Asian FX Focus: RMB

Stealth depreciation

Currencies
Mainland China

- The recent decline in USD-RMB has been more subdued than in 3Q24
- Corporates' FX sales are smaller this time around and there are still large portfolio outflows by residents that offset inflows
- The RMB's underperformance – a decline in the CFETS RMB index – helps to alleviate the impact of tariffs

Some recent developments in the financial markets remind us of August-September 2024 – a retracement of "US exceptionalism" and a reversal of DXY strength, accompanied by some pockets of improvement in China's growth outlook. But against this similar backdrop, the RMB has not been able to relive its strength in 3Q24. USD-RMB has dropped 1.4% from the January peak, compared with a c3.5% drop in August-September 2024 (Chart 1). The RMB's underperformance against other major currencies has also been evident in a c3% drop in the CFETS RMB index (Chart 2). We believe this is appropriate as the RMB faces more tariff-induced depreciation pressure than other major currencies. The SAFE's cross-border flow and FX settlement data for February shows more clearly why the flow picture has not been as rosy as August-October 2024 (Chart 3).

Corporates have been reluctant to sell USD. They sold USD14bn in January and USD17bn in February for their net export proceeds, much lower than the single-month average of USD49bn between August and October 2024. Divided by the large trade surplus, we estimate that **the net FX conversion ratio by exporters dropped to 18% in the first two months of 2025, compared with 55% in August-October 2024 or the 2024 full-year average of 30% (Chart 4).** Exporters' FX sales were insufficient to cover FX demand for services and income deficit at USD18bn in February, even though the demand dropped from an off-season spike of above USD30bn per month in December and January. Considering heightened tariff concerns, corporates may be thinking about retaining USD for future supply chain reconfiguration.

Improved sentiment regarding China's growth prospects, especially its tech innovation, has resulted in more balanced portfolio flows (after months of outflows, Chart 5), but the net inflows remain smaller than in September 2024. Recent focus has been given to mainland investors' record-high outflows through the Southbound Stock Connect (USD16bn in January, USD20bn in February, and USD14bn in the first half of March, Chart 6). This is because of **H-shares' outperformance over A-shares** (Chart 7). However, SAFE data revealed that there were probably inflows from foreign investors too: there were USD2bn worth of net inflows (denominated in both FX and RMB) for the purpose of portfolio investments in February, for the first time since September 2024 (USD20bn), and following large net outflows in October-January (USD114bn).

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Morningstar data (a subset of total flows, Chart 8) suggested about USD3bn worth of foreign inflows into Chinese stocks (including A shares, H shares, and ADRs) during the four weeks ending 28 February, after persistent outflows between November 2024 and January 2025 (USD7bn). That said, foreign investors still seem divided regarding China's recovery, particularly against the backdrop of rising trade uncertainties. In contrast, in late September – early October 2024, there was expectation for large stimulus. Back then, the Morningstar data showed USD10.5bn of inflows in total. Moreover, this time around there were large net purchases of onshore bonds (USD10bn).

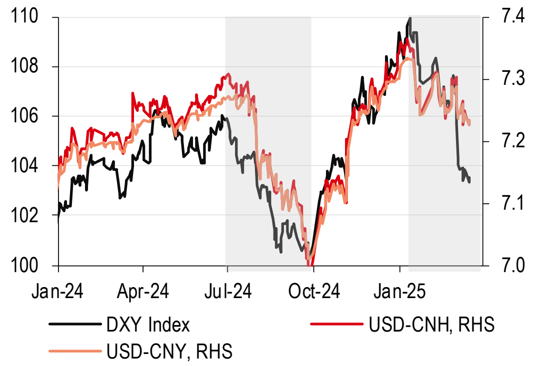
Overall, despite a retracement in the DXY index, SAFE's flow data suggests that tariff-induced growth concerns may have caused reluctance among corporates in increasing their FX conversion and kept investors more cautious about making broad-based onshore investments. Consequently, even though there has been a narrower imbalance between FX demand and supply (to USD7bn of net FX demand, after a sizable deficit of USD39bn in January), it remained far from the monthly net FX sales average of USD20bn between August and October 2024 (Chart 3). To meet the market's net FX demand, banks have likely continued to sell USD, evident in another USD21bn drop in banks' "FX purchase position" (to a low level of around USD40bn), together with USD9bn in the PBoC's FX assets as well. The large decline in FX assets in February may be related to the maturing of short FX forward positions.

