



China: CNY rubber-stamped

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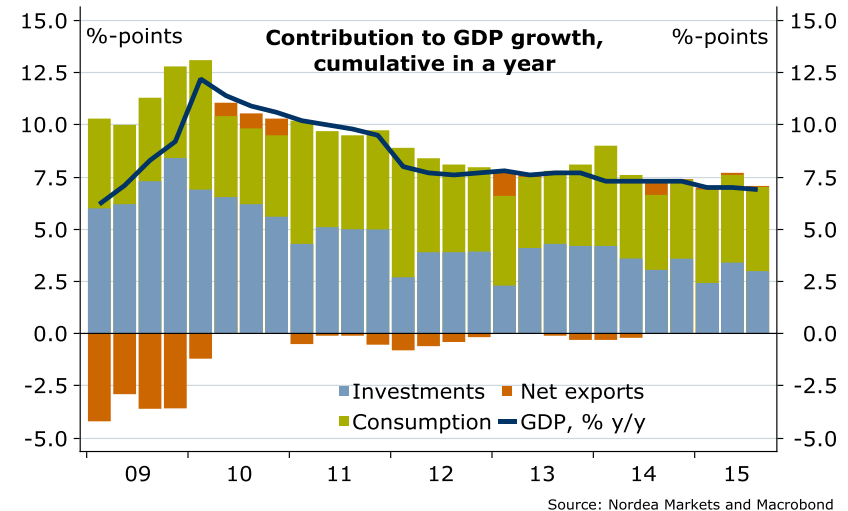


Executive summary

- In late November, **the IMF has rubber-stamped the CNY as the next reserve currency by including it in the Special Drawing Right (SDR) basket**, effective from October 2016, which until now only consisted of USD, EUR, JPY and GBP.
- It is an important milestone to achieve for China's financial reform and the currency internationalisation. The direct benefit immediately would be symbolic. But over time and in the longer term, China would likely gain larger influence in the global financial markets. **The implications will also be positive for most other players** but also only in the medium to long term, as global investors will take time to adapt to China's larger and deeper financial markets.
- **The CNY will be kept stable in the short term** of 3 months, before **weakening later next year** driven by market forces. **In 2017, the CNY may likely strengthen** vs the USD on increased demand from global central banks, which start holding the currency in their portfolios as a result of the SDR inclusion.
- Apart from the news on the CNY, most macro data continued to be weak and paint a subdued picture for Chinese growth. We maintain our long-held view **that the economy will trending downwards but no growth collapse is likely in the coming year**, due to supportive economic policies and the housing recovery.
- We also still remain **sceptical that indicators such as power consumption and rail freight volumes should be used solely** to reflect China's growth situation.

