China Signals Flexibility in the CNY exchange rate

On Saturday, 19 June, China signalled the end of its currency peg which fixed the CNY at 6.83 to the USD and said it would gradually make the its currency more flexible. The CNY appreciated to 6.80 on Monday.

A stronger CNY it was hoped would:

- Address the trade imbalances between the US and China.
- Address inflationary pressures in China.
- Provide impetus to developing a more balanced Chinese economy away from exports towards domestic consumption.
- Increase outward overseas investment due to increased purchasing power.
- Reduces foreign debt obligations and debt service, China had in 2005 about 180 billion USD of external debt.
- Ease the risk of asset bubbles by delinking Chinese monetary policy from US policy.
- Keep the Washington trade hawks at bay and reduce the risk of a trade war.
- Be a vote of confidence for the global economy in general and the Asian and Chinese economies in particular.

However:

- One wonders how prepared China's companies are for FX volatility, especially smaller and less sophisticated exporters.
- A stronger CNY can become a much stronger CNY as capital inflows increase in anticipation of further CNY appreciation. Such capital inflows can exacerbate existing asset bubbles such as real estate.
- A stronger CNY will put pressure on the agricultural sector as imports become cheaper. There are some 500

million farmers in China.

- What is the PBOC’s objective, is it a stronger CNY or a freely floating one? There are pros and cons of each route. A freely floating CNY would imply independent monetary policy. On the other hand the PBOC might not want to live with the volatility of a market determined exchange rate.
- A lot depends on the magnitude of the CNY appreciation. Elasticity of exports and imports takes a long time to adjust and usually adjusts to secular trends, of which it is a circular driver, which by implies that the trade balance will adjust more to larger and more established moves in the exchange rate.
- Given the behaviour of CNY when it was allowed to appreciate from 2005 to 2008, it is likely that the PBOC does not intend a floating exchange rate but rather will manage the exchange rate in very tight fashion to achieve a steady and controlled appreciation. This addresses many of the risks of a floating exchange rate that the Chinese economy might otherwise struggle to manage.
- Absent a managed float, market forces are likely to encourage a weaker CNY not a stronger one, as the balance of trade swings towards balance with the US.
- Allowing more flexibility in the CNY exchange rate is likely to translate into a reduction of demand by the PBOC for US treasuries which is a de facto withdrawal of vendor financing for Chinese exports. Demand for trade settlement is likely to strengthen the USD. The natural pressure on CNY is not clear.

Murphy’s Law:

Forecasts and expectations are often confounded as reality has an uncanny tendency to defy all logic and reason.