Mizuho Chart Speak: FX & China

Economics & Strategy | Asia ex-Japan

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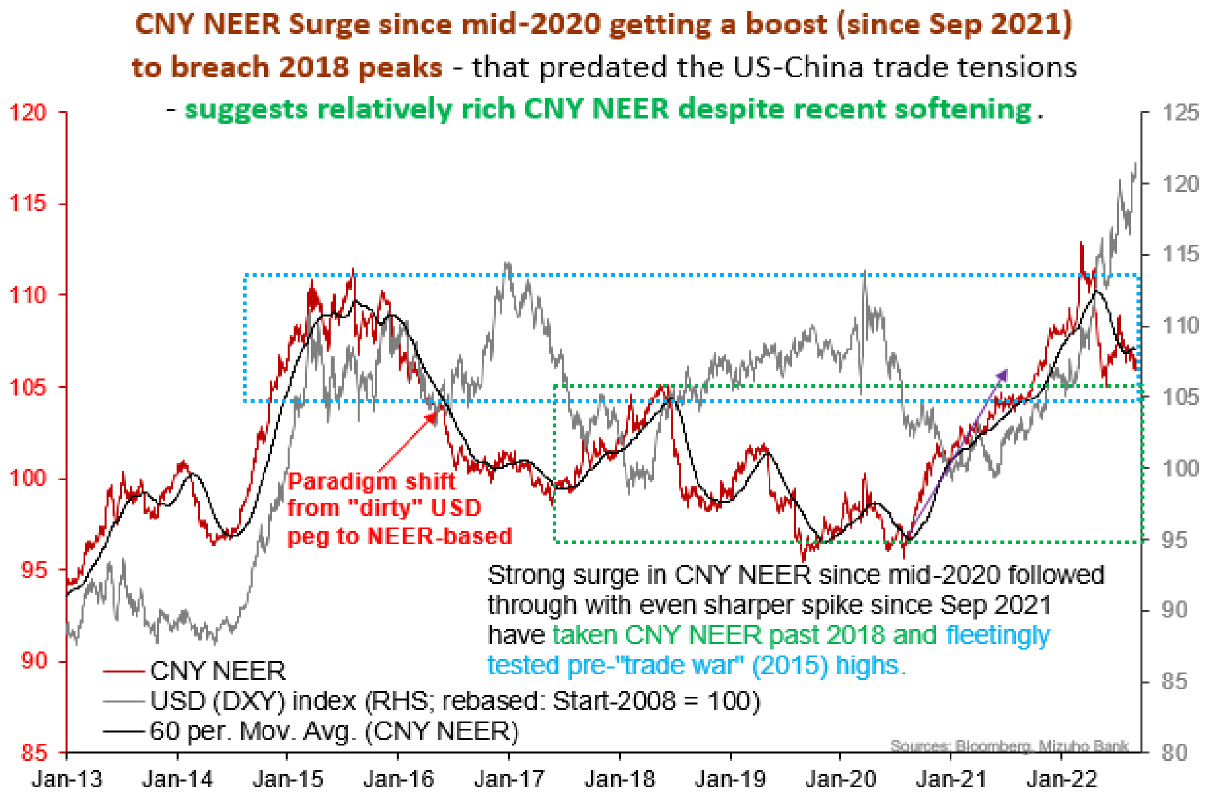
Can CNY Defy the Dollar (Bull)?



FX Forecasts	Sep 22	Dec 22	Mar 23	Jun 23	Sep 23	Dec 23	Mar 24	Jun 24
USD/CNY	6.60 - 7.12 (6.98)	6.57 - 7.07 (6.89)	6.59 - 7.10 (6.75)	6.41 - 6.88 (6.62)	6.23 - 6.70 (6.44)	6.18 - 6.55 (6.38)	6.24 - 6.62 (6.45)	6.21 - 6.59 (6.42)

"It is not our part to master all tides …"**– Gandalf, Lord of the Rings**

In a Nutshell: Admittedly, the 2%-pt cut to FX reserve requirements from 8% to 6% **may slow and partly subdue CNY pressures**. But this merely buys temporary relief. The bigger picture being, the **PBoC cannot draw a line in the sand to decisively stem CNY pressures *unless the bullish USD tide turns***. Especially as *China risks from COVID lockdowns, property sector overhang and resultant confidence deficit squares with* **more CNY pressures in the pipeline that defers to a bullish USD trend**. But **while inconvenient** (especially ahead of the 20th NPC set for mid-October), a **weaker CNY** that is *in line with broader FX market trends* is **not an unmitigated disaster**.