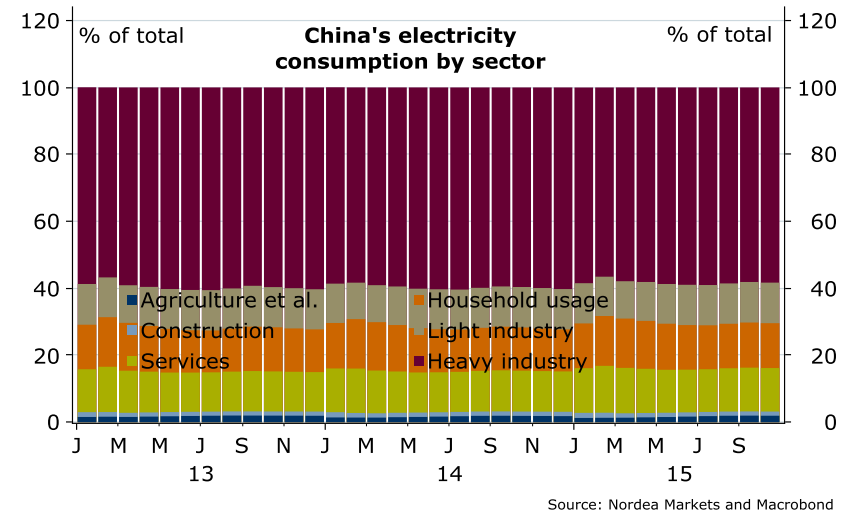
Lower growth is undeniable

- Despite weak macro data in October and likely also in November, and the increasingly popular view that the Chinese economy has already hard landed, we see a very small chance for a collapse in the near term. The economy is most likely to trend downwards gradually in the coming two years.
- The economy faces downward pressure that comes from the industry-to-service sector transition.
- However, economic stimulus through credit and investment is there to avert any shock to growth. These stimuli will prove less and less effective to maintain very high growth and they create large risks for the medium-term outlook, but in the coming two years, they are still useful to contribute positively and provide a floor for growth.



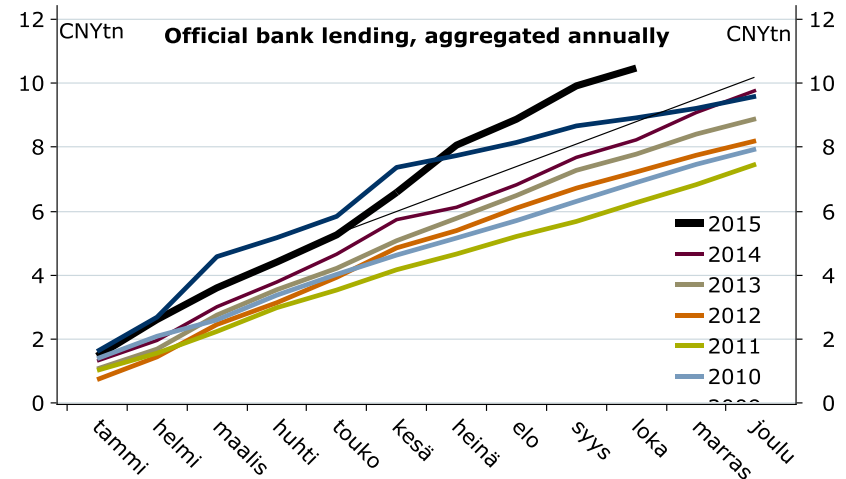
Why Chinese economy has not yet collapsed

- There is little dispute about the downward trend in Chinese growth. But we find the currently popular view about an already collapsed economy in China to be unjustified.
- One of the most used indicators to argue for much lower growth in China is rail freight volumes, which have collapsed and suggested only 5% GDP growth now. A limitation to this argument is that rail freight in China is skewed to mining. Coal accounts for 50-60% of the total freight tonnage. Ores and minerals for another 20%. Given mining is the mostly struggling sector now, plunging freight volumes are hardly surprising.
- Another popular alternative growth measure is power consumption but heavy industry uses 60% of the power. So falling power consumption could reflect struggling heavy industry and not the whole economy.

