Danske Bank

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FX Strategy

Will China devalue? We doubt it

- **Talk of CNY devaluation has hit the headlines lately as upward pressure on USD/CNY continues.**
- **We doubt China will turn to such a move. PBOC is currently taking measures to slow the decline, not increase it. And a devaluation is a risky move that could undermine efforts to support the equity market, trigger capital outflows, and add fuel to the fire in trade tensions with US and EU at a time when China is running a 5% trade surplus.**
- **We do, however, look for PBOC to allow for a small and gradual move higher in USD/CNY from 7.25 towards 7.30 in 12 months as depreciation pressure persists due to relative strength of the US economy.**

Chart 1. In August last year China changed FX policy and kept fixing stronger than spot

Source: Bloomberg, PBOC, Danske Bank. Note: Past or current performance is no guarantee of future performance.

Chart 2. USD/CNY would trade weaker if China did not keep fixing stable

Source: Bloomberg, PBOC, Danske Bank. Note: Past or current performance is no guarantee of future performance.

Recently, there has been rising talk of a possible CNY devaluation. China has stockpiled some commodities, which has led to speculation that it plans to devalue the currency. At the same time, the Chinese economy is still struggling more than a year after coming out of Covid and giving a boost to exports through a devaluation could support the manufacturing sector. A weaker currency would also alleviate the deflationary pressures. These seem to be good reasons why China might want a weaker currency. Nevertheless, we see the odds skewed towards China refraining from a devaluation and offer our key arguments below. We would only put a probability of around 20% of a devaluation taking place.

Before turning to the arguments, let's first define what we mean by a devaluation. We see a devaluation as either a deliberate decrease in the value of a country's currency in order to boost exports or a country giving up its defence of the currency in a fixed or semi-fixed regime that leads to a sharp decline in the currency. For a CNY decline to be characterized as devaluation it would in our view imply a) that China stops its actions to slow the depreciation and b) that we see a rapid decline of the yuan within a short period by at least 5-10% versus the dollar. Hence a move to around 7.80 from the current levels of 7.25.

1. **China has a strong preference for stability and control.** This was stressed as late as during the National People's Congress in March this year, where the Work Report stated that "S*tability is of overall importance, as it is the basis for everything we do*". At the Central Financial Work Conference in September 2023, China *stated* that "*The management of foreign exchange markets should be strengthened, and the RMB exchange rate should be kept generally stable at a reasonable and balanced level.*" A devaluation would entail a high risk of instability and loss of control. The 2015/16 currency turmoil *triggered capital outflows* and sharp equity declines when investors saw PBOC's 2% adjustment of the USD/CNY fixing as a sign that China was going to make a bigger devaluation (it was in fact done to meet an IMF requirement for entry into the SDR, which stated that the fixing should be close to the spot rate. The latter was trading 2% weaker than the fixing prior to the adjustment).

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2. **China intervenes to slow CNY depreciation, not increase it.** Since the autumn last year, China has taken active steps to slow any further depreciation of the yuan versus the dollar, most visible in the broadly stable currency fixing since August last year. China has also refrained from cutting policy rates much to avoid too much divergence with US monetary policy that could increase depreciation pressure. Both words and actions reveal a preference for currency stability rather than a sharp weakening.

3. **A devaluation would undermine efforts to shore up foreign investor confidence.** China *took several measures* in February to try and turn the negative equity sentiment around this year and has struggled to improve foreign investor sentiment. Since the measures in February, the battered stock market has recovered somewhat with a gain of around 20% in offshore stocks as more foreign investors have returned. A devaluation would undermine investor's equity gains and could quickly erode the hard won improvement in confidence once again.

4. **Exports are rising this year - and China has a big trade surplus.** As mentioned above, devaluations tend to happen in order to boost exports. However, China's exports are rising again after facing a sharp set-back last year. In addition, China in 2023 had a trade surplus of 5.4% hardly suggesting a lack of competitiveness or great urgency to boost exports through a devaluation. The nominal effective CNY is quite strong, but it has weakened a lot in real terms due to low Chinese inflation (chart 7).

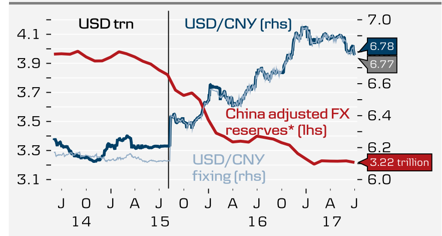
5. **Devaluation would add fuel to the fire in trade tension with EU and the US.** With a trade surplus of more than 5% and rising trade tensions with EU and the US, no doubt a Chinese devaluation would add significantly to trade frictions. Not least US President Joe Biden, who is facing off with Donald Trump in the November election, would be under strong pressure to punish China for such a move by raising tariffs. This would quickly erode the benefit of a devaluation for China.

