Chinese currency may still be overvalued after weakening past 7 mark

Evan Fallor, Jill Ornitz, Peter Brennan

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U.S. President Donald Trump may be right about China manipulating its currency. Just not in the way he has claimed.

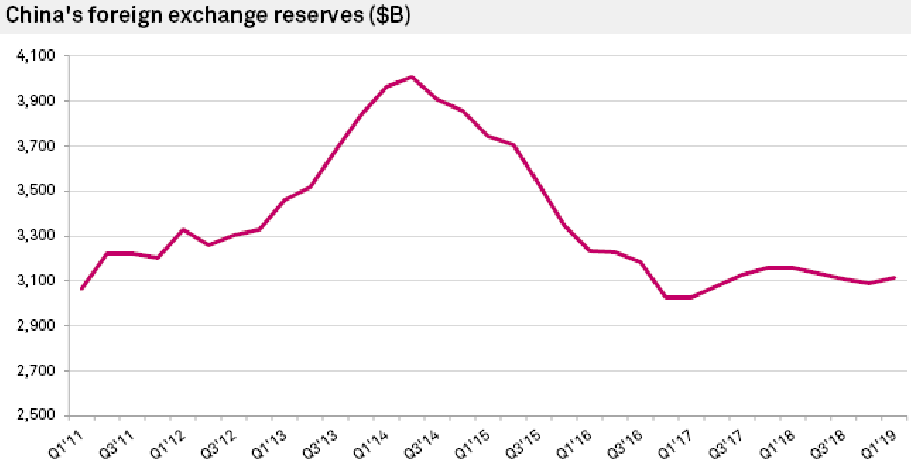
The People's Bank of China has been supporting the yuan in recent years and it would probably fall further without intervention from the nation's central bank. Yet, China was labeled a currency manipulator by the U.S. Treasury on Aug. 6.

China let the yuan weaken past 7 to the dollar on Aug. 5 for the first time in 11 years, surpassing a psychological barrier that it has defended assiduously in the face of continued dollar strength in recent years. In fact, the greenback's 15% advance against the yuan over the past five years compares with an 18.5% gain for the Dollar Index, which measures the dollar against a basket of its biggest developed-market peers.

China's foreign-exchange reserves have also fallen over that period, suggesting, at the very least, that it hasn't been acting to weaken the yuan, and may have been selling dollar-denominated assets to strengthen it.

Ironically, the trade war being waged by the current U.S. administration has boosted the value of the dollar as the disruption leads investors to seek out safer assets and has put more pressure on the yuan than most other currencies because of the targeting of the Chinese economy.

China's foreign exchange reserves ($B)



Data compiled Aug. 8, 2019.
Source: S&P Global Market Intelligence

In fact, the yuan's move past 7 shouldn't be seen as a devaluation, but rather a decision by China to stop keeping it artificially high in the face of U.S. trade measures, according to Simon Lester, associate director of the Cato Institute's Herbert A. Stiefel Center for Trade Policy Studies.

Under current circumstances, China will let the yuan weaken to around 7.20-7.30 against the dollar, according to analysts and investors interviewed by S&P Global Market Intelligence, including Daryl Liew, head of portfolio management at REYL Singapore, Peter Kinsella, global head of FX strategy at Union Bancaire Privée and Fritz Louw, currency strategist at Mitsubishi UFJ Financial Group.

The yuan will fall further should the Trump administration go through with its threat to impose a 10% tariff on a further $300 billion of Chinese imports, they said. In that scenario, the yuan's fair value would be about 8.3 to the dollar, but the PBoC wouldn't let it weaken that far, because of negative repercussions for the Chinese economy, said UBP's Kinsella.

Chinese corporates have $1.5 trillion of dollar-denominated debt, an increase of 20% since 2015, according to the Institute of International Finance. That's a manageable risk with a slightly weaker yuan, but becomes much more of a burden should it fall more dramatically, severely increasing debt-servicing costs.