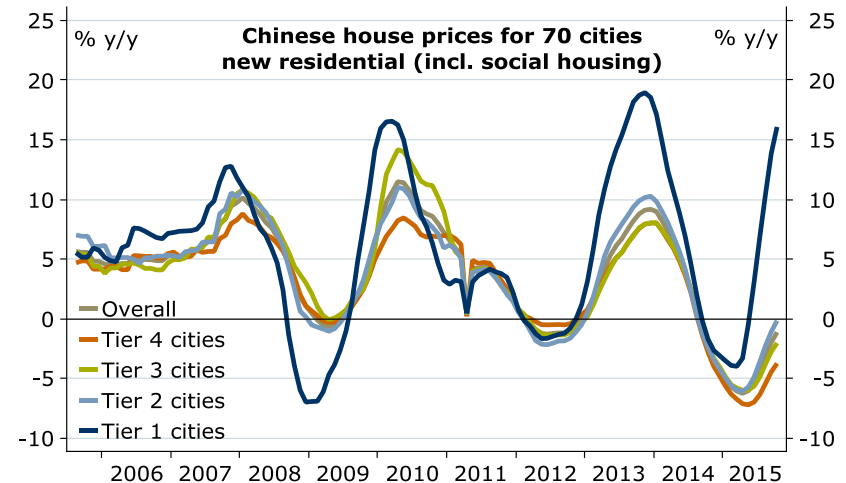


Relying on the “old normal” stimuli

- The two existing tailwinds driving the economy now will continue to support growth next year: loose economic policy and the recovering housing market.
- The PBoC has been pumping record amount of credit into the system at record-low interest rates. Given the persistently weak macro data, we expect one more rate cut of 25bp in the coming three months and two more RRR cuts before June 2016.
- Also fiscal stimulus has been used. General government spending rose nearly 30% y/y. The spending went mostly to infrastructure investment such as building transportation.
- The housing market recovery is likely to last at least H1 2016. The regulation is expected to tighten during the summer but the market will not lose steam before 2017.



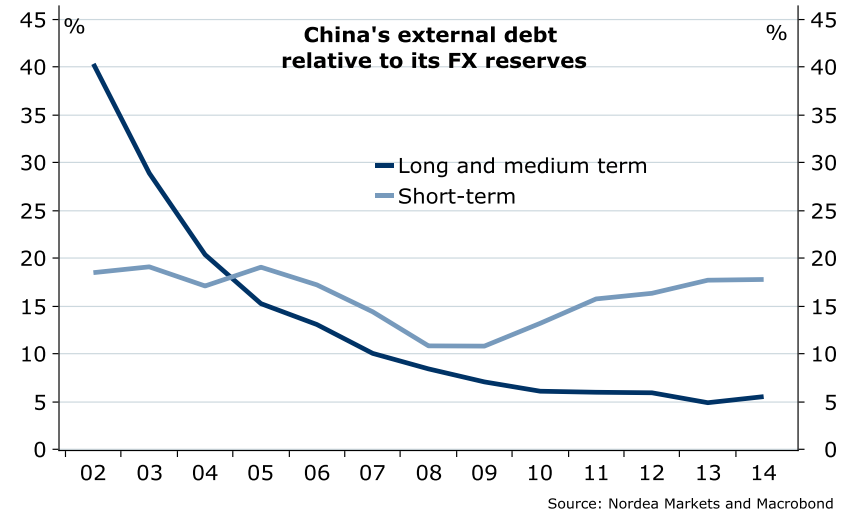
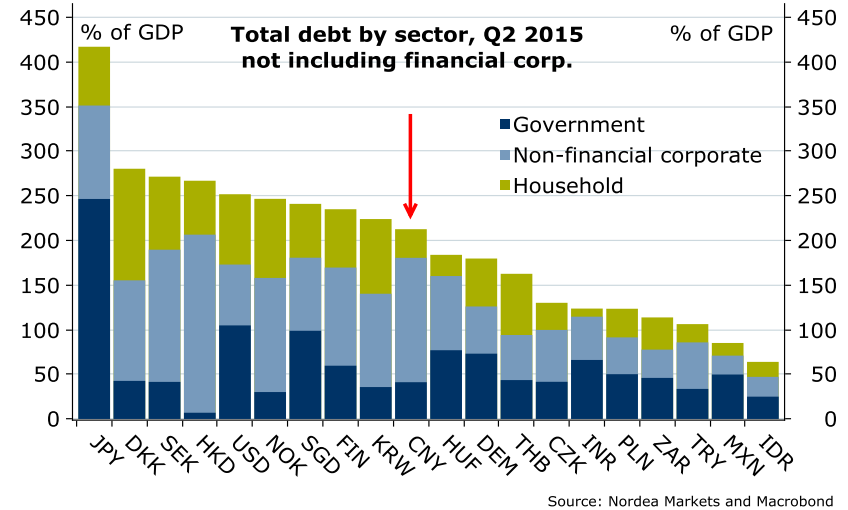
Source: Nordea Markets and Macrobond



