China: A market driven yuan is positive for a deal

China's central bank governor spelt out what was discussed regarding the yuan in the China-US trade negotiations. We believe that USD/CNY will move more like a "float" currency by following the dollar index in general

China-US discussion allows the yuan to depreciate according to market movements

During the Two Session media meeting, central bank (PBoC) governor Yi Gan, revealed that the yuan exchange rate mechanism is part of the trade negotiations. But it is not as described by President Trump in that the yuan cannot depreciate against the dollar. Here are what the two sides discussed:

1. respect the autonomy of the other's central bank monetary policy decisions
2. adhere to a market-driven exchange rate system
3. comply with the promise made in previous G20 summits, eg, not engage in competitive devaluation of the exchange rate
4. disclose data in accordance with the IMF's data transparency standards

China and US: easier to have a deal

We believe that according to points 1 to 3, the yuan exchange rate mechanism will allow the yuan to depreciate if the market trend is a strong dollar. So, it is different from President Trump's opinion that the yuan cannot depreciate during any deal.

This has eased our concern that it will be difficult to have a deal if the exchange rate mechanism is included in any trade agreement. Now, it is easier for both sides to enter into a deal.

USD/CNY to follow the dollar index to show it follows market movements

Optically, we believe that USD/CNY will follow the dollar index in general. This will show that the yuan follows market movements before the yuan is ready to be a free float currency.

To be able to have a free float currency, the capital account has to be open. China is not ready to fully open its capital account. And forcing it to do so now means a strong chance of high volatility in the flows of funds across borders, and therefore big volatilities in the yuan exchange rate, which could create too many surprises to the market.

It is good for the rest of the world if China opens up its capital account gradually and carefully.

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