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

Source: Shutterstock

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.

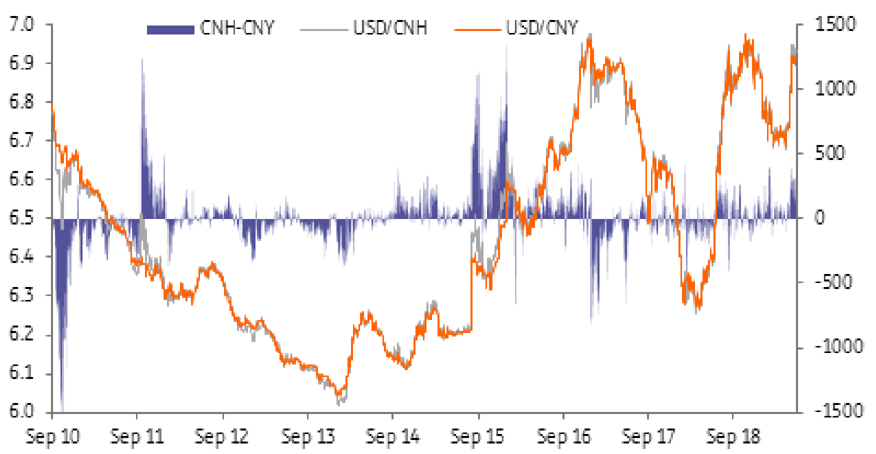
Revising yuan forecasts

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



Source: ING, Bloomberg

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com