China blinks at a 7.00 handle for the yuan

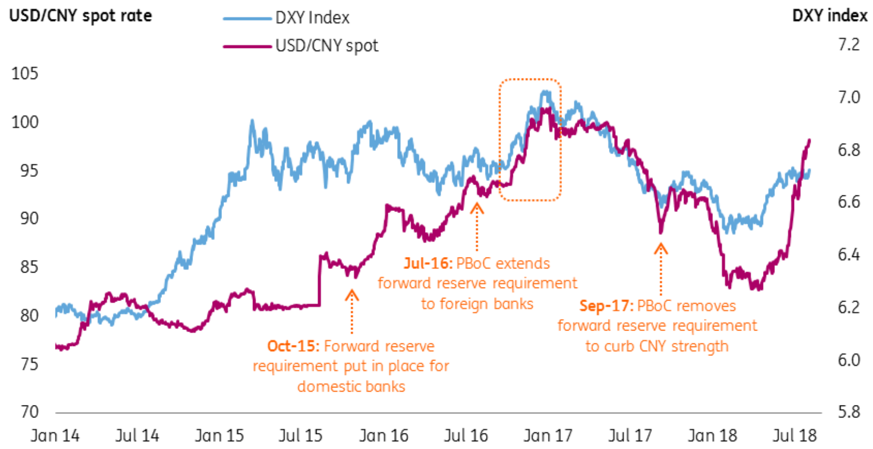
The People's Bank of China (PBOC) has announced a re-introduction of reserve requirements on FX forwards trading – a move clearly aimed at taking pressure off the renminbi as USD/CNY closed in on 7.00. This looks only a temporary reprieve for the renminbi; prior PBoC attempts to stem CNY weakness haven't been all that successful in reversing a trend

Reserve requirements back in play

Since 2015 the PBOC has used reserve requirements on FX forward transactions as a tool to control 'macro-financial risks'. The measure puts a 20% required reserve ratio for financial institutions when conducting onshore CNY forwards business on behalf of customers. The move makes it effectively costlier for the market to fund short CNY positions through the forwards market.

This measure was first used for domestic financial institutions in October 2015 and then broadened to include foreign institutions in July 2016 when USD/CNY was pushing above 6.70. These reserve requirements were scrapped when USD/CNY was dipping below 6.50 in September 2017 amidst broad dollar weakness.

Prior PBoC attempts to stem CNY weakness haven't been all that successful



Source: ING, Bloomberg

Why now?

It seems pretty clear that these measures have been introduced to trigger a squeeze in short CNY positions and keep USD/CNY away from 7.00. This reserve requirement is a relatively soft measure and avoids the bigger stick of FX intervention or rate hikes at a time policymakers are delicately deleveraging the economy.

We also think Chinese policymakers had a bad experience when USD/CNY was last trading near 7.00 in late 2016. Investors struggled to digest the message at the time that the renminbi was stable versus the basket and that the move to 7.00 was all about the dollar. That message will be so much harder to deliver today given the 6% decline in the renminbi against its trading basket since late June and the uncertainty over whether this is a market-led decline or the PBOC is using the renminbi as a weapon in the current trade war.

Temporary reprieve

USD/CNH has sold off 1% on today's (Friday) news, but we doubt investors will be encouraged to return to Renminbi exposure anytime soon. US Commerce Secretary Wilbur Ross has made the US trade position clear by outlining that Washington wants to create a situation where it’s more painful for China to continue current practices than it is for China to reform.

An increase in the proposed tariff rate to 25% on the next $200bn worth of Chinese imports looks likely over coming weeks. And combined with firm US rates and what look like continued dollar strength over coming months, it looks as though the PBOC will be forced to use more of its currency toolkit to prevent USD/CNY going through 7.00.

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