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Investment Strategy Bulletin

Why the hurdle for a major CNY devaluation remains high

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In the wake of the unexpected – and rather intense – re-escalation of the trade dispute between the US and China, many investors are fretting that China might devalue its currency to counter trade-related provocation from the US or create stronger pressures for a compromise. While this appears a reasonable concern, we believe that the hurdle remains very high for such a move. In fact, it is entirely possible (and indeed, more reasonable) for China to opt for the currency's stability, even if a protracted and difficult bilateral negotiation has become quite a realistic scenario. In this piece, we explain our reasoning.

The People's Bank targets foreign exchange value... not inflation

A key point here is the fact that the People's Bank of China (PBoC, the country's central bank) implicitly targets the value of its currency, not inflation. Most central banks that investors are familiar with (e.g. the US Federal Reserve/Fed or the European Central Bank/ECB) target the inflation rate in their economy via market-driven floating exchange rates and minimal restrictions on capital flows. China has neither. The official inflation target adopted by the National People's Congress every year (3% in 2019) **has little to do with** the PBoC's day-to-day operations.

Importantly, China still maintains substantial control on its capital border – especially on capital outflows – despite its long-term pledges for capital account liberalisation. This unique combination of partially closed capital accounts and an unclear macroeconomic target leaves the foreign exchange rate target as the logical policy framework for the PBoC. In fact, China has been managing the level of its exchange rate ever since it began to liberalise its economy in the 1980s, with the latest innovation (in 2015) being the implicit stability of the currency vs a basket of 24 currencies (a crawling peg arrangement similar to Singapore).

Given this context, a large decline in the value of the yuan would be the outcome of two mutually exclusive scenarios.

1. **PBoC decides to let markets find the fundamental value of the yuan without intervening**

   In this scenario, the PBoC lets markets find the fundamental fair value of the currency without any regulatory constraints or policy intervention. This case would imply China moving fully to a "floating exchange regime" with open capital accounts and the PBoC operating independently under an explicit inflation-targeting mandate. However, our reading of China's policy thus far suggests that its policymakers are very keen to maintain managed and controlled capital account liberalisation (their caution being motivated by troubling precedents of turbulent liberalisation in Japan, South Korea, and Thailand). This "hold and control" approach would be completely inconsistent with the floating rate regime scenario.

2. **PBoC devalues to "re-define" the level of FX it is comfortable with**

   The second scenario is that China is in the process of "re-defining" the level of FX rate with which it is comfortable. Such a process, however, would be extremely disruptive, as it would imply that market participants' expectations about the PBoC's exchange rate policy would be "de-anchored" rather abruptly. This "new unknown" would ripple through markets, generating high volatility, and seriously undermining domestic financial market stability.

The controlled devaluation of the yuan between 2015 and 2016 illustrates this dynamic perfectly. The three-day consecutive yuan devaluation in August 2015, that knocked off 3% of its value, caused such a significant shock to global markets (the Shanghai Composite index collapsed by over 25% in just two weeks) that the PBoC was forced to make a huge effort to assuage investor concerns. Notably, the central bank had to drain its FX reserves substantially in the subsequent months, by as much as USD 560 bn, to keep the yuan from veering too far off-course. Such moves in principle reduce any economy's financial buffer against external shocks, and even fuel anxieties about the country's fundamentals, resulting in vicious and tough-to-manage downward spirals.

CNY devaluation: only an instrument of "ultimate resort".

Aside from the high costs of "re-defining" a new range for the CNY basket, devaluing the yuan would make neither tactical nor strategic sense.

First, for China to devalue its currency while the door for a cease-fire agreement on tariffs and other trade disputes remains open pending the G20 summit in Osaka would be illogical. Despite the volatile news flows on the trade row, we believe that the two sides are still trying to come up with a deal that their leaders can formalise during the summit (28-29 June 2019), as the economic incentives for it are still compelling despite the blustery rhetoric out of Beijing and Washington.

Second, currency devaluation is an instrument that affects all trading partners, not just the US. A large devaluation in the yuan would therefore be an act of provocation against all, especially because China is already the largest trading partner for many key economies. In the month that followed the August 2015 yuan devaluation, emerging market currencies fell by an average of 4% against the USD. Although this alleviated some of the competitive pressures, it did pose a serious problem for domestic monetary policies due to the inflation pass-through channel. Aside from EM, China is facing a delicate situation on intellectual property protection and 5G technology adoption (i.e. Huawei). Angering Europe and Japan by devaluing would be unadvisable, as it could isolate China further in dialogues with the global community on these topics.

Third, another large devaluation episode for the yuan when the 2015 episode is still a fresh memory would severely dent the currency's fledgling stature as a reserve currency. While China has made the internationalisation of the yuan one of its main medium- to long-term priorities, devaluation would definitely harden the perception that the currency cannot be trusted as a store of wealth. More concretely, the move would dampen investor appetite for the currency precisely when many important equity and bond index inclusion decisions are looming on the horizon for China's onshore assets.

