AT A GLANCE | China

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Yuan's Depreciation Continues Even as Economy Begins to Bottom Out

Senior Economist: Yuji Ono

Emerging Asian currencies are falling against the dollar as U.S. long-term interest rates rise. If we look at the gains and losses since the beginning of the year, we can see that the currencies of major Association of Southeast Asian Nations (ASEAN) countries are generally weak, but even more so is the depreciation of the yuan. One of the reasons for the yuan's weakness is concern about the future of the Chinese economy, and outflows by foreign investors have been particularly pronounced since 2022, when the economy stalled due to strict zero-coronavirus policies and tighter property regulations.

On the other hand, the recently announced real GDP growth rate for July-September 2023 was +4.9% year over year, exceeding market expectations (+4.5%). Of course, there is still a lot of room for acceleration compared to the potential growth rate, but with the economy continuing to recover, it is fair to say that the economic recovery commenced in the July-September quarter, albeit slowly.

In this report, we summarize the bottoming out of China's economy from the latest economic data, and then look at the environment surrounding the yuan and its future trends.

In conclusion, while the economic recovery is expected to continue moderately, the upward pressure on the yuan is expected to persist. This is because there are many factors other than the outlook for the Chinese economy that make investment in China less desirable, such as differences in monetary policy stance between the United States and China and the trend of supply-chain restructuring.

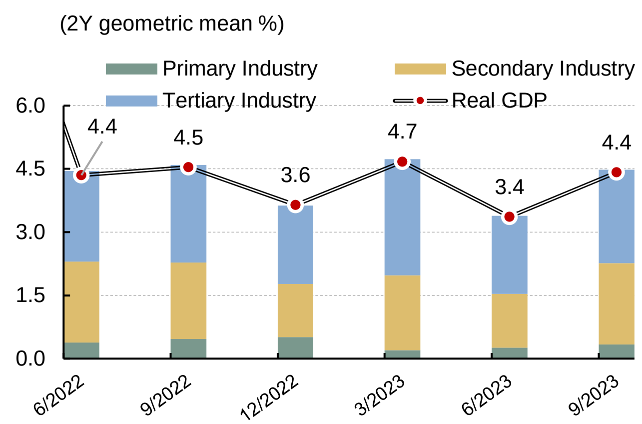
China's Economy Began Bottoming Out in July-September 2023

Real GDP grew 4.9% year over year in the July-September 2023 quarter (forecast: +4.5% YoY, +6.3% YoY in the April-June 2023 quarter), beating market expectations. Although the rate of growth has slowed compared to the previous fiscal year, which saw a large increase due to the backlash after the city lockdowns in the April-June period of 2022, the geometric mean for the period of July-September has increased by 4.4% from the previous fiscal year (up 3.4% from the previous fiscal year), which shows an acceleration from the previous fiscal year (Figure 1). Overall growth was driven by growth in the tertiary sector (up 5.2% year over year), partly due to strong consumption of accommodation and food services during the summer holiday season.

The seasonally adjusted quarterly figure for the April-June quarter was revised down, and the figure for the July-September quarter was up 1.3% year over year (+5.3% annualized) from 0.5% in the April-June quarter (+2.0% annualized).

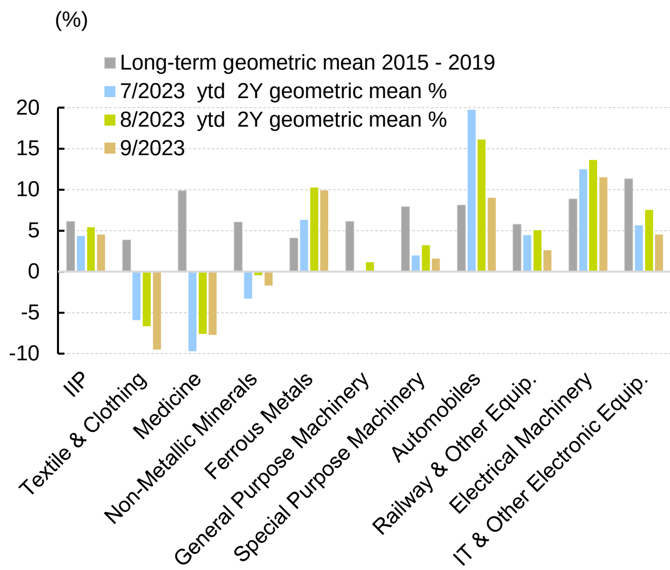
Production slightly exceeded expectations. In September 2023, industrial production increased 4.5% year over year (forecast: +4.4%, previous forecast: +4.5%), unchanged from the previous month, but accelerated to +5.4% on a two-year geometric mean basis (up 4.3% on the previous month) (Figure 2). If we examine the breakdown in terms of the two-year geometric mean growth rate, we note that the growth rate has accelerated from the previous month in many industries, and production of steel products, electrical machinery and automobiles has been particularly strong.