From the PBoC's perspective, its policy reaction to the weaker DXY shows a clear preference for a stable USD-RMB and RMB underperformance on a basket basis. Despite a drop in the DXY by more than 5% since US President Trump's inauguration on 20 January, the **USD-CNY fixing remains in a tight range from 7.1688 to 7.1745 (Chart 10).** The authorities have likely dialled back other support for the RMB, which is reflected in a convergence of onshore and offshore swap points. The onshore forward curve has steepened and narrowed its basis with levels implied by interest rate parity amid a likely culling of banks' short USD-RMB forward positions (Chart 11). In the offshore market, CNH funding has loosened quickly after CNH-CNY basis narrowed (Chart 12).

We think this is appropriate as China has been more exposed to tariff risks than many other economies so far. The EUR and JPY – which combined account for 26.5% of the CFETS basket, versus the USD's 18.9% – have both appreciated about 4% against the RMB year-to-date. **The RMB index has fallen by some 3%. This is in-line with our estimate of the theoretical depreciation required to offset the impact of the additional 20% tariffs** imposed by the US (see *RMB: Doubling down on tariffs*, 14 March 2025).

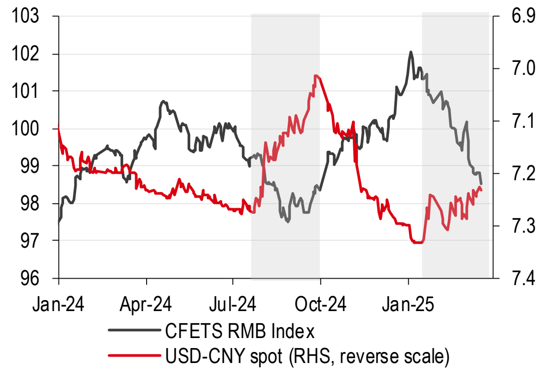
But if there are potentially more tariffs ahead, we doubt that China can keep relying on EUR and JPY strength to generate a further decline in the CFETS RMB index. While we have moderated our expectations for DXY strength to end-2025, we still expect the USD to recover later against the EUR and JPY on the back of higher yields, subdued global economic fundamentals and tariff risks, and assuming more supportive growth policies in the US (see *Currency Outlook, Seismic shifts*, 14 March 2025). Even though we believe the Chinese authorities have their own motivations for keeping USD-RMB reasonably stable, some moderate adjustment may be warranted to alleviate the impact on exporters if there are more tariffs. **We have therefore retained our year-end forecast for USD-RMB at 7.40.**