And with a ***still rich CNY NEER*** (despite recent moderation), the **PBOC need not** aggressively defy CNY weakness from a bullish USD. In fact, it **should not if doing so involves costly FX reserve depletion**; as the latter may perversely intensify CNY depreciation and capital outflow spirals. For now, **so long as adverse depreciation-capital outflow spirals may be averted**, the mix of capital controls, **CNY fixing and reserve requirement tools should suffice**. *Under more stress, direct intervention in asset markets to stabilize capital flows may be preferred to direct FX intervention at the risk of potentially destabilizing FX reserve depletion.*

Futility of Lines in the Sand: The **PBoC cannot draw a line in the sand to decisively stem CNY pressures while a vehemently bullish USD wave overwhelms**. Put another way, **plans to defend 7** (or any other arbitrary USD/CNY levels) are **likely to prove futile *unless the bullish USD tide turns***.

And so, any further **PBoC action**, not unlike the 2%-pt cut to FX reserve requirements from 8% to 6% (aimed at increasing USD/foreign currency supply onshore), **may retard** and perhaps **even dampen CNY pressures**. **But only temporarily**.

Deferring to Broader Bullish USD Trend: Instead, the **broader (bullish) USD trend will determine the direction of travel**. Which is to say an emphatic and durable CNY rebound will be reliant USD turning course. Whereas, *China risks from COVID lockdowns, property sector overhang and resultant confidence deficit squares with* **more CNY pressures in the pipeline that defers to a bullish USD trend**.

As King USD is Unchallenged: **Especially as other Major currencies** such as **EUR**, **JPY** and **GBP fall far short of credibly challenging**, much less **displacing**, '**King USD'**; thereby **entrenching USD bulls backed by an aggressively hawkish Fed**. In contrast, EUR, GBP and JPY are hobbled; be it because of a stridently dovish BoJ or in spite of *ECB's and BoE's hawkish impulses* (inevitably overshadowed by more acute stagflation risks amid sharper policy trade-offs).

But Not a Disaster: But **while admittedly making for undesirable optics** (especially ahead of the 20th NPC set for mid-October), a **weaker CNY** that is *in line with broader FX market trends* is **not an unmitigated disaster**. Point being, **sweeping USD dominance** (with resultant declines across G10 and EM currencies alike) **diminishes relative risks associated with USD/CNY above 7** (or any other arbitrary target). Especially given that **despite fairly significant moderation** over the past few months, the **trade-weighted CNY remains exceptionally rich**; well above post-"China Crisis" (2015-16) peaks (See Chart).

Controlled, Not Crashing: And so, the **PBoC need not resort to rigid FX interventions**; **so long as CNY descend is controlled** and *not a crash.* Thus, for now, the evidence suggests the PBoC manage via FX reserve requirements, capital controls, CNY fixing guidance and light touch intervention. That is, **so long as PBoC is able to prevent speculative bets** snow-balling into on one-way CNY depreciation; thereby creating self-fuelling spirals of CNY depreciation and capital outflows.

Folly of Mis-guided Force: In fact, there is a case to be made that barring worst-case scenarios **PBoC *should not* aggressively defy USD bulls**. Particularly **if this involves drawing down FX reserves** to defend the CNY. If nothing else, the **lesson of 2015-16 China crisis was that the "cash-burn" that depleted $1trln of FX reserves** (from $4trln to $3trln) in trying to defend the CNY **perversely exacerbated the sell-off**. And so, *forcefully defending specific levels of USD/CNY may not only be futile, but a costly folly.*

Tools & Tactics: For now, **capital controls** *burnished by tighter border restrictions from "Zero COVID"* policy alongside **FX reserve requirement lever** and **CNY fixing guidance ought to help manage a controlled descend in CNY**, which is likely to be **more subdued than in other EM FX**. In addition, under greater periods of turbulence, **direct intervention in asset markets** to support prices (and *indirectly stem capital outflows*) may be **preferred to burning through FX reserves to directly support the CNY**; given the 2015-16 'China Crisis' experience of adverse feedback between FX reserve depletions and depreciation.

All said, the **CNY cannot defy sustained USD bullishness**, *nor is it in the best interest of Beijing to do so forcefully;* although it is arguably better placed to contain excessive volatility compared to other EM FX. Drawing counsel from Gandalf, it is *not the part of the PBoC to master (and defy) the USD tide.*