Fourth, the move could undermine the financial soundness of China's strategic Belt and Road Initiative (BRI) by inadvertently increasing the FX mismatch between BRI borrower countries' assets that generate returns in local currencies (which are sensitive to CNY movement) and hard currency debts owed to Chinese institutions.

Finally, subjecting domestic consumers to another episode of weaker purchasing power and import demand compression is wholly inconsistent with Beijing's stated goal of medium-term transition towards domestic demand. In our view, a proper economic transition would be synonymous with increasing purchasing power for consumers and industrial sophistication away from cheap, labour-intensive manufacturing jobs vulnerable to currency fluctuations, towards high value-added jobs and services that can compete in spite of changes in FX rates. If China is serious about economic adjustments, accepting gradual strength of the currency over the medium to long term is the proper course of action.

Some investors argue that China could opt for extreme capital controls if it ends up triggering currency market volatility with another instance of devaluation. This is in the realm of theoretical possibilities, but we do not believe it is likely because of China's formal commitment to the "freely usable" criteria of the IMF Special Drawing Rights basket in which the yuan is included, as well as the aforementioned discussions on the inclusion of Chinese onshore assets in key global asset class benchmarks.

In our view, a major yuan devaluation would be an instrument of "ultimate resort", to be used only if negotiations between the US and China completely break down and the situation escalates into a full-blown trade war, with no holds barred.

China's line in the sand: not the USDCNY at 7, but the CFETS renminbi index at 92

Some investors are obsessing over the possibility that USDCNY spot rate could breach (and perhaps even surpass) 7.00, a level not observed in more than a decade. It is tempting storytelling material, because the spot rate is already quite close to that level, and trying to defend it at the expense of FX reserves seems foolhardy.

We believe that whether or not the level is breached will not matter too much to Chinese policymakers, as long as the current implicit guidance on the CNY basket range holds. In other words, if USDCNY briefly breaches 7.00 while other key currencies also undergo substantial depreciation vs the USD, then China will be able to keep the value of the CNY basket (the CFETS RMB index) above 92 – and maintain its credibility as a policy signal.

Can the breach of 7 for USDCNY spot rate be sustained even with the stability of the CFETS index above its implicit lower bound? We believe this is quite unlikely, because the pre-condition – a CNY stable against all other currencies except for the US dollar – would imply that the US dollar is unbearably strong for US policymakers. We argue that the Fed, given its heightened sensitivity to overseas developments, will be strongly motivated to lean against this disinflationary development by cutting interest rates.

As we maintain a medium-term bearish outlook on the US dollar, we believe it will be difficult for USDCNY to breach 7.00 and stay above it. China could, of course, upend all this by removing the implicit CNY basket lower bound, but we have already explained the costs associated with such a decision.

Large-scale sale of FX treasuries to "punish the US"

Some investors also ask if China will use the sale of US Treasuries to "punish" the US. The idea is that the large-scale sale of US Treasuries would send US yields higher, tightening US financial conditions and delivering a blow to US growth. We believe that this is not a convincing argument.

China holds only arelatively small part of the outstanding treasury market. While China's holdings of US Treasuries (in the US and Belgium) stand at approximately USD 1.1 trn, the outstanding amount of marketable US Treasuries is approximately USD 16 trn. That means China's holdings constitute a respectable but not dominant 7% of the overall market. However, it is the marginal buyer/seller that matters, and if markets start believing that China is about to offload large chunks of its Treasury holdings, then it is quite likely that private investors and institutions will try to pre-empt the move. This would result in significant price pressure on US paper and a sharp rise in yields. Selling US Treasuries, however, would have two important consequences: first, a sharp tightening of financial conditions in the US would risk bringing the rest of the world down with it, which would be the last thing China would want at a time when it is trying to stabilise growth. Second, China would have to endure big capital losses to its remaining holdings of US Treasuries, hence buffers against external shocks would be reduced severely. In sum, China would find itself an unhappy camper in this situation.

Moreover, if the purpose was to punish the US, selling FX reserves does not make sense, because it is very likely to make the US dollar more competitive against other currencies as China searches for a new asset class to park its money. Selling US Treasuries in large-scale operations would create the enormous problem of finding proper substitutes. In that respect, there are not many instruments with similar depth, liquidity, and safe-haven status (especially when the global economy has entered a late-cycle environment). So China would either have to use the funds to buy yuan (hence, making the US dollar even more competitive) or be ready to accept paying extremely high liquidity risk premia.

Overall, we do not think that China is about to embark on large-scale sale of US Treasury holdings. Such a move would create more problems than it would solve, even risking a significant tightening of global financial conditions that could make global growth, China's included, even more fragile. We think USDCNY will find a ceiling around 6.95 and, assuming that trade tensions stabilise later in the year, the yuan will appreciate modestly against the dollar. Our current forecast for USDCNY is 6.80 by the end of first quarter in 2020.

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