ECONOMIC REVIEW (A Monthly Issue) November, 2015

BANK OF CHINA (HONG KONG) LIMITED Economics & Strategic Planning Department http://www.bochk.com

The Trajectory of the Dollar and its Impact on RMB Internationalization

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Recently, the RMB has remained weak against the dollar. Even though the IMF deemed the RMB a freely usable currency and recommended it be included in the SDR basket, this favorable assessment did not reverse the weakness of the RMB. The depreciation of the RMB against the dollar has been largely due to dollar strength, which in turn resulted from expectation of the Fed hiking interest rates in December and Euro weakness. Looking ahead, as the dollar is likely to strengthen moderately, the exchange rate of the RMB may continue to be pressured, and RMB internationalization will be faced with new challenges.

I. A Fed rate hike in December almost a done deal

The U.S. economy continues to recover moderately and in 2015 will probably grow at a pace of 2.5%, slightly stronger than the 2.4% growth rate in 2014 and an average of 2.28% since the end of the financial crisis. In October, 2014, the Fed began to tighten monetary policy by terminating QE3. However, the Fed funds rate remained between 0% and 0.25%. In order to mitigate the distortion on financial markets caused by 7 years of zero interest rate policy, interest rate normalization should not wait any longer. Based on the following rationales, a Fed rate hike in December is probably a done deal.

First, the labor market's performance is one of the two policy goals of the Fed. In October, the U.S. non-farm payroll increased by 271,000, far greater than the consensus forecast of 185,000. Meanwhile, the unemployment rate dropped to 5%, a level considered full employment and a 7.5-year low. Overall, the U.S. labor market is clearly improving.

Second, inflation, another key factor in the Fed's decision making, will likely trend upwards. In October, CPI and core CPI rose 0.2% and 1.9% compared with the same period last year, lower than the Fed's 2% target. Among the components of CPI, shelter related costs account for about 42% of the weight, and home prices and rents continue to rise. More importantly, average hourly wages in October rose 0.4% compared to a month ago and 2.5% compared with the same period last year. Rising wages will translate into inflationary pressure soon.

Third, the Fed must initiate rate hikes to protect its credibility. The Fed has been strongly hinting at raising interest rates by the end of the year. The prospect of rising interest rates caused turbulence in global financial markets in August and September. However, given that domestic consumption remains a key driver of the U.S. economic recovery, the Fed will have to fulfil its promise and raise the Fed funds rate at the last FOMC meeting of the year.

Four, the majority of FOMC members support a rate hike. Prominent and influential figures such as Vice Chairman Fischer, New York Fed President Dudley have publicly called for early and gradual rate hikes.

Five, in the futures market, the implied probability of a December rate hike has soared to over 70%. Some institutional investors have begun to rebalance their portfolios, reducing their treasury holdings and buying dollars. Financial markets and the Fed appear to be on the same page.

II. Fed rate hikes and euro weakness will strengthen the dollar

A December rate hike will likely strengthen the dollar. Since 1990, the Fed funds rate and the dollar index have been closely correlated. From February, 1994 to 1995, the Fed funds rate rose from 3% to 6%. From 1999 to 2000, the Fed funds rate rose from 4.75% to 6.5%. From June, 2004 to June, 2006, the Fed funds rate rose from 1% to 5.25%. During each rate hike cycle, the dollar strengthened. After 7 years of zero interest rate policy, market expectation of Fed tightening will continue to push the dollar higher.

In the meantime, euro weakness will also lead to a stronger dollar. In the oft-quoted dollar index, the weights of the six currencies are as follows. The euro, the Japanese yen, pound sterling, the Canadian dollar, the Swedish Krona, and the Swiss Franc account for 57.6%, 13.6%, 11.9%, 9.1%,4.2%, and 3.6%, respectively. Due to the predominant weight of the euro, euro weakness will result in a stronger dollar.

The euro will likely keep trending downwards. The terrorist attack in Paris is bound to pressure the euro, although the exact impact is yet to be determined. Moreover, the Euro-zone economy remains sluggish, with third-quarter GDP growth coming in at 0.3%, weaker than the 0.4% growth recorded in the second quarter. While terrorism will damage the tourism industry, increasingly stringent border control may impede labor mobility and negatively impact the economy. To boot, the Volkswagen emission scandal will also reduce automobile sales. As for monetary policy, ECB President Mario Draghi has hinted at further easing measures in December. Therefore, the euro will remain weak, and the dollar will continue to be strong.

