Yuan Direction

• Politics will decide the sanctity of CNY 7 to the USD
• But the economic case for a break is not without merit
• The longevity of the trade dispute may be a factor

In 2008, China sought to fend off the turbulence of that year’s financial crisis by bringing the currency’s three-year appreciation to an end (which culminated in export growth of over 30% two years later).

And as the US-Sino trade war ratcheted up last year, it was widely assumed that Beijing was content to see the CNY depreciate in order to counter US tariffs on $50 bn worth of Chinese exports.

Inevitably, therefore, with US-Sino trade imbalances depriving China of the requisite symmetry to impose its own, effective retort to the latest US tariffs, speculation abounds as to whether the CNY is currently being deployed in a similar vein and whether, given its recent trajectory, this might ultimately entail a breach of the pivotal 7 to the USD level.

While China has understandably played down the likely impact from any sustained trade war, it must be assumed that Beijing desires talks to progress – starting, perhaps, during a possible tête-à-tête at the Osaka G20 – and for that, assurances that the CNY will not build on its 2% slide could be considered one quid pro quo for a deal.
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But that said, political considerations are hardly mutually exclusive to China’s economic exigencies and a year of trade conflict has taken its toll – in China and in the economies of its principal trade partners.

Many observers are starting to see the current turbulence in US-Sino trade relations as the opening salvo in a long-term economic war – something discussed recently in The New York Times.

And sustained intervention to prevent the CNY’s depreciation could not be undertaken without negative implications for domestic monetary growth and the economy in turn.

Moreover, there is no question of the CNY’s undervaluation at current levels: although China continues to run a large trade surplus with the US, its current account surplus has not only been trending lower, it has been doing so rapidly as its deficit in services has grown: last year, the surplus fell to $50bn from more than $300bn in 2015, and it is widely expected to remain on this downward path.

In fact, a weakening global economy could make for a very different backdrop than currently envisaged.

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Despite year-to-date volatility in the data, China’s exports are **clearly trending lower** whilst respective Caixin and official PMIs of 50.2 and 50.9 – both indicative of flat activity in April - speak of the negative impact this has had before the latest round of tariffs were unveiled this week.

In turn, the **weakest retail sales growth in sixteen years** also attests to the impact on the broader economy. So whilst a swift trade deal would certainly help, clearly, a lot of damage has already been done.

One final consideration is the sheer scale and source of the stimulus required to maintain China’s economic momentum and hence, the attractions of a modest, managed decline in the CNY as a relatively trouble-free (and largely inflation-free) alternative.

Surging bank lending directed at smaller firms perhaps belies Beijing’s expressed wariness about fresh credit growth, but at some point it will need to manage a shrinking in the construction sector, which has given rise to 6.4bn square meters of empty residential floor space. And few options provide better commensurate support than a boost to trade.

Only time will reveal Beijing’s intent; but as we concluded yesterday, in the meantime, the potential for markets to remain wary of taking-on risk is all too apparent.

Please direct questions or comments to:

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