China is also trying to build a reputation as a stable destination for foreign investment. If the yuan weakens sharply, it would be harder to attract overseas capital to its bond markets.

"Not only would excessive yuan depreciation invite added tension with the U.S., feeding further into the currency manipulation narrative, it would also have the undesired impact of fueling massive outflows from the mainland," said Joel Kruger, FX Strategist at LMAX Exchange Group.

'Real' exchange rate

The People's Bank of China set its daily reference rate for the yuan at 6.9225 to the dollar on Aug. 5, but because it is allowed to trade 1% either side of the mid-point, it closed the day at 7.0458. The PBoC has since tried to keep the market guessing by shifting the reference rate both up and down, but set it at 7.0211 on Aug. 12, the third straight session it was weaker than 7.

The IMF said in a June report that the yuan was "broadly in line" with its valuation and praised China for "reducing external imbalances."

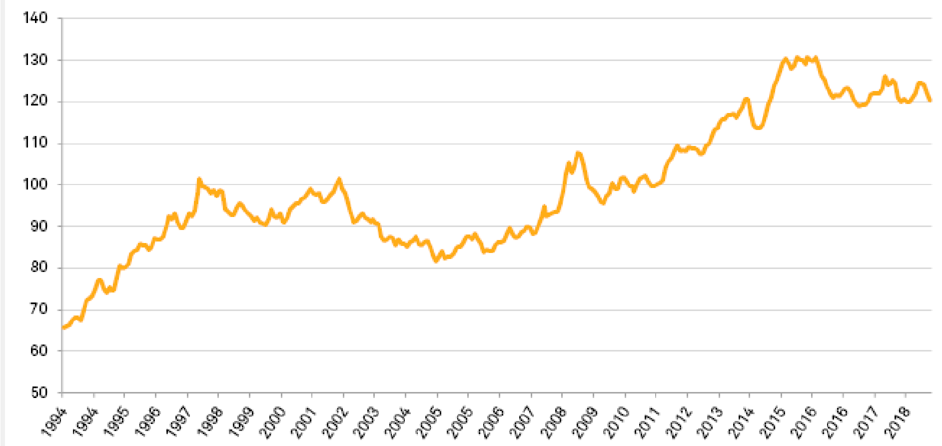
China's current account surplus has shrunk from 10% of GDP in 2008 to just 0.4% in 2018.

Stephen Roach, a senior fellow at Yale University and former chief economist and chairman at Morgan Stanley Asia, also cites the disappearance of China's current-account surplus when saying that the renminbi is closer to fair value than it has been "in a long time." However, determining the true valuation of a currency is "more art than science," he said in an interview.

"In terms of assessing the overall value of the currency relative to the competitive position of any economy, the multilateral, what we call the real effective exchange rate, is much more relevant than the narrow bilateral cross rate with any one country," said Roach, pointing out that, since the beginning of the trade war in March 2018, it has fallen much more against the dollar than on a broad, inflation-adjusted basis.

While the yuan weakened by 11% against the dollar since the U.S.-Sino trade conflict began in March 2018, its real broad effective exchange rate, as measured by JPMorgan, has fallen just 5.3%, suggesting that it is responding to U.S. trade pressure.

Real Broad Effective Exchange Rate for China



Index 2010 = 100
Data compiled Aug. 8, 2019.
Sources: Bank for International Settlements; Federal Reserve Bank of St. Louis

Other activity by the central bank would suggest that China is actively looking to prop up its currency.

The PBoC will issue 30 billion of yuan bills in Hong Kong this week. Robert Carnell, chief economist and head of research for the Asia-Pacific at ING said in a research note that while the sales are part of regular issuance, "the amount is larger than needed to simply replace maturing bills" so "should provide some boost" to the yuan.

"So, far from looking like the PBoC is embarking on an aggressive depreciation, it is looking more likely that they are now trying to put the brakes on [the devaluation] and bring some two-way risk back to the CNY outlook," he said.