III. Dollar strength will be contained by the pace of Fed tightening

To gauge the trajectory of the dollar, the pace of tightening will be more important than the timing of the first rate hike. According to the dot plot released by the FOMC, the median fed funds rate will rise to 1.375% at the end of 2016 and 2.625% at the end of 2017. The pace of tightening implied by the dot plot will be considerably slower than previous rate hike cycles.

Due to the following rationales, the Fed's rate hikes will not only be slow but also rather limited.

When it comes to the pace of rate hikes, the Fed will probably take some time to gauge the impact of a December move. Therefore, the second rate increase will likely be delayed until March, 2016. Afterwards, the Fed may stay put till the presidential election is over in November, 2016. As a result, a third rate hike will not take place until the FOMC meeting in December of next year.

As for the debt load of the federal government, the latest debt ceiling agreement will raise the level of federal debt to 18.9 trillion dollars in 2017. Higher interest rates will inevitably increase the burden of debt service and risks of a default.

In the meantime, a strong dollar will negatively impact economic growth. The current expansion has been ongoing for 77 months and counting, and the next downturn is probably closing in. An overly strong dollar is likely to bring the U.S. economy closer to a recession.

Therefore, the Fed funds rate will probably rise to 1% in 2017 and stay there, and the possibility of rate cuts in 2018 cannot be ruled out. As a result, dollar appreciation will be fairly moderate but could last for two to three years.

IV. A strong dollar will challenge RMB internationalization in the short to medium term

The current environment is fairly conducive to RMB internationalization. The RMB is entering the final stage of being included in the SDR basket and, upon inclusion, will become a new engine of RMB internationalization. IMF member states will begin to hold RMB reserves and drive demand for RMB assets, as the RMB joins a select group of important reserve currencies. However, it should be noted that the benefits of SDR inclusion on RMB internationalization will be realized in the medium to long term, while the impact of a strong dollar on RMB internationalization will be felt in the short to medium term.

A strong dollar will challenge RMB internationalization in four channels. First, when the dollar rises, the RMB will be perceived by market participants as a weak currency against the dollar. Second, rising yields offered by dollar assets will continue to attract capital. Three, a rising dollar will pressure commodity prices, which makes it more difficult to launch RMB-denominated commodity futures products. Four, a strong dollar will increase the financial risks of emerging markets in general and the developing economies along the “one belt one road” in particular, making a smooth implementation of the strategy more difficult.

Among these impacts, the one development that market participants are most focused on is RMB depreciation against the dollar, for the following three reasons. First, it has been 10 years since the first exchange rate reform took place in 2005. However, the dollar remains a benchmark for the RMB’s exchange rate. A rising dollar due to interest rate normalization in the U.S. will weaken the appeal of the RMB as a payment currency and lead to market expectation of RMB depreciation against the dollar.

Second, one of the major policy goals of the U.S.’s strong dollar policy is to promote reindustrialization. In contrast, capital outflow and high property prices in China does not bode well for China’s manufacturing sector, as the real economy is starved of capital. Exchange rates hinge on economic fundamentals, and the challenges the Chinese economy is faced with in the short to medium term will reinforce market expectation of RMB depreciation against the dollar.

Third, it would be extremely difficult for the Chinese government to stabilize the equities, real estate, and foreign exchange markets perfectly. Under a strong dollar background, China’s economic and financial strategy may have to choose between asset price decline and RMB depreciation. Therefore, provided that financial stability is ensured, a prudently managed depreciation of the RMB against the dollar while undergoing two-way fluctuation could become an option.

Rising expectation of the RMB’s depreciation against the dollar has led to discrepancies in market perceptions. As a matter of fact, the RMB has been the second strongest currency next to the dollar. According to data released by the BIS, From January, 2014 to October, 2015, the RMB’s real effective exchange rate appreciated 6.5%. Since the first reform of the exchange rate regime in July, 2005, the RMB’s real effective exchange rate has strengthened by 60%. Nevertheless, the RMB has been perceived as a weak currency simply because of its depreciation against the dollar.