Figure 1: Real GDP Growth Rate (2-year geometric mean year over year)



Sources: NBSC, CEIC

Figure 2: Industrial Production (year over year by industry)



Sources: NBSC, Wind

Industrial production in January-September 2023 accelerated to +4.0% (January-August period: +3.9%), but the growth rate is still sluggish considering the long-term average (+5.5%) before the pandemic, and there is ample room for further acceleration.

Real estate remained a key investment. Although fixed asset investment in the January-September period of 2023 slowed down from the previous month to +3.1% year over year (forecast: +3.2%; previous forecast: +3.2%), the growth in September 2023 alone accelerated to +2.5% year over year (previous year: +2.0%) (Figure 3).

Infrastructure investment has remained stable due to government fiscal investment. In addition to electric machinery such as semiconductors and solar panels, business fixed investment in automobiles, which has seen strong sales including exports, also increased.

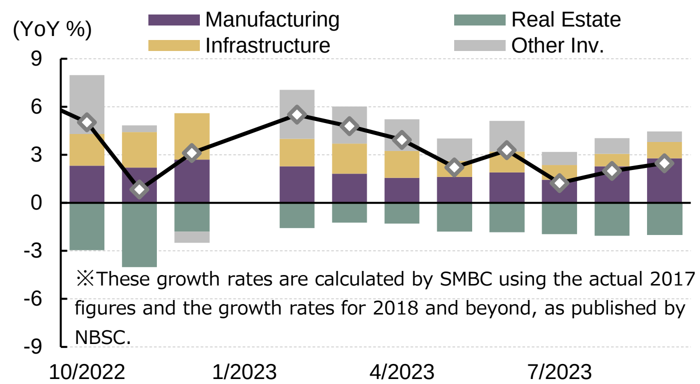
Real estate investment, on the other hand, has remained weak, despite lower interest rates due to monetary easing and government measures to support real estate. Even after the easing of real estate transaction regulations in September, housing starts have not increased due to sluggish sales of new properties. Therefore, it will take a reasonable amount of time for real estate investment to recover.

Consumption grew faster than expected, but the recovery slowed slightly. In September 2023, retail sales increased 5.5% year over year (forecast: +4.9%; previous forecast: +4.6%), accelerating from the previous month. However, the geometric average for two years increased 4.0% year over year (previous year: +5.0%), decelerating from the previous month (Figure 4), indicating a rebound in consumption during the solid summer holiday season.

By category, growth in car-related goods was higher than the long-term average, but growth in lodging and dining services, which were strong in August, slowed. Consumption of the National Day holiday in October remains weak, with the number of tourists falling short of initial expectations, although the unit cost of consumption has recovered significantly.

The growth rate is expected to increase on the back of measures to support the consumption of goods through consumption vouchers and other means, as well as policies such as support for automobile sales through the reduction of the down payment ratio for automobile loans. However, stable income growth will be indispensable for autonomous consumption expansion.[1]

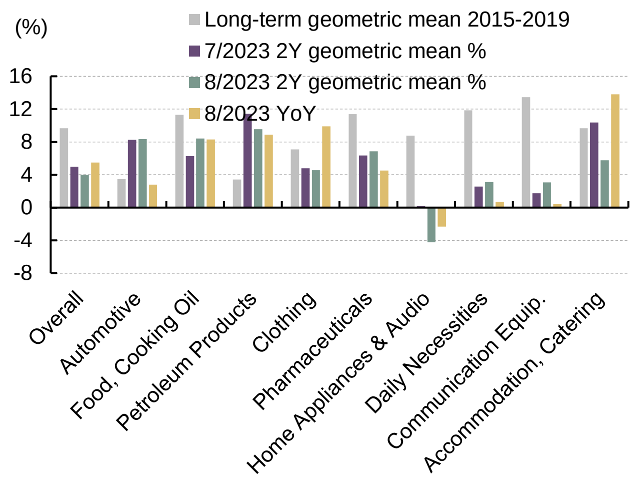
Figure 3: Investment in Fixed Assets (monthly, YoY)



*The latest investment in real estate is estimated by our bank.