1. USD-RMB has not followed the recent retracement in DXY strength as it did in 3Q24



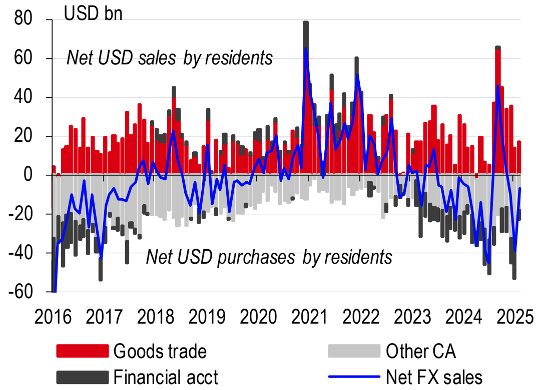
Source: Bloomberg, HSBC

2. RMB's underperformance against the EUR and JPY led to a drop in the CFETS RMB index



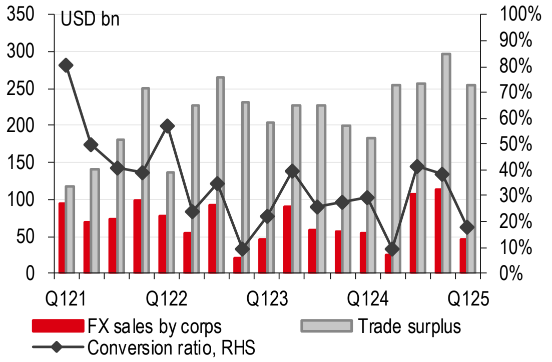
Source: Bloomberg, HSBC

3. Net FX purchase narrowed amid the recent DXY retracement



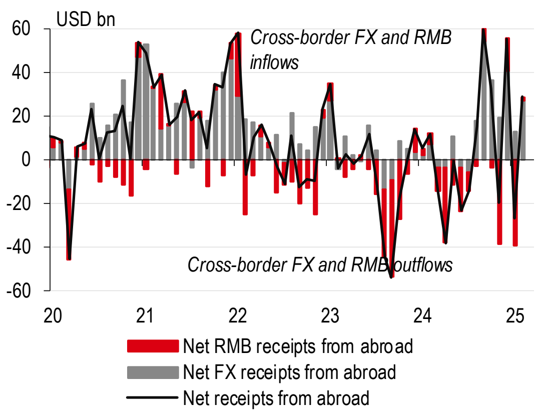
Source: CEIC, HSBC

4. Corporates remain reluctant to sell USD from their export proceeds



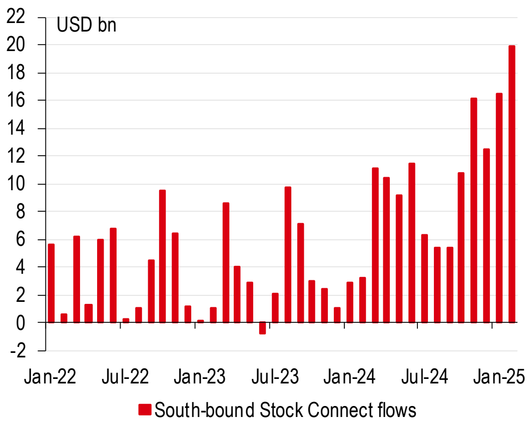
Note: Q125 data are estimates based on January and February data. Source: CEIC, HSBC

5. February showed net cross-border inflows of USD29bn on the back of portfolio inflows…



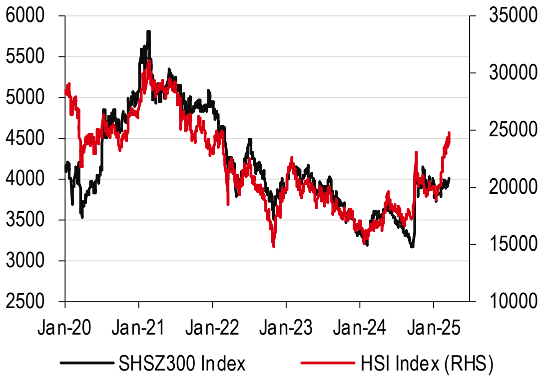
Source: CEIC, HSBC

6. …even though outflows in the Southbound Stock Connect continued to make new highs



