Currency Bulletin: CNY Depreciation

A few words on recent developments of CNY

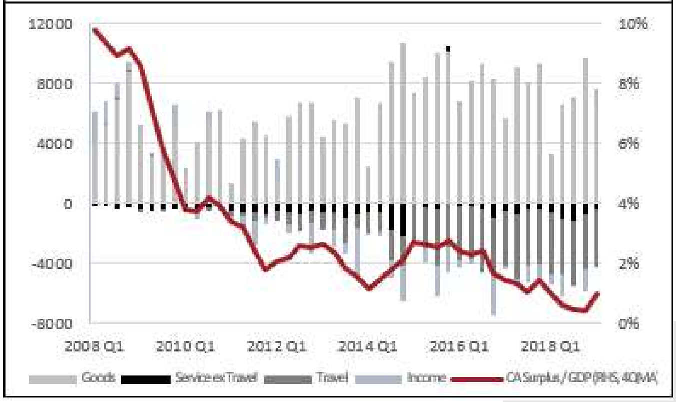
CNY depreciated, rather surprisingly, by 1.6% on Aug 5th 2019. We anticipated the necessity to depreciate and for USDCNY to break the threshold of 7, though the timing is still unexpected as USDCNY traded only around 6.9 last Friday. The move undoubtedly triggered a global equity selloff and subsequently the US labeled China as a currency manipulator instantly instead of in its semi-annual reports to Congress. The label is mostly symbolic at the current stage, yet it opens room for further escalation.

We think that the depreciation is fundamentally implied as China is facing increasing pressure from maintaining a sustainable BoP balance. The current account has shrunk to a meagre 0.3% of GDP in 2018 while capital inflows have stalled, if not reversed, amid trade tensions with the US.

China's current account balance implies depreciation pressure

China's current account surplus has structurally decreased to below 1% of GDP, with the travel component being the most significant debit item. USDCNY hanging around the 6.3-6.6 level since 17Q4 had already pushed the current account surplus down even before the US initiated trade tensions, and it recently trending higher to the 6.8-7 level upon trade tensions has greatly alleviated pressure on the current account.

Figure 1 China Current Account Surplus and Components



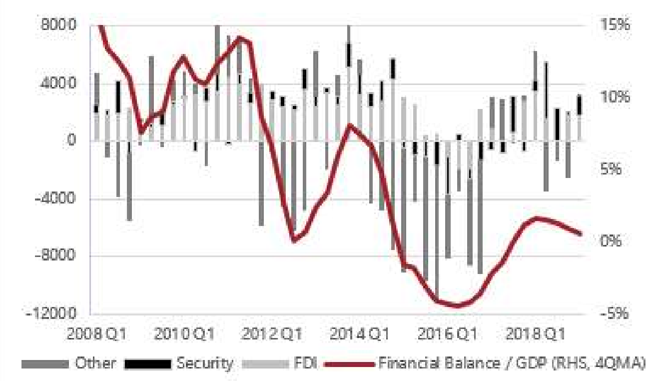
Structurally, the travel item began dragging down the current account surplus in 2012 and accelerated further from end-2014. We believe this partially reflects depreciation driven private sector demand for overseas assets, given that capital account control is still in force. Measured by the SHFE gold futures price compared to the COMEX price, depreciation expectation is so far contained compared to the previous selloff. Apart from tariffs, USDCNY below 7 should be enough to maintain balanced international payments.

Figure 2 Shanghai Gold Price in USD to COMEX Gold Price

Capital account may see outflows

Appetite for emerging market assets may wane through 2019 with increased uncertainty and global growth continuing to slow. It may have to wait until 20Q1 for a Chinese growth pick-up to lay solid ground for capital inflows into China. Of course, there are positive developments from the inclusion of Chinese capital markets in well tracked international indices, but the inflows that follow are likely to be a short-term impulse. The CNY internationalization policy has been largely suspended since end-2016 when depreciation expectation mounted, and offshore CNY liquidity had almost drained.

Figure 3 China Non-reserve Capital Account



Currency manipulator

Following the CNY depreciation, the US treasury labeled China as a currency manipulator formally and instantly. Traditionally the US Treasury files a semi-annual report to Congress addressing its view about countries involved in currency manipulation, measured by its 3 standards. Yet in this case, China only met 1, or arguably 2, standards due to its effort to maintain CNY at an overvalued position against USD.

The accusation may grant Trump more leeway to impose higher tariffs and marks a new round of escalation. As of now the announced tariff is 25% on about half of Chinese exports to the US, and 10% on the rest. The depreciation may void the tariff to a mild penalty, which perhaps is the main reason behind the currency manipulator accusation. The uncertainty is growing significantly once again, and so is the probability of the standoff slipping into a full-blown conflict between the world's two largest economies.

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