Sources: NBSC, Wind

Figure 4: Retail Sales (YoY)



Sources: NBSC, Bloomberg, SMBC

The urban unemployment rate fell to 5.0% (forecast: 5.2%, 5.2% in the previous month) in September from the previous month (Figure 5). Although the unemployment rate of foreign registered workers, including peasant workers, has risen, the unemployment rate of young people has fallen seasonally, and the unemployment rate of those who want to work at their registered domicile has fallen. However, the average working hours also increased to 48.8 hours/week from 48.7 hours/week in the previous month and remained high, suggesting that there is no change in the trend of companies responding to demand by extending the working hours of existing employees rather than by hiring new employees.

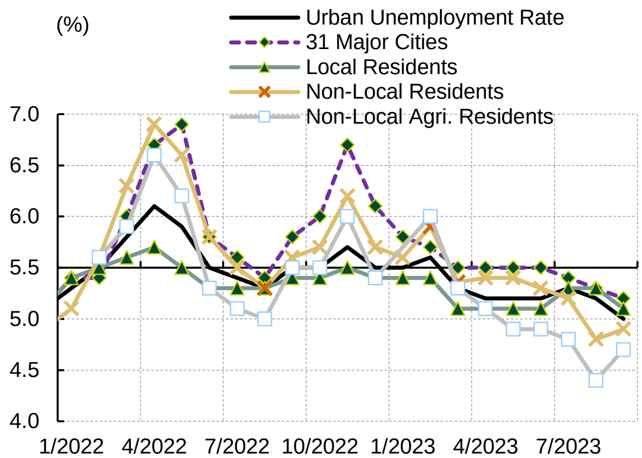
Amid this employment environment, the two-year geometric average of nominal disposable income in the July-September period of 2023 improved to +6.2% (April-June period: +5.5%) from the previous year, but the growth was still sluggish compared to the long-term average, and we expect further improvement.

Weak stock prices and falling housing prices have slowed the growth of asset management income, raising concerns about adverse asset effects, particularly among the wealthy. However, we can note that the growth of self-employed business income and salary income, which are mainly sources of income for the low- and middle-income groups with a high propensity to consume, has accelerated.

In light of the above, it is safe to assume that the July-September quarter marked the beginning of a gradual economic recovery. In response to the economic data for the July-September period, the growth forecast for the Chinese economy in 2023 was revised up to +5.2% from the previous forecast of +5.0% year over year.

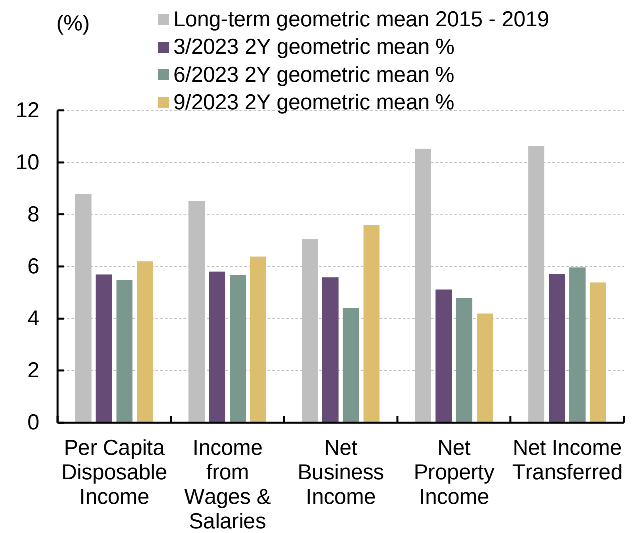
1 The minimum down payment ratio is currently 20%, but on October 11, 2023, the government notified that it would be lowered and that the loan term would be extended (https://www.yicai.com/brief/101872721.html).

