Dealing With CNY Weakness

- Shifts in Fed rhetoric have helped stave off CNY weakness in past
- Likely would take a substantial shift this time however to make a material difference
- H2 2015 highlighted how costly fending off CNY weakness can prove to be

With pressure mounting on the CNY, it’s worth recalling that the shift in Fed rhetoric in November of last year coincided with another period of particular stress for the currency.

The question that emerged back then was whether the shift in messaging might be enough to relieve the pressure on the CNY. On its own the answer was no given that the CNY remained under pressure in the spot market until early December when President Donald Trump and his counterpart Xi Jinping agreed to halt new trade tariffs for 90 days to allow for talks. However, the scaling back in US rate hike expectations from November 8 onwards appeared to have some impact with USD/CNY NDF outrights through to 1-year remaining well below the highs hit in late October.

This wasn’t the first time that a shift in Fed rhetoric emerged at a time of CNY weakness. It’s worth recalling that the Fed’s growing caution in early 2016 came at a time when the CNY was under such pressure that some had even begun to suggest the need for capital controls in China. It’s also true that this pressure begin to abate in the...
aftermath of the Fed shift (albeit to return as summer approached).

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So far, however, there is very little evidence of a shift in tone from members of the FOMC with only Boston Fed President Eric Rosengren saying anything that could be construed as vaguely dovish. Nevertheless, it seems worth tracking whether other members start to sound warnings should the USD resume its upward rise towards CNY 7 (see headlines).

As to whether it would matter, the evidence from 2016 and 2018 suggests that it would take a substantial shift in stance from the FOMC to have a material impact on USD/CNY (particularly given that this is a market that is already pricing in at least one rate cut by year end).

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In the absence of this the question that will very quickly arise is what action (if any) Beijing might take were the USD to strengthen to CNY 7.00.

The experience of the second half of 2015 when China saw its FX reserves fall in value by around 10% and again in late 2016 helps highlight the difficulties of trying to defend against currency weakness even when the firepower available might appear overwhelming. Indeed, the fact that China’s FX reserves have effectively remained within a range of USD 3 trn to USD 3.2 trn since then despite last years sustained CNY weakness perhaps suggests the authorities took careful note of this.

2.

US/Turkey: President Donald Trump says (following evidence of a sharp drop in steel imports): “Given these improvements, I have determined that it is necessary and appropriate to remove the higher tariff on steel imports from Turkey.”

3.

US: Federal Reserve governor Lael Brainard notes that underlying trend inflation “appears to be somewhat below” the Fed’s 2% goal. She adds that the Fed can achieve its goal of sustaining 2% inflation by aiming for a level of price growth “slightly above” its target “for a couple of years”.

4.

UK: The BBC reports that “Brexit talks between the Conservatives and Labour are about to close without an agreement.”
This isn't to say the authorities would do nothing. Since 1998 Beijing has been prepared on occasion to take action in the currency markets to help stabilise broader market sentiment. It's also noticeable that last year did see modest reductions in the USD value of reserves during the months the CNY was weakening (although at least some of this would be down to valuation effects). There is therefore an argument to be made that while the authorities might prove cautious about defending a specific level, they might equally be willing to lean into any move if it helped minimise unwanted volatility elsewhere.

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