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China Economics Update: USDCNY likely to remain weak amid USD strength
中国经济评论：强美元下，人民币兑美元汇率预计持续偏弱

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- 人民币对美元汇率近期显著走弱，昨天创下 2007 年一来的最低水平后,今天反弹。强美元是近期人民币兑美元走弱的主要原因。人民币兑一篮子货币指数仍较坚挺。人民币兑美元汇率的下行压力与其他几个亚洲新兴市场货币一致，而明显低于非美元 G7 货币。中国强劲的贸易顺差继续支撑人民币汇率的基本面。
- 我们预计中国人民央行将继续容忍人民币兑美元汇率的弹性，避免汇率水平大幅偏离基本面。但同时央行可能继续通过政策指引，人民币对美元中间价和其他政策工具（例如重启逆周期因子等），以防止人民币汇率的过度波动。
- 在持续的美联储鹰派态势和全球经济增速放缓的背景下，我们预计美元指数在未来 3-6 个月持续位于高位。但中期仍会随联储加息见顶而走弱。持续的强美元意味着相对弱的人民币。我们预计人民币对美元汇率近期可能在 7-7.3 区间徘徊。
- Until the USD/CNY rebounded today, it had weakened to a level last seen in 2007. US dollar strength has been driving recent USD/CNY weakness. The CNY index remains solid against a basket of currencies. Downward pressure of the renminbi against the US dollar is in line with several other EM Asia currencies, but significantly less pronounced than pressure on non-USD G7 currencies this year. China's strong trade surplus continues to support renminbi demand.
- We expect the PBoC will continue to tolerate greater currency flexibility in order to avoid large currency misalignments. Meanwhile, it plans to reduce excessive volatility through verbal signaling, stronger USD/CNY fixing, and other policy tools, for example, through the formal re-introduction of countercyclical factors in its daily fixing.
- We expect US dollar strength to persist in the next three-to-six months as the Fed stays hawkish and as global uncertainty persists. Following this period, we would expect US dollar strength to wane, especially once the Fed hiking cycle draws to a close. Continued US dollar strength is likely to be mirrored by a soft USD/CNY, which in our view is likely to hover within the recent range of 7.0-7.3.

CNY weakens against the strong USD

The renminbi weakened against the US dollar in recent days. The USD/CNY topped 7.3, its weakest level since Dec 2007, before a significant reversal in the past few hours. The spot USD/CNY and its daily fixing widened to 1.6%, pointing to the downward pressure on the renminbi against the dollar (Fig 1).

The driver of renminbi weakness has been US dollar strength. The CNY index, measured against a basket of currencies has been quite resilient (Fig 2). Downward pressure of the renminbi against dollar has been in line with other EM Asia currencies such as the Malaysian ringgit (MYR), the Thai baht (THB) and the Philippine peso (PHP), but significantly less than the pressure on non-USD G7 currencies this year (Fig 3 and 4). While the soft domestic growth outlook and the PBoC's accommodative monetary policy have been a headwind to the currency, trade and the current account surplus have continued to climb, supporting demand for the renminbi. In turn, bearish sentiment and selling pressure on the renminbi has been relatively contained, keeping both well below the levels seen in 2015-2016 (Fig 5).

PBoC allows for downward flexibility while sending reassuring signals

The PBoC has in general tolerated the flexibility of the bilateral exchange rate and weaker