Figure 5: Unemployment Rate



Sources: NBSC, Wind

Figure 6: Personal Nominal Disposable Income (2-year geometric mean year over year)



Sources: NBSC, CEIC

Factors Leading to the Dollar's Appreciation

The beginning of the economic downturn is a source of support for the yuan, but could this be a factor in reversing the depreciation against the dollar? Unfortunately, with persistent downward pressure on the yuan, China's economic factors alone will not be enough to reverse the trend.

Originally, the exchange-rate threshold (less than or equal to the reference value) announced by the yuan is set almost mechanically by taking into account the previous day's closing price of the yuan and the overnight movements of the currency basket set by the People's Bank of China (PBOC).[2] As a result, when the yuan depreciates at the prevailing exchange rate, the benchmark value on the next business day shifts accordingly, and the prevailing rate of the yuan has rarely been close to the upper limit of the allowable fluctuation range since the implementation of the reform to market the benchmark value in 2015.[3]

However, the latest movement of the yuan shows that since August 2023, the dollar/yuan rate has been around the upper limit of the allowable range of intraday trading (Figure 7).

Since the reform of the exchange-rate reference value in 2015, the actual exchange rate deviated significantly from the reference value and came close to the permissible fluctuation range after the authorities introduced the Counter Cyclical Factor (CCF) into the calculation formula of the reference value in May 2017 in order to manipulate the reference value arbitrarily. After that, until the PBOC officially announced the abolition of the CCF in 2021, the CCF was set when the yuan's depreciation pressure intensified excessively, and the gap between the actual market price and the reference value often became large.

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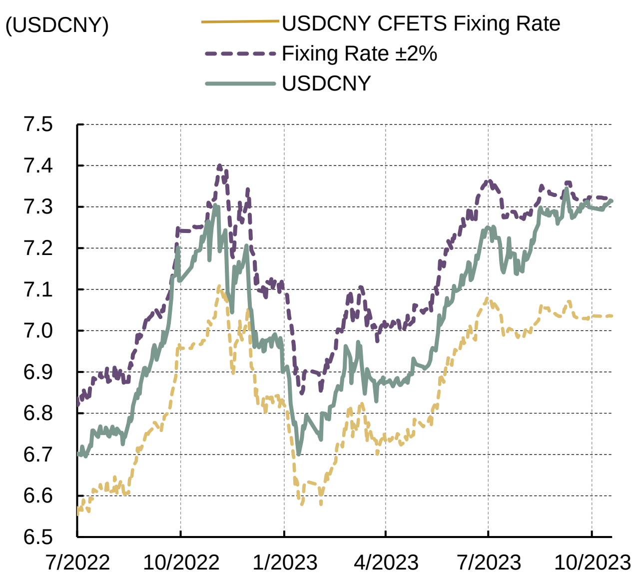
2 The currency basket consists of 24 currencies (USD, EUR, JPY, HKD, GBP, AUD, NZD, SGD, CHF, CAD, MYR, RUB, THB, ZAR, KRW, AED, SAR, HUF, PLN, DKK, SEK, NOK, TRY, and MXN). The weighted average of these weights, published annually, is the renminbi index, which corresponds to the renminbi's nominal effective exchange rate.

3 The yuan can only trade intraday within a 2% range above or below the PBOC's daily 10:15 (JST) threshold.

Although there has been no official statement that the CCF has been reintroduced since 2022, it is fair to assume that the CCF has been effectively reintroduced because there is a large discrepancy between the theoretical reference value determined by mechanical calculations that do not take into account the CCF and the official reference value.