6. **Risk of currency war.** A deliberate devaluation could trigger a currency war with other countries, not least in Asia. China *prides itself* for *not devaluing* at any point during the 1997/98 Asian crisis where it saw currencies among its' Asian counterparts depreciate very fast. China likes to see itself as a responsible actor in the Asian region that contributes to economic and financial stability rather than the opposite. Part of China's arguments for not devaluing during the Asian crisis was that it would trigger counter-devaluations and fuel instability.

7. **China has the tools to avoid a devaluation**. Even if China does not desire a devaluation, it could happen if the country is not able to fend off the depreciation pressure. However, we believe China has adequate tools to manage a gradual depreciation of the currency rather than see a rapid sharp devaluation. In 2016, pushing up CNH offshore rates proved an efficient weapon that had little cost to the Chinese economy because the majority of financing is taking place on the mainland. This weapon is available today too, and China is to some extent already using it. China also has more than 3 trillion USD of FX reserves that it can use. So far, the reserves have been quite stable despite the currency pressure.

While it can be argued that China needs to take bigger steps to underpin the economy, what is mostly needed are measures that support *domestic* demand. It would serve the purpose of both benefitting China as well as benefitting trade partners and foreign companies - and thus help mitigate some of the US and EU critique of its' rising exports, continued high trade surplus, and lack of domestic demand. China is in fact this year *rolling out a trade-in scheme* for consumer goods with exactly that aim.

Chart 3. China burned off a lot of FX reserves in 2015/16 to stop the outflows and deprecation pressure

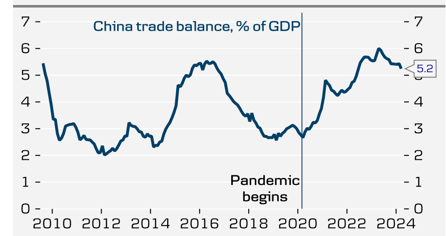


*Source: Macrobond Financial, SAFE, PBOC, Danske Bank. *Adjusted for impact from changes in exchange rates. Note: Past or current performance is no guarantee of future performance.*

Chart 4. Signs of improving exports lately does not call for devaluation...

Note: Index is average of PMI export orders from NBS and Caixin. Source: Macrobond Financial, S&P, NBS, Danske Bank.

Chart 5. ... and hard to justify a devaluation with a 5% trade surplus



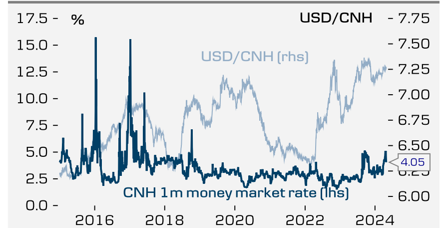
Source: Macrobond Financial, NBS

Where to go from here – and where we could be wrong

Our forecast is for a continued a gradual weakening of USD/CNY from the current level of 7.25 towards 7.30 in 12 months and we are still long USD/CNH in our Top Trades portfolio from December. We believe China will continue to aim for a gradual increase in the cross but to avoid the risk of instability. It can do this by allowing for a slow rise in the daily fixing as we have seen over the past week. It meets some of the depreciation pressure in the market but avoids disruption that could undermine financial stability.

There are of course risks to the view. We cannot be sure China has not changed its mind about the right FX policy and see the need to make a risky move through a devaluation that could allow them to cut policy rates more aggressively. It would be a clear change in strategy, though, and an unusual move from a leadership that since the Global Financial Crisis in 2008/09 has moved in cautious steps and who sees fiscal and industrial policy as the preferred tools to meet China's goals of supporting demand and the long-term goal of a high-tech economy. **Another risk factor to our view could be if the US economy performs stronger than expected and instead of cutting rates starts raising rates again**. It would add further upward pressure on USD/CNY and could make PBOC eventually give in to the depreciation pressure. **Finally, a third risk factor could materialize next year if Donald Trump returns to the White House.** He might restart the trade war and increase tariffs on China significantly, which would trigger renewed depreciation pressure on the CNY.

Chart 6. CNH offshore rates can be pushed up much further to defend the currency - as was the case in 2016



Source: Macrobond Financial, Bloomberg. Note: Note: Past or current performance is no guarantee of future performance.

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