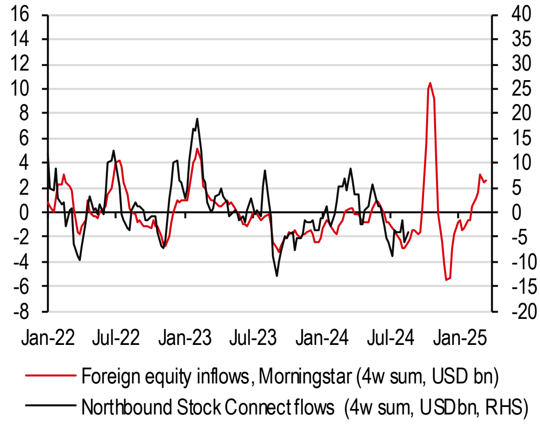
Source: CEIC, HSBC

7. The Hang Seng Index has rallied 23% year-to-date, versus a 1.8% increase in CSI 300



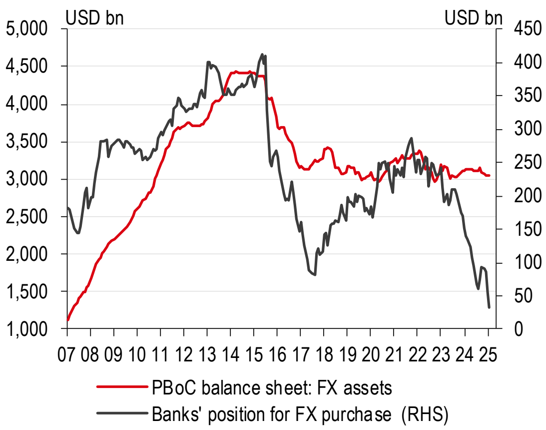
Source: CEIC, HSBC

8. The size of equity inflows is not comparable to the stimulus-triggered rally in Sep 2024



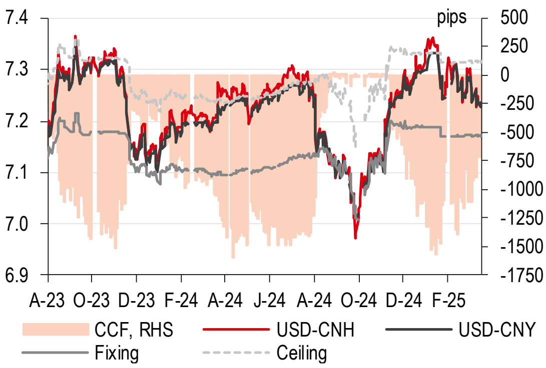
Source: Morningstar, Bloomberg, HSBC

9. Banks likely further sold USD in February to meet residents' continued net USD demand



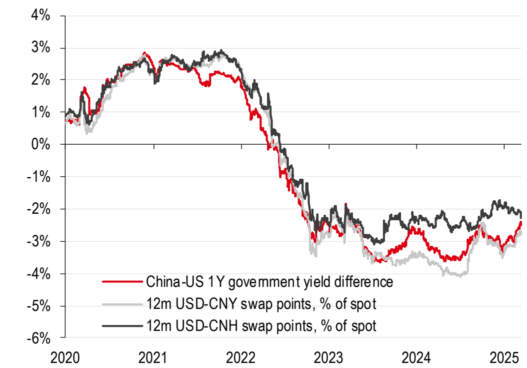
Source: Morningstar, CEIC, HSBC

10. USD-CNY fixing remains in a tight range (7.1688 to 7.1745) since President Trump's inauguration



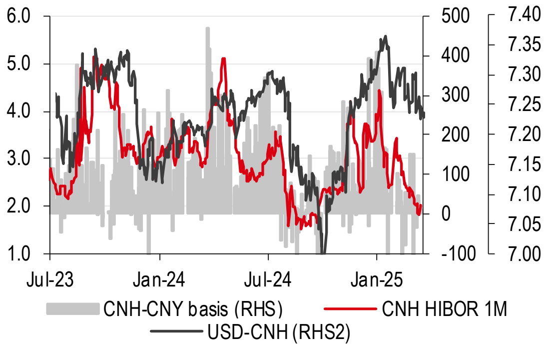
Source: Bloomberg, HSBC

11. A convergence of onshore and offshore swap curves suggests that banks have likely rolled less short USD-CNY forwards



Source: Bloomberg, HSBC

12. CNH HIBOR has dropped quickly as narrower CNH-CNY basis reduced CNH T/N point intervention



Source: Bloomberg, HSBC

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