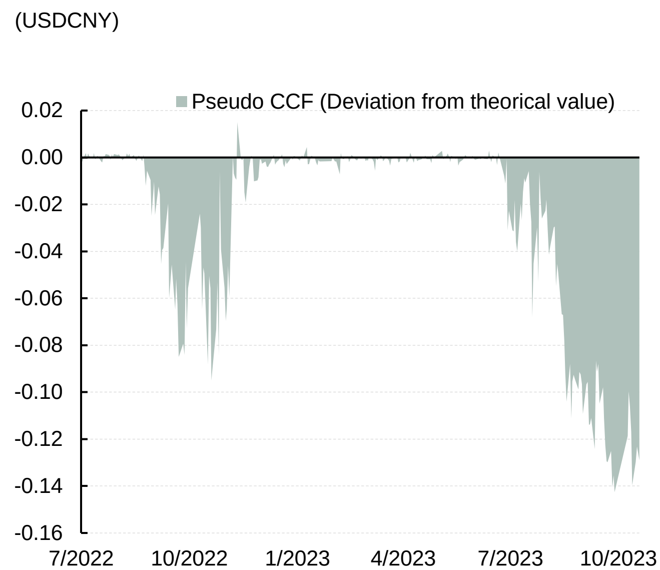
Based on the discrepancy between the theoretical standard value and the PBOC published standard value, the latest CCF setting situation is estimated (Figure 8), and it can be confirmed that the largest setting has been repeated since August 2023. This suggests that the yuan is under strong pressure and that the authorities are forcefully restraining the depreciation of the currency.

Figure 7: USDCNY and RMB Reference Values and Trading Thresholds



Sources: PBOC, Bloomberg, SMBC

Figure 8: CCF Estimates



Sources: PBOC, Bloomberg, SMBC

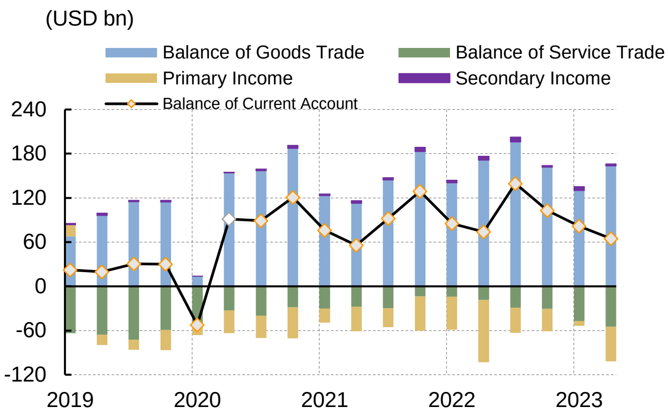
Behind the downward pressure on the yuan are a shrinking current account surplus and outflows of direct and securities investment.

Behind the contraction of the current account surplus is the expansion of the service deficit (Figure 9).

Although the reduction in the surplus in the goods balance is limited because imports of goods are also weak due to the slowdown in domestic demand, an increase in service imports due to travel has contributed to the reduction in the current account surplus. Even though the number of international flights has not yet returned to the pre-pandemic level, the travel deficit has increased, and the service deficit is expected to increase further as the number of flights increases.

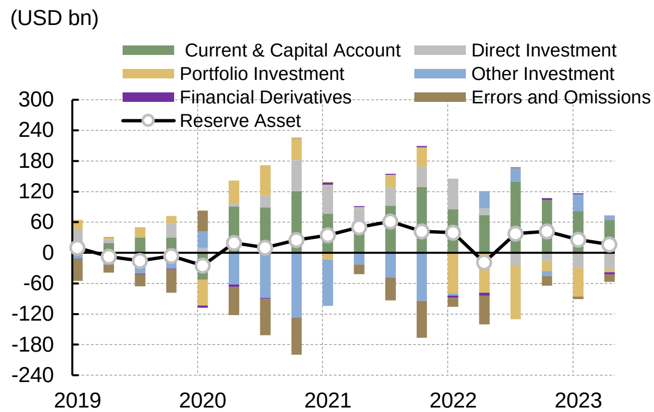
The reasons behind the outflow of direct and securities investment (Figure 10) include China’s economic outlook concerns, the rising policy risks of the Chinese government, the restructuring of supply chains due to the U.S.-China conflict, and the diverging stance of monetary policy between the United States and China.

Figure 9: Current Account Balance



Sources: PBOC, CEIC

Figure 10: Balance of Payments



Sources: PBOC, CEIC

With regard to direct investment, while there has been no significant change in foreign investment by Chinese companies, the amount of investment in China by foreign investors has significantly decreased.

This is due to concerns about China's economic outlook, as well as rising policy risks, such as the tightening of regulations on IT companies implemented by the Chinese authorities in 2021 and the non-profit-making of education-related companies. In addition, the move to "de-China" the supply chain, exemplified by the tightening of U.S. regulations on Chinese semiconductors, has begun to advance not only in the United States but also in Europe and Japan.

