handle currency sales and purchases by individuals and corporations, SAFE said in its May 21 statement. Adjustments will also be required for cross-border payments and the new foreign debt that companies issue.

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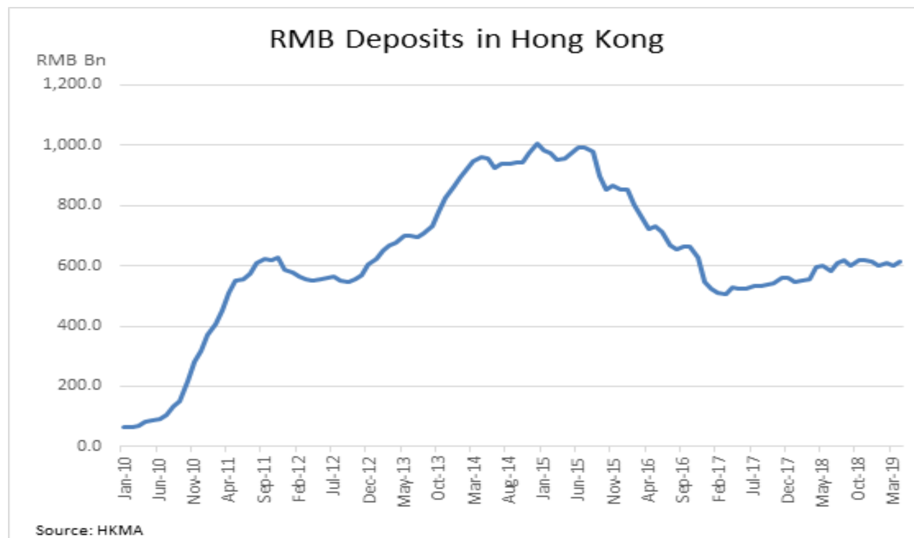
The window for accessing foreign currency out of China is closing.

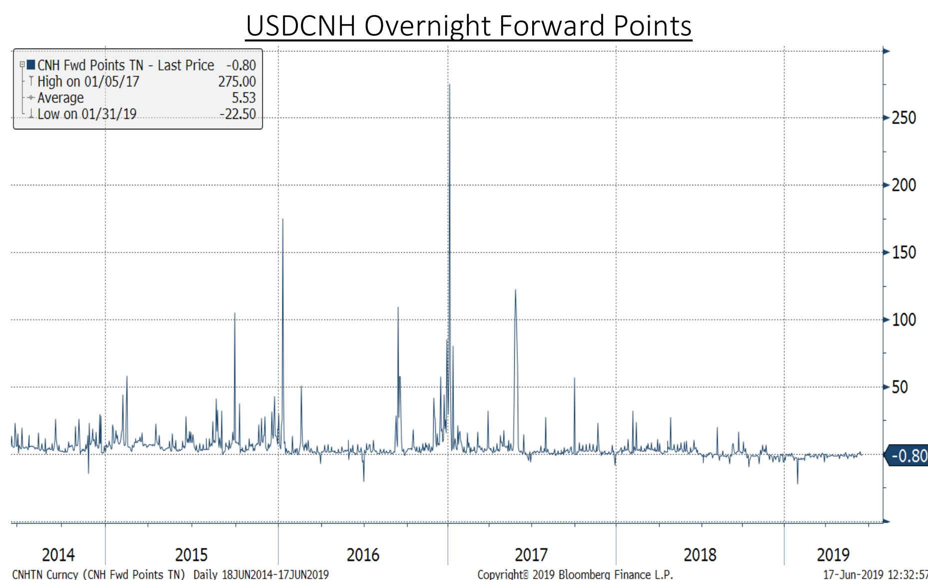
The CNH Market is on an Island

Note also the reference to "*adjustment for cross-border payment*." In 2015-16 the CNH market served as a porthole to China's capital account, requiring some $400bn in CNH-stabilizing interventions. The porthole is now closed. **PBoC has put a tight clamp on the cross-border flow of RMB**:



With the pool of offshore RMB cut off from arbitrage with onshore rates and FX markets, PBoC/HKMA can push around CNH interest rates as needed to stabilize the CNH absent intervention (the spikes below imply triple-digit overnight rates):

USDCNH Overnight Forward Points



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By limiting arbitrage functionality and generating wild instability in CNH funding costs, **Chinese policymakers have sacrificed development of the CNH market on the altar of "RMB stability."**