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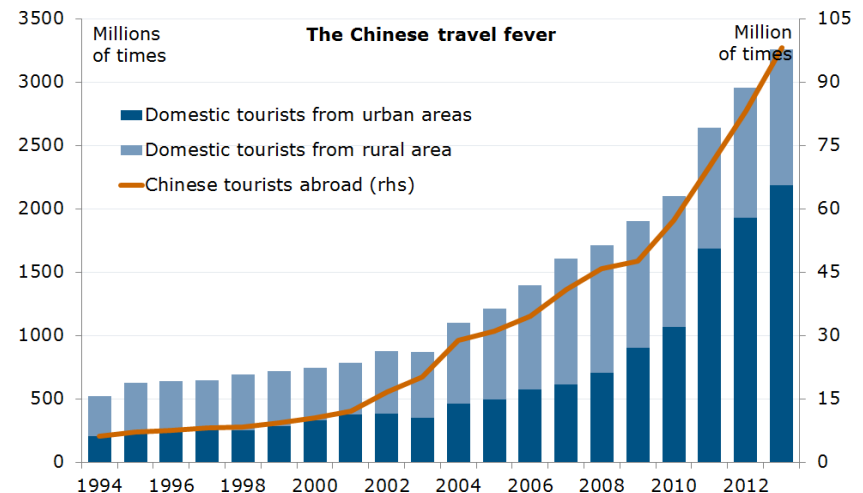
Domestic credit is worrying, not external debt

- A Lehman-alike debt crisis is our largest concern for China. If the credit bubble bursts, the Chinese economy can probably not escape a hard landing.
- In Q2 this year, China's total debt (according to data from BIS and IMF) rose to 234% of GDP. Most debt is from non-financial corporates, which are mainly state-owned enterprises (SOEs) in the heavy manufacturing.
- This part of the domestic debt is worrying because many of these companies have seen sharply falling profits, if outright losses. Their repayment ability is questionable. Banks have been implicitly forced to keep rolling over these debt to keep down the overall NPL ratio.
- Although China is seeing rising short-term external debt, it faces little external debt risk, thanks to its huge FX reserves.



“New normal” drivers are emerging

- Although the “old normal” stimuli are the forces in the economy at the moment, there are some encouraging “new normal” trends. These provide counterarguments for the view that the Chinese economy has collapsed.
- The Golden Week holiday (1 -7 Oct) provides good anecdotal evidence to the new China. According to official data, 527 million people took a holiday travel (including one-day trips) during these seven days, an increase of 11% from last year. Total tourist revenue rose 17% compared to the year before.
- Holiday travel is a good alternative indicator on consumer confidence and propensity to consume, because retail sales measure sales of all retail shops. So this data could potentially include small business purchases as well as households.

