

China: Will the dollar/yuan breakthrough 7?

China's foreign reserves fell by \$8.23 billion in August to \$3109.72 billion. This implies capital outflows were not significant during the month and suggests the yuan has room to weaken. The question now is not whether USD/CNY will reach 7.0 but whether it will actually pass this key level



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Foreign reserves indicate no massive capital outflows

There were worries in the market that a weak yuan could trigger capital outflows. We have long been advocating that this would not be the case as capital outflow channels are managed by the authorities and the capital account of China has never been freely opened.

It seems that, indeed, outflows have been small, with foreign reserves at \$3109.72 billion in August from \$3177.95 billion in July. To put these numbers into context, the fall in foreign reserves back in 2015 ranged from \$17.31 billion to \$107.921 billion per month. In comparison, an \$8.23 billion loss of foreign reserves is relatively mild.

Yuan can weaken further

As capital outflows will be small compared to inflows in September- helped by MCSI's inclusion of another round of A-shares- we expect that the yuan still has some more room to depreciate against the dollar.

The question we have been asked is no longer "Will USDCNY reach 7.0", but "Will USDCNY pass 7.0?"

The yuan could weaken to a range of 6.9 to 7.0 from the current range of 6.8 to 6.9 if the US administration imposes 25% tariffs on \$200 billion goods. At that point, risk off sentiment would dominate, and the additional protectionism would likely boost the dollar against all other currencies.

Is 7.0 a hard-line in the mind of PBoC?

Recently, we have been asked not whether USD/CNY will reach 7.0 but whether it will actually surpass this key level.

We believe that there is no hard line in the mind of the Chinese central bank (PBoC). Our view is that the central bank would not let the USDCNY jump from 6.80 to 7.00, as that would be too volatile for the market.

Can USD/CNY pass 7.0?

Still, the PBoC could allow the USD/CNY to test ~7.0 a few times, and then let the pair gradually pass this level.

This could happen if the US administration continues to escalate the trade war by imposing another \$200 billion tariffs on Chinese goods. President Trump mentioned that tariffs could be imposed on a total of \$505 billion worth of Chinese imports.

We are also aware that if the US administration imposed tariffs on a much smaller amount or unwound them at a latter stage, the yuan could stop depreciating and stabilise or even appreciate slightly. But the chances of a rethink on tariffs are low at the moment, and are certainly unlikely to happen until after the US mid-term elections.