The Market Has Lost Access to PBoC Reserves

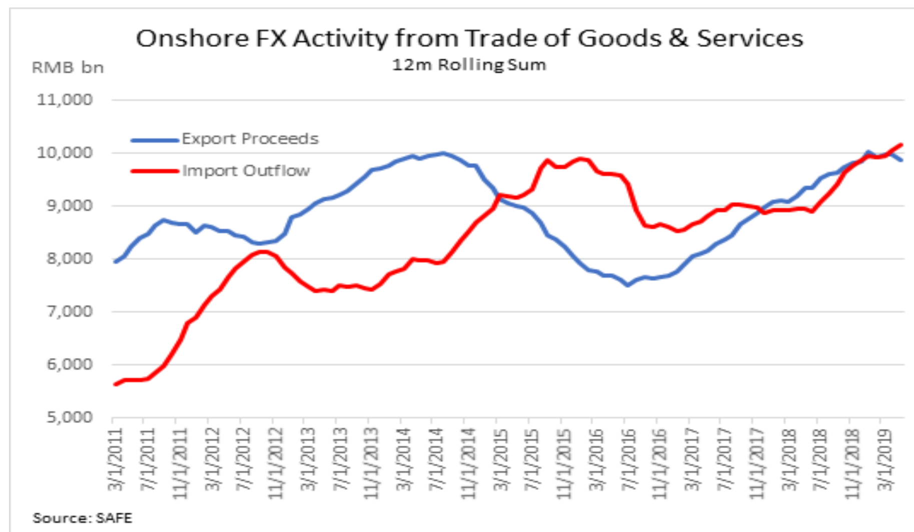
In a sense, China's FX reserves comprise the "capital base" for the Chinese financial system. Given the government's track record of bailing out even Ponzi schemes, investors presume that domestic assets are "money good" *in RMB terms*. But if PBoC is printing money willy-nilly to support the system, the real value of an RMB asset can only be realized if the investor sells the asset *for hard currency*.

The 2015-16 reserve drawdown was akin to systemic bank run. China may have lost as much as $1.5T (see appendix for a details). In response, the bank (i.e. PBoC) shut its doors to the crowd.

Ring-fencing the FX reserve to sustain systemic credibility is a catch-22. Yes, the pool will no longer shrink. But if the reserves can no longer be used, what good are they really? Are they even still "there?"

The Key Variable: Export FX Conversion

The key to limiting economic damage from the FX quota system is to ensure a high rate of conversion of hard-currency export proceeds back into RMB. This was accomplished by a broad shakedown of exporters in 2017-18. I've heard of even small (single-digit million-Dollar revenue) Chinese companies who received an inquiry from SAFE regarding U.S. Dollar balances they held in Hong Kong banks. The message was not so subtle: **bring it home**.



The chart above shows onshore FX activity resulting from trade of goods and service. (Blue = sale of FX resulting from export / red = purchase of FX for purpose of import).

The chart illustrates the sharp decline in export conversion behind the 2015-16 hemorrhaging of reserves, as well as the improvement resulting from SAFE's "shakedown" program. The key question going

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forward: has SAFE fixed the export conversion problem with the complicity of Hong Kong banks? Or will Chinese exporters, now realizing that Hong Kong is no longer "out," change behavior in this ongoing game of "cat & mouse" in ways that cause renewed problems for Chinese policymakers?

The history of such things suggests that "where there's a will, there's a way." Aggregate export proceeds do appear to have peaked. With the Chinese capital flow data rendered useless – when a measure becomes a target it ceases to be a useful measure - I'll be watching aggregated export proceeds closely for signs of pressure in coming months.