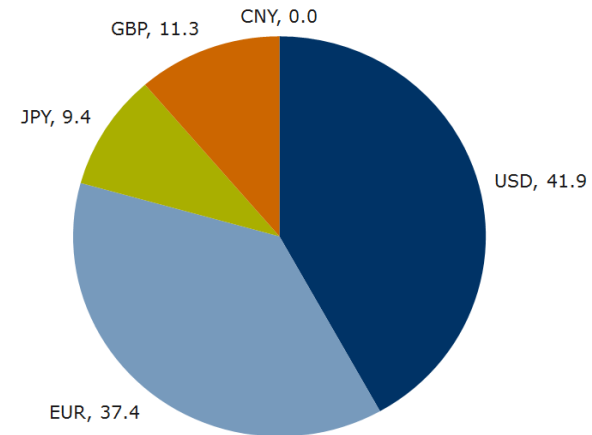


Source: China National Bureau of Statistics and Nordea

CNY rubber-stamped by the IMF

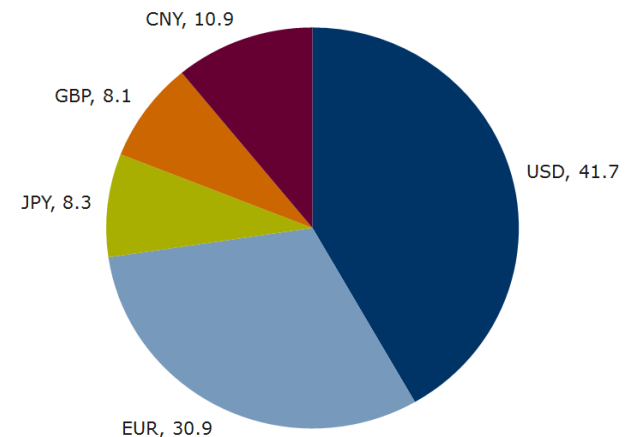
- On the 30th November, the IMF decided not surprisingly to include the CNY in the Special Drawing Right (SDR) basket, which also contains USD, EUR, JPY and GBP.
- The direct impact of this move is symbolic, as the CNY is now rubber-stamped by the IMF to become the next reserve currency.
- Indirectly, China will likely gain more influence in the global financial market, as asset managers will be attracted to hold more CNY assets. Being a reserve currency could also help China becoming a safe haven, lowering its offshore borrowing costs and mitigating capital outflows in case of external shocks. But all these positive implications will be visible in the long run and gradually over time.
- The EUR and the GBP have seen the largest drop in weight. However, no immediate implication is expected on these currencies.

The SDR basket currency weights 2011-2015



Source: Nordea Markets & IMF

The SDR basket currency weights 2016-2020



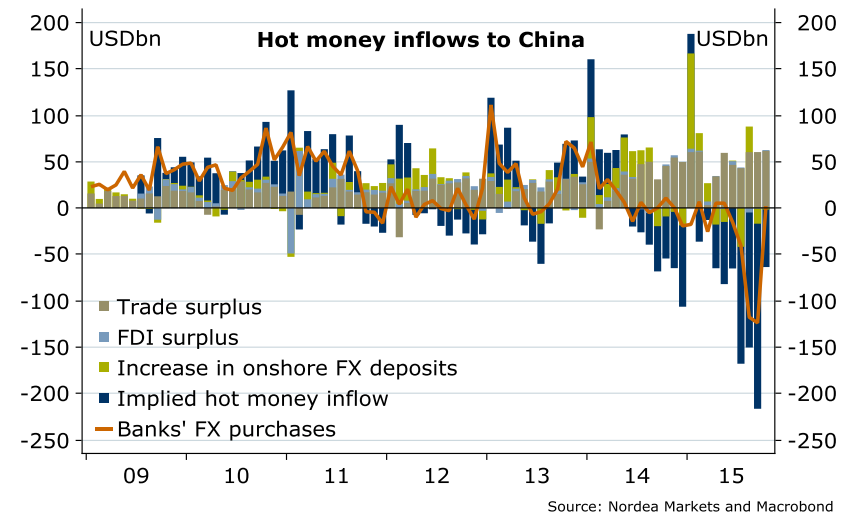
Source: Nordea Markets & IMF

China's efforts to meet IMF recommendations

- In early August the IMF released a document on its initial considerations about the SDR review. Specifically, it made a list of shortcomings of the CNY, which China has responded to with reform changes (in red). This has further increased the CNY's likelihood to be included, as China is an important global player and has demonstrate determination in opening up it financial markets.
 - 1) A market-based "representative" RMB rate, which refers to the daily fixing rate set by the PBoC. The IMF recommends to use the CFETS calculated benchmark exchange rates, about four times a day. *China's response was to change the fixing rate mechanism on 11 August.*
 - 2) The deviations between offshore CNH and onshore CNY. *We believe China has intervened to narrow the gap*
 - 3) Availability at European trading hours. *China's response was to extend the trading hours to 11.30pm local time (15.30 GMT) from 4.30 local time (8.30 GMT)*
 - 4) Greater access to the onshore equity and bond market. *China's response was to issue offshore RMB note in London. Shenzhen-Hong Kong stock connect will start this year*
 - 5) An appropriate interest rate that properly reflects the credit risk. *China's response was to remove the deposit rate ceiling and further liberalise interest rates*