In terms of investment in securities, investment in Chinese stocks shrank, and foreign investors' investment in Chinese bonds, which had experienced an excess of inflows, outflowed.

Concerns about slowing growth in the Chinese economy due to worsening real estate market conditions led to a decline in investment in Chinese stocks. In addition, due to the difference in policy stance between the U.S. Federal Reserve, which is tightening monetary policy, and the PBOC, which is supporting the economy by strengthening monetary easing, the rise in U.S. interest rates and the fall in Chinese interest rates have simultaneously intensified, and Chinese bond investment by foreign investors, which had been in excess of inflows until 2021, has shifted to excess outflows since 2022. In addition, domestic investors have increased their purchases of foreign bonds, which also puts pressure on the yuan.

As described above, in addition to the Chinese economy, policy risks from the Chinese authorities, the "de-Chinazation" of the supply chain, and differences in the stance of monetary policy between the United States and China have caused pressure on the yuan to weaken.

Of course, if the U.S. economy starts to slow and the U.S. Federal Reserve starts to cut interest rates, the pressure on the yuan will ease and the yuan will gradually fall. However, it will be difficult to restrain the Chinese authorities from mitigating policy risks and restructuring supply chains, and even if the dollar/yuan rate starts to decline as U.S. interest rates decline, the pace will be slow (Figure 11).

Figure 11: RMB Outlook

	2023Q4	2024Q1	2024Q2	2024Q3	2024Q4
USDCNY	7.04-7.40	6.99-7.35	6.91-7.27	6.81-7.17	6.72-7.06
End of Quarter	7.26	7.17	7.09	6.98	6.89
CNYJPY	18.80-21.32	18.30-20.77	17.50-20.00	18.00-20.58	18.30-20.87
End of Quarter	19.97	19.53	18.76	19.34	19.59
(USDJPY)	138.00-152.00	133.00-147.00	126.00-140.00	128.00-142.00	128.00-142.00
(End of Quarter)	145.00	140.00	133.00	135.00	135.00

Source: SMBC

Economic Outlook: 2023-2024 Forecast

Figure 1: Forecasts for Economic Growth, Inflation, and Unemployment Rates

		2022			2023				2024				2021	2022	2023	2024
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
US	Real GDP	−0.6	2.7	2.6	2.2	2.1	2.5	1.2	0.6	1.0	1.2	1.7	5.9	2.1	2.1	1.2
	Inflation	5.2	5.2	5.1	4.8	4.6	4.0	3.6	3.0	2.7	2.6	2.5	3.6	5.2	4.3	2.7
	Unemployment	3.6	3.6	3.6	3.5	3.6	3.7	3.9	4.2	4.4	4.4	4.5	5.4	3.7	3.7	4.4
Euro Area	Real GDP	0.8	0.3	−0.1	0.1	0.1	0.0	0.1	0.2	0.3	0.3	0.4	5.6	3.4	0.5	0.8
	Inflation	8.0	9.3	10.0	8.0	6.2	5.1	3.2	3.3	3.2	3.0	2.8	2.6	8.4	5.6	3.1
	Unemployment	6.7	6.7	6.7	6.6	6.4	6.5	6.6	6.7	6.8	6.8	6.8	7.7	6.7	6.5	6.8
Japan	Real GDP	5.3	−1.2	0.2	3.2	4.8	0.9	0.8	0.9	0.9	1.1	1.1	2.2	1.0	1.5	1.0
	Inflation	2.1	2.7	3.8	3.5	3.2	2.9	2.5	2.9	2.8	2.5	2.1	−0.2	2.3	3.0	2.6
	Unemployment	2.6	2.5	2.5	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.8	2.6	2.4	2.3
China	Real GDP	0.4	3.9	2.9	4.5	6.3	4.9	5.2	4.0	4.7	4.7	5.0	8.4	3.0	5.2	4.6
	Inflation	2.2	2.8	1.8	1.3	0.2	0.0	0.6	1.1	1.5	1.8	2.0	0.8	1.7	0.5	1.6
	Unemployment	5.8	5.4	5.6	5.5	5.2	5.2	5.1	5.1	5.0	5.0	5.0	5.1	5.1	5.2	5.0

Real GDP growth is in QoQ annualized for U.S. and Japan, QoQ for euro area and YoY for China and India. Inflation rate is in YoY%. Inflation rate is YoY, % of core index (ex. fresh food) for Japan, YoY % of PCE deflator for U.S., and total YoY% for the rest.

