China: Revising yuan lower but 7.0 should hold

We are revising our USD/CNY and USD/CNH forecasts to reflect expectations for a weaker yuan. This is a result of the rising tensions between China and the US over trade and technology. However, we don't expect the currency pairs to pass through 7.0. Here's why

Content
- Our yuan forecast has been hit by the technology war
- Letting the USD/CNY or USD/CNH pass 7.0 is playing with fire
- Revising yuan forecasts

Our yuan forecast has been hit by the technology war

Back in April, we thought trade negotiations were progressing well. We were wrong. China has since demanded a revision to the terms of the draft trade deal which it says are "disrespectful" to China. This move has rocked the market globally.

USD/CNY jumped from 6.7349 at the end of April to 6.7915 at the open of the first trading day in May. This change of sentiment means the yuan is going to depreciate rather than appreciate for the rest of the year.

China also wants to leverage the yuan's depreciation, showing that it does not intend to appease the Trump administration, which has urged Beijing to stabilise the value of the yuan.

Letting the USD/CNY or USD/CNH pass 7.0 is playing with fire

While we do expect the yuan to depreciate, we need to answer the big question of whether the USD/CNY or USD/CNH will pass the key 7.0 mark.

We believe that the yuan exchange rate will not be allowed to touch this level as this would create considerable turmoil in onshore asset markets. We believe that the central bank will prevent this from happening.

If the People's Bank of China were to let the USD/CNY pass 7.0 tomorrow, this would result in a depreciation of 1.33% in a single day. Exporters wouldn't receive more orders simply because their product unit price is 1.33% cheaper, so this move wouldn't make a significant impact on exports.

However, letting the USD/CNY pass through 7.0 has the potential to lead to considerable volatility in the onshore equity market, similar to what followed the sudden exchange rate liberalisation event in 2015. Since the collapse in 2015, the A-share index has not returned to its high of 5,353 points and closed at 3,632 points on 3 June 2019.

As the trade and technology war escalates, Chinese policy makers are likely to aim to dampen uncertainty to the market. As such, we rule out any scenario of USD/CNY and USD/CNH passing through 7.0 unless tensions ease to a level where there is no longer any threat of a trade or technology war, something we do not expect in 2019.
Revising yuan forecasts
We are revising our USD/CNY and USD/CNH forecasts to 6.90, 6.95 and 6.90 by end of 2Q, 3Q and 4Q 2019, respectively, from our previous forecast of 6.75 by the end of 2019.

We expect the central bank, PBoC, to stabilise the onshore yuan mainly through stabilising the daily fixing of the exchange rate, so as to send a signal to both onshore and offshore markets that the yuan is stable.

The spread between the onshore and offshore yuan, which is the difference between USD/CNY and USD/CNH, should not increase, as there are very few arbitrage channels for carry.

The spread between onshore and offshore yuan not large enough for cross border arbitrage

Iris Pang
Economist, Greater China
+85 22 848 8071
iris.pang@asia.ing.com

Source: ING, Bloomberg
Disclaimer
This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. ING forms part of ING Group (being for this purpose ING Group NV and its subsidiary and affiliated companies). The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. The producing legal entity ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is subject to limited regulation by the Financial Conduct Authority (FCA). ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.