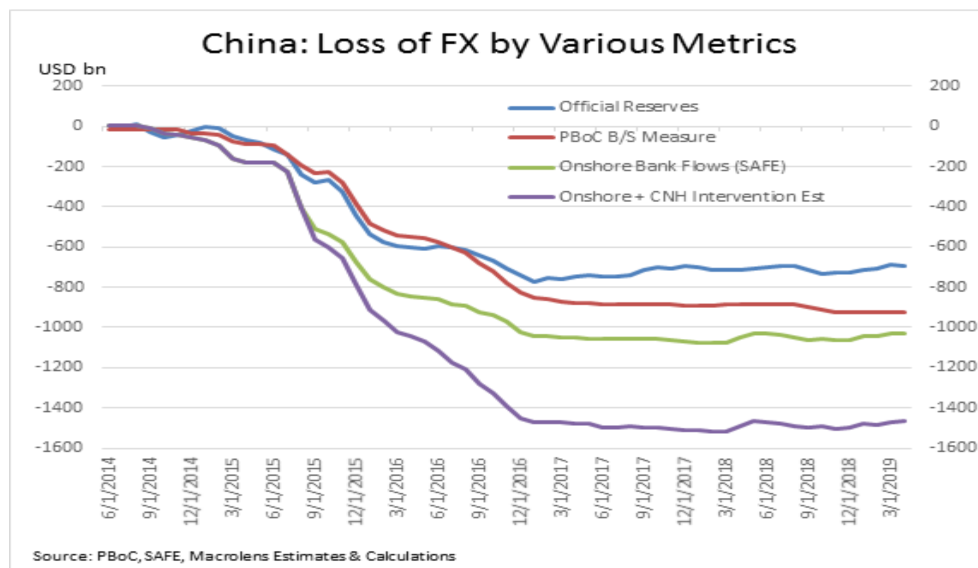
A slowing of the flow of Dollars into China threatens economic dislocation and even market panic.

Conclusions

- FX Quotas: Balance of Payments stability is occurring by administrative fiat
- The CNH market is "on an island" – funding costs highly unstable
- Ring-fencing FX reserves risks systemic credibility
- Watch export FX conversion levels - not the capital flow balance - for signs of systemic stress

APPENDIX: A $700bn "Hole" in the FX Reserve?

Some useful esoterica on Chinese FX reserve activity…



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Since 6/1/14:

- The headline figure for FX reserves is down ~$684bn
- The PBoC Balance sheet measure of reserves is down $922bn
- Bank transaction data in onshore FX shows net USD sales of $1.01T
- Adding an estimate of offshore (CNH) Dollar sales yields a figure or $1.45T

The $238bn gap between the two official measures (blue and red) stems primarily from the realization of investment gains.

For example, if PBoC sells $1b face of an aged Treasury Bond at a market price of 110 and rolls the proceeds into $1.1bn face of a new issue at par, *reported reserves would increase by $100m*. The PBoC balance sheet entry for FX reserves – a book value measure – would not however.

This is why I favor the less-widely followed PBoC balance sheet measure of reserves to monitor PBoC activity on a monthly basis. Changes in this book-value measure are purely reflective of intervention activity.

The $238bn gap between the headline reserve figure (blue) and the PBoC balance sheet measure (red) is reflective of the "harvesting" of unrealized gains to flatter the FX reserve figures. What we don't know is whether PBoC was carrying net gains on the books to begin with, or whether they've simply been turning over the winners to artificially flatter the reserve figures and now carry a book with sizeable net losses. The next gap which requires an explanation is between the red line (the cleanest representation of the flow rate of PBoC Dollar sales) and the green and purple lines – estimates of the flow rate of Dollar sales done by banks on PBoC's behalf in the onshore market and in total, respectively.

SAFE provides monthly data on the onshore activity of FX banks which show roughly $100bn in net Dollar selling in excess of what is revealed by the PBoC balance sheet. If we add an estimate for the heavy intervention in the offshore FX (CNH) market, **the total sales by banks exceed the loss of PBoC reserves by over $500bn**.

Where did this $500bn come from? No one knows for sure (Brad Setser at CFR argues, unconvincingly in my view, that Chinese banks ran down hidden net Dollar assets). I on the other hand start from a simple premise: banks don't run large FX funding mismatches. It is implausible that Chinese state banks had been running a net $500bn long Dollar position prior to 2014 (which would generated billions in losses).

If Chinese state banks were "flat USDCNY" into 2014, where did they get the extra $500bn that didn't come from PBoC? There was no sign of them liquidating Dollar assets on this scale.

Many contend (and I tend to agree) that **Chinese State banks are carrying several hundred billion in short-USD forward positions** on behalf of PBoC (either on a "handshake" agreement or papered via off-balance sheet forward agreements).

It's plausible that China's FX reserve portfolio has a $500-700bn "hole" in it stemming from net unrealized portfolio losses and a large short-forward exposure to State-owned banks.

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