Figure 2: Forecast for Rates

Interest rate		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
US	Policy rate	4.25 ~ 4.50	4.75 ~ 5.00	5.00 ~ 5.25	5.25 ~ 5.50	5.25 ~ 5.50	5.25 ~ 5.50	5.00 ~ 5.25	5.00 ~ 5.25	4.75 ~ 5.00	4.25 ~ 4.50	5.25 ~ 5.50	4.75 ~ 5.00
	2yr	4.43	4.03	4.90	5.04	5.00	5.00	4.75	4.75	4.75	4.43	5.00	4.75
	10yr	3.87	3.47	3.84	4.57	4.20	4.00	3.90	4.00	4.00	3.87	4.20	4.00
Germany	Policy rate	2.50	3.50	4.00	4.50	4.50	4.50	4.50	4.25	4.00	2.50	4.50	4.00
	Deposit rate	2.00	3.00	3.50	4.00	4.00	4.00	4.00	3.75	3.50	2.00	4.00	3.50
	2yr	2.50	2.68	3.20	3.20	3.00	2.80	2.60	2.40	2.30	2.50	3.00	2.30
	10yr	2.20	2.29	2.39	2.84	2.50	2.30	2.20	2.10	2.10	2.20	2.50	2.10
Japan	Policy rate	−0.10	−0.10	−0.10	−0.10	−0.10	−0.10	0.10	0.10	0.10	−0.10	−0.10	0.10
	2yr	0.04	−0.06	−0.07	0.06	0.15	0.20	0.30	0.30	0.30	0.04	0.15	0.30
	10yr	0.42	0.35	0.40	0.77	0.75	0.80	0.90	0.90	0.90	0.42	0.75	0.90
China	Policy rate	2.75	2.75	2.65	2.50	2.50	2.50	2.50	2.50	2.50	2.75	2.50	2.50
	2yr	2.39	2.41	2.11	2.26	2.27	2.32	2.37	2.47	2.52	2.39	2.27	2.52
	10yr	2.83	2.85	2.64	2.67	2.62	2.67	2.72	2.77	2.82	2.83	2.62	2.82

Figure 3: Forecast for FX and Oil Price

		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
USD/JPY	Range	130.58 ~ 151.95	127.23 ~ 137.91	130.64 ~ 145.07	137.25 ~ 149.71	138.00 ~ 152.00	133.00 ~ 147.00	126.00 ~ 140.00	128.00 ~ 142.00	128.00 ~ 142.00	113.47 ~ 151.95	127.23 ~ 152.00	126.00 ~ 147.00
	End of quarter	131.12	132.86	144.31	149.37	145.00	140.00	133.00	135.00	135.00	131.12	145.00	135.00
EUR/USD	Range	0.9633 ~ 1.0735	1.0806 ~ 1.1033	1.0635 ~ 1.1095	1.0488 ~ 1.1276	1.0100 ~ 1.1100	1.0000 ~ 1.1000	1.0100 ~ 1.1100	1.0100 ~ 1.1100	1.0200 ~ 1.1200	0.9536 ~ 1.1495	1.0100 ~ 1.1276	1.0000 ~ 1.1200
	End of quarter	1.0705	1.0839	1.0909	1.0573	1.0500	1.0400	1.0500	1.0600	1.0600	1.0705	1.0500	1.0600
EUR/JPY	Range	138.81 ~ 148.40	124.40 ~ 145.67	142.55 ~ 158.00	151.42 ~ 159.76	148.00 ~ 162.00	141.00 ~ 155.00	135.00 ~ 149.00	135.00 ~ 149.00	136.00 ~ 150.00	124.40 ~ 150.00	137.39 ~ 162.00	135.00 ~ 155.00
	End of quarter	140.41	144.01	157.43	157.93	152.25	145.60	139.65	143.10	143.10	140.41	152.25	143.10
Crude Oil Prices (WTI)		82.64	75.99	73.67	82.22	89.50	85.50	79.50	80.50	80.00	98.74	80.35	81.38

※ Crude oil prices are averages for each period. Source: SMBC.

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