Growing Focus On CNY 7.00

• Beijing has history of working to minimise market turbulence
• Intervention tactics remain key
• Is a weaker CNY such a bad thing?

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With the debate over the outlook for USD/CNY now focused on what happens around CNY 7.00, it’s worth considering three key questions. Firstly, how important is CNY 7.00? Secondly, what tactics might it use to defend against currency weakness? Finally, why not let the CNY weaken?

**How important is CNY 7.00?** Beijing has a history since the summer of 1998 of stepping in to minimize currency market volatility when there is a concern it could feed through into broader asset market turbulence. Given the authorities held the line at CNY 7.00 in Q4 of last year (the USD hasn’t traded above there since 2008) it seems reasonable to assume they are concerned that a rapid move beyond this level might lead to heightened volatility in a range of markets and that this is worth defending against.

Set against this is the fact that China’s FX reserves have been maintained in a range between USD 3 Trn and USD 3.2 Trn for around 3 years now. While this is not the only tool in Beijing’s armoury for defending the CNY, as the use of tighter funding costs and higher than expected fixings last year highlighted, it remains the most significant. Therefore the unanswered question is how important the authorities consider holding the value of the reserves at around the USD 3 Trn level?

**Tactics?** Alongside the use of more unconventional tools by the bank, one approach the PBOC might take to tackling CNY weakness is for it to adopt a “line in the sand”
defence. With just over USD 3 Trn in FX reserves that’s clearly possible. However, the history of this kind of approach is mixed. As one example of this it’s worth recalling the MOF/BOJ’s efforts in the first half of September 2003 when they bought over USD 38 Bn - a huge amount for the time - in just over two weeks in a futile attempt to defend the JPY 115 level. What was notable was that as the market became used to the presence of the BOJ the impact of their actions became increasingly muted with investors ultimately just using the intervention as an opportunity to buy cheap JPY. While these numbers are small when compared to the firepower now available to the PBOC, the bank will likely also recall the 10% drain on their FX reserves in H2 2015 as they attempted to battle CNY weakness back then.

![Chart showing change in USD value of China's FX reserves and USD/CNY exchange rate](chart.png)

An alternative strategy is the “bear trap”. Again Tokyo provides a good example of this. The third quarter of 1994 had seen the authorities intervene intermittently to try and stabilise the JPY. However, in the second half of October the USD began to come under more sustained pressure despite steady JPY selling by the BOJ. By November 2 the USD had fallen from around JPY 100 to JPY 96.00 its weakest level ever. By this point it was very clear that the authorities would intervene again. However, what was not clear was how hard they would hit, authorising the purchase of about USD 1.1 Bn (over 10 times the amount purchased the previous day) in several waves during the late New
York morning and driving the USD up 2 JPY. Although the JPY 96 would ultimately be broken four months later, this action (along with more modest intervention the following day) provided Tokyo with a surprisingly long lasting reprieve from JPY strength.

Why not let the CNY weaken? The key issue remains asset market volatility and investor confidence. As a secondary factor it seems reasonable to assume based upon past actions that the authorities would be unhappy should speculative CNY short selling emerge. However, the former concern could presumably be moderated by the authorities judiciously leaning in to the move when required. Equally, the latter issue could be discouraged by the occasional use of bear traps (especially given the fire power available to the authorities - "shock and awe"). Moreover, while Beijing has made it clear that it does not intend to use the CNY as a weapon in the trade dispute, it’s harder to see why they should stand against a move that might be justified by economic circumstances (particularly if they do not wish to drain their FX reserves unnecessarily). They might also recall that the US seemed to have few concerns in the period between 2002 and 2011 with allowing the USD to weaken at a steady pace (one of the key reasons why China’s FX reserves stand at current levels).

For the moment it does look as if the authorities will look to slow the move towards CNY 7.00 and will attempt to hold it there in the near term. However, it will be worth looking for clues from the NDF market given that it has proved a pretty useful guide to broad trends over the years.

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