26 October 2020

FX Strategy

The rise in the CNY and what it means for the global economy

Key points.

- **The strengthening of CNY is driven by the outperformance of the Chinese economy and increased likelihood of a Biden win**
- **There are downside risks to our 12M USD/CNY forecast of 6.60**
- **A stronger CNY is good for the world economy as it makes exports to China cheaper and stimulates global reflation**

The CNY is one of the undisputed winners in this post-corona world. Since May, USD/CNY has fallen by 7%. In trade weighted terms, CNY is almost at its strongest level since mid-2018 before the trade war blew up.

What's going on? We think two factors explain the move: 1) the outperformance of the Chinese economy amid better control over the coronavirus and higher interest rates than the US; and 2) the increased likelihood of a Biden win, reducing the risks of an uncontrolled, damaging trade war that would ensue under a second term Trump presidency (yes, Biden will also be tough on China, but in a different, more multilateral and predictable way, which provides more certainty for investors and about the Chinese economy).

On the outperformance of the economy, the Chinese economy recovered back to its pre-corona crisis levels in Q2 with a strong rebound. This week, Q3 GDP numbers together with retail sales and industrial production further underscored the growth in the economy. The background for the significant expansion is twofold:

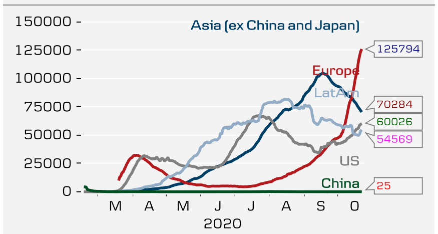
- The authorities have managed to keep the virus under control. This is partly due to a strong reporting system and tough action if you are found to have a fever, according to my conversations with people in China. The official statistics of almost no cases may be hard to believe but if the country had an unreported problem then we know from Europe and the US that the situation could easily spin out of control. Local media do report new cases widely, which then prompts immediate action – closing down and isolating regions or cities and taking precautions. Hence, reported cases are mostly connected to interaction with foreigners or foreign goods. Thus control over the virus allows even the service sector to flourish in addition to the production side of the economy.

- The recovery has been supported the steady stimulus from the monetary and fiscal side. However, this stimulus is still more modest than seen in most parts of the world, at least when it comes to fiscal support. Furthermore, there are signs that the authorities are taking the foot off the accelerator when it comes to monetary stimulus as the money growth is slowing and the economy appears to be recovering quite well. This explains in part the higher interest rates in China.

Recent publications

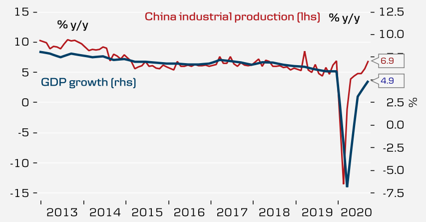
- *COVID-19 Update - Tighter restrictions in Europe - risk of second lockdowns is increasing*, 22 October
- *The Big Picture: What if our downside global scenario materialises?* 19 October
- *China Macro Monitor - A bright spot in the global economy*, 6 October

China has kept the virus under control



Source: European Centre for Disease Prevention, Danske Bank

A V-shaped recovery in the Chinese economy



Source: Macrobond Financial

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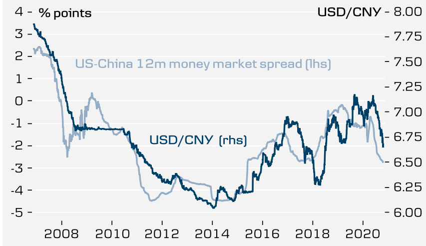
How is all this playing into the CNY's strong performance? Well the key thing here is that the difference in short-term interest rates between China and US has widened to the biggest margin since 2018 (i.e. China has much higher interest rates, attracting capital flows to China). Back in 2018, when the interest rate differential was at that level USD/CNY fell to 6.25, which also coincided with a general synchronised upswing in the global economy that we are (still) seeing at the moment. The Chinese central bank has abandoned the rule making it more expensive to speculate against the currency in the offshore market to take the upward pressure off the currency somewhat. But we do not think the central bank will forcefully stem the rise as long as the strengthening does not go too fast and derail the recovery. In fact, the central bank has recently signaled that it sees the strengthening of the CNY as part of a re-adjustment of the Chinese economy towards a more consumption based/less export driven economy.

The second driver for the recent CNY strength is the rising probability of a Biden win and even the Democratic Party taking a 'clean sweep', winning both chambers of the US congress. If a democratically controlled congress indeed turns out to be the case, it would mean two things that would benefit the CNY: 1) the likelihood of a fiscal expansion increase which would boost growth in the US economy and weaken the USD and 2) albeit a Biden administration would be critical of China, it would choose a less abrupt strategy than the uncontrolled, damaging trade war that has hurt the Chinese economy and global risk sentiment quite badly.

Hence, bottom-line, this explains the CNY strength and we see potential for more strength, if indeed the US election turns out to provide a clear Biden win, creating downside risk to our 12M USD/CNY forecast of 6.60. Among upside risk for the cross is a surprise Trump win and/or a muddy election result as well as renewed rising tensions between US and China, but also between China and Taiwan where tensions have built lately.

A stronger CNY is generally good for the global economy. 1) It makes it cheaper for foreign companies to sell their goods on the Chinese market, boosting export growth in economies like Germany and Asia and to some extent Latam which supplies a lot of raw material to China. 2) It strengthens global reflation as import prices increase in the rest of the world on more expensive imports from China which is still a very important production hub. This is good news for the efforts in economies such as the eurozone which is struggling to get inflation rates up. 3) A stronger CNY also defuses criticism in the US that China is trying to gain advantage from a cheap currency, reducing the risk of adverse restrictions on trade with China.

Growing interest rate differential with the US and rest of the world behind CNY strength...

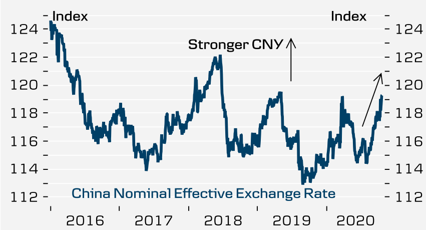


Source: Macrobond Financial, Bloomberg

...which is driven by both higher Chinese and lower US interest rates

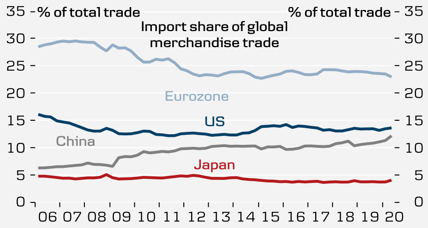
Source: Macrobond Financial

In trade weighted terms, CNY is almost back to the levels seen in 2018



Source: Bank of International Settlements, Macrobond Financial

Chinese imports as a share of global trade is now as important as the US



Source: WTO, Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Jakob Christensen, Head of Macro & Emerging Markets Research.

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None.

Date of first publication

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