As a result, the willingness of some merchandize traders and investors to hold RMB has declined, impeding RMB internationalization. Long RMB positions have been curtailed in offshore centers, reducing the size of the offshore RMB capital pool. In September, 2015, Hong Kong’s RMB deposits dropped 8.5% to 895.4 billion Yuan, while Taiwan’s RMB deposits declined 2.26% to 332.3 billion Yuan. According to the HKMA, RMB deposits in Hong Kong continue to decline in October. Meanwhile, RMB’s market share as a payment currency declined from 2.79% in August to 2.45% in September, lower than the Yen’s share of 2.88%, with its ranking dropping from 4^{th} to 5^{th}.

主要經濟指標 (Key Economic Indicators)

一 . 本地生產總值 GDP	**2013**	**2014**	**2015/Q2**	**2015/Q3**
總量(億元) GDP($100 Million)	20,961	21,446	5,332	5,717
升幅(%) Change(%)	2.9	2.3	2.8	2.3
二 . 對外貿易 External Trade	**2013**	**2014**	**2015/9**	**2015/1-9**
外貿總值(億元) Total trade($100 Million)				
港產品出口 Domestic exports	544	553	36	359
轉口 Re-exports	35,053	36,175	3,132	26,270
總出口 Total exports	35,597	36,728	3,167	26,629
進口 Total imports	40,607	42,190	3,531	29,949
貿易差額 Trade balance	-5,010	-5,463	-364	-3,321
年增長率(%) YOY Growth(%)				
港產品出口 Domestic exports	-7.6	1.7	-13.8	-14.9
轉口 Re-exports	3.8	3.2	-4.5	-1.3
總出口 Total exports	3.6	3.2	-4.6	-1.5
進口 Imports	3.8	3.9	-7.6	-3.0
三 . 消費物價 Consumer Price			**2015/10**	**2015/1-2015/10**
綜合消費物價升幅(%) Change in Composite CPI(%)	4.3	4.4	2.4	3.2
四 . 樓宇買賣 Sale & Purchase of Building Units				
合約宗數(宗) No. of agreements	70,503	81,489	4,491	66,129
年升幅(%) Change(%)	-29.9	15.6	-43.6	-2.0
五 . 勞動就業 Employment			**2015/7-2015/9**	**2015/8-2015/10**
失業人數(萬人) Unemployed(ten thousands)	11.84	14.95	13.6	13.2
失業率(%) Unemployment rate(%)	3.4	3.2	3.3	3.3
就業不足率(%) Underemployment rate(%)	1.5	1.5	1.4	1.4
六 . 零售市場 Retail Market			**2015/9**	**2015/1-9**
零售額升幅(%) Change in value of total sales(%)	11.0	-0.2	-6.4	-2.7
零售量升幅(%) Change in volume of total sales(%)	10.6	0.6	-3.1	1.0
七 . 訪港遊客 Visitors			**2015/9**	**2015/1-9**
總人數(萬人次) arrivals (ten thousands)	5,430	6,077	456	4,442
年升幅(%) Change(%)	11.7	11.9	-4.0	-0.5
八 . 金融市場 Financial Market			**2015/8**	**2015/9**
港幣匯價(US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.4	775.6	775.1	775
貨幣供應量升幅(%) change in Money Supply(%)				
M1	9.7	13.0	17.6	20.3
M2	12.3	9.5	6.0	4.9
M3	12.4	9.6	5.9	4.9
存款升幅(%) Change in deposits(%)				
總存款 Total deposits	10.6	9.7	8.2	7.5
港元存款 In HK$	5.1	9.3	10.8	10.8
外幣存款 In foreign currency	16.2	10.1	5.7	4.3
放款升幅(%) in loans & advances(%)				
總放款 Total loans & advances	16.0	12.7	6.4	4.9
當地放款 use in HK	13.8	12.1	4.0	2.6
海外放款 use outside HK	21.4	14.2	12.2	10.4
貿易有關放款 Trade financing	43.8	-1.4	-16.9	-20.7
最優惠貸款利率(%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恒生指數 Hang Seng index	23,306	23,605	21,671	20,846