CNY: inverted V movements

- Our forecasts for the CNY vs. the USD looks like a inverted V. Now that the SDR decision has been made, Beijing could allow for more weakening of the CNY, but only gradually and with small steps. Thus, currency intervention will remain in the coming months
- Later next year, intervention will slowly be scaled back (for both currency and equity markets), as IMF will continue pressuring China to give bigger role to market forces. In this case, the concern about continued falling growth in China and capital outflows will likely weaken the CNY vs the USD.
- In 2017 we expect the CNY to strengthen vs the USD because global asset managers will start demanding CNY-denominated assets. Beijing's latest aggressive moves to deepen and open up its equity and bond markets to foreign investors is a preparation for this.

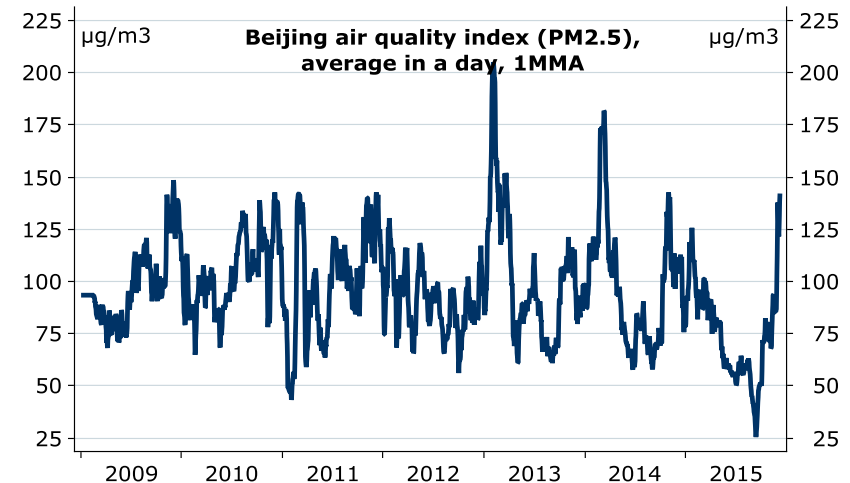


The return of the smog

- In early December, same time as the Paris Climate Summit, smog returned to Beijing, forcing the government to declare a red alert. It happened after two months with relatively good air quality.
- The World Health Organisation recommends the PM2.5 index to around 25 (at least below 50), a level that Beijing has almost exceed everyday in the past 7 years.
- In fact, half of the time during 2008 – 2015, Beijing had an unhealthy air quality, i.e. PM2.5 index between 151 and 200.
- The near-term outlook does not look good. The government has pledged to reduce coal's share of total energy consumption from currently 65% to 60% by 2020 and China's total CO2 emission will peak in 2030. These unambitious targets mean that it could get worse before it gets better.

Air Quality Guide for PM2.5

Index reading	PM2.5 health effects statement	Caution against outdoor activity
0-50	Good	None
51-100	Moderate	Unusually sensitive people
101-150	Unhealthy for sensitive groups	Active children and sensitive adults
151-200	Unhealthy	Active children and sensitive adults, while everyone should limit outdoor activity
201-300	Very unhealthy	Active children and sensitive adults, while everyone should limit outdoor activity
301-500	Hazardous	Everyone
>500	Beyond hazardous	Everyone



Source: Nordea Markets and Macrobond

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Thank you!

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