Daily Note

CHANGE OF VIEW: STABLE YUAN IN 2019

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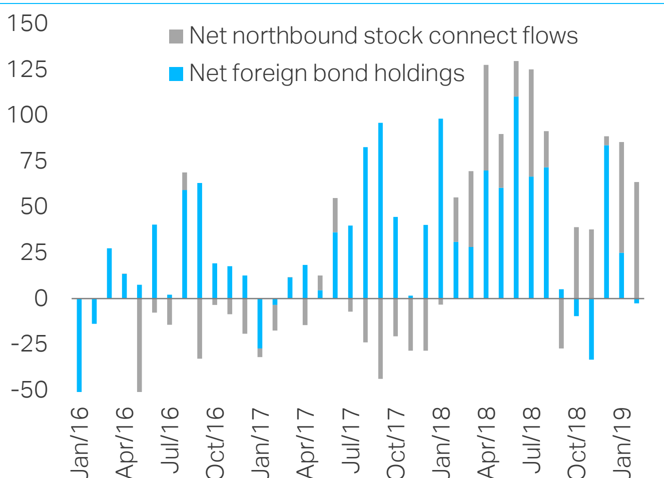
- **Political considerations will shape the near-term Chinese currency outlook**
- **Larger foreign portfolio inflows will support a stable yuan in 2019**
- **But abandoning currency depreciation means other stimulus measures will have to be strengthened in order to stabilize growth later this year**

Last August, we argued that the likely full-scale trade war between China and the US would fundamentally change the outlook for the yuan: namely, if 25% tariffs were imposed on all exports to the US, the Chinese currency could devalue as much as 15% vs USD. But contrary to our previous base-case assumption of a full tariff war, President Trump decided in early November to engage in trade talks with China following a telephone call with President Xi. For this reason, we revised our yuan call in November from large-scale deprecation to small-scale devaluation. After the Trump-Xi G20 dinner in early December and the announcement of a temporary truce in the trade war, the yuan appreciated by 3.4% against the dollar and 3.5% vs the CFETS trade basket. Its strength not only reflected greater optimism about the likelihood of a trade deal but also was driven by foreign portfolio flows into China.

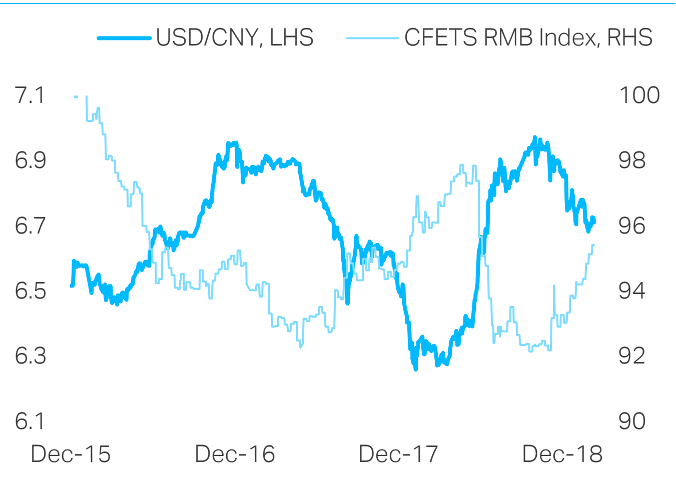
Among the elements of a trade deal reported to being discussed currently is that Beijing will commit to maintaining a stable currency as part of a final agreement. PBoC Governor Yi Gang confirmed last Sunday that FX policy was on the table in the most recent round of negotiations

Chart 1: Foreign portfolio inflows, RMB bn



Source: CEIC.

Chart 2: RMB exchange rate



Source: CEIC.

and said the two sides had reached consensus on many key issues. In our view, a "stable yuan" is likely to be included in the agreement being discussed ahead of the next Trump-Xi summit.

Market expectations vary widely as to what an agreement on a "stable yuan" would entail. We believe it is most likely that China will promise to keep its currency below a certain level – for example, 7 to the dollar – for the time being and to refrain from one-off or rapid competitive devaluation on the scale witnessed in 2015 and 2018, i.e. not use depreciation to boost exports. Similar to the framework of United States Mexico Canada Agreement (USMCA), China would formally commit to refraining from large direct FX intervention, informing the US promptly if there is a need to carry out FX intervention and increasing transparency in areas such as the timely publication of monthly intervention data.

Committing to a stable currency would be contrary to China's longer-term plan of gradually moving towards a more market-driven exchange rate. But the near-term yuan outlook could be shaped largely by the political consideration of reaching a trade deal that satisfies the US desire to include currency stability, particularly given pressure by Washington on sensitive issues such as enforcement.

Fundamental economic factors in China such as the growth outlook, interest rate differentials and the current account balance still point to a weaker yuan. But if both China and the US agreed to measures to ensure a "stable yuan", the central bank might not have to prop up the currency because market optimism would likely suffice to keep it stable in 2019. This means there would be less pressure on the PBoC to take other measures to stabilize the yuan later this year if foreign capital continued to flow in.

Despite the strong recovery in Q4/18, China's annual current account surplus fell from a surplus of 9.9% of GDP in 2007 to 0.4% of GDP in 2018 – its lowest level since 1995. We expect the current account to move to US$30-50bn deficit in 2019 owing to a smaller merchandise goods trade surplus. On the other hand, total foreign inflows into stocks and bonds combined were around US$130bn last year, contributing to overall stability in China's capital flows.

The inclusion of the onshore bond market in a major global bond index and the further expansion of A-shares in major global equity indices will continue to attract more portfolio inflows in 2019. Bloomberg has confirmed it will include Chinese government and policy bank bonds in the Bloomberg-Barclays Global Aggregate Index starting from April. And in February, MSCI announced an increase in the inclusion factor for China A share Large Cap from 5% to 20% as well as the introduction of A share Mid Cap and ChiNext stocks. These additional index inclusions point to further sizeable increases in net inflows during the rest of this year, meaning that the projected current account deficit is likely to be offset by larger foreign portfolio inflows.

A trade deal that will likely include a "stable yuan" backed by both China and the US suggests that our earlier expectation of USD/CNY exceeding 7 is unlikely in 2019, even if growth slows further, as we expect. We thus change our USD/CNY outlook from small-scale depreciation to stable in the next six to nine months. If a trade deal is announced and some or all existing tariffs were to be removed, we could see scope even for small-scale yuan appreciation, since the market will be positively surprised.

Thus, for the time being, political considerations are likely to outweigh fundamental factors such as growth outlook, interest rate differentials and current account and capital account liberalization in determining the USD/CNY level. But relinquishing depreciation as a tool would mean that policy would likely to shift to stronger conventional credit easing and fiscal stimulus if domestic growth were to decelerate more than expected. This would then increase the probability of China heading towards Japanese style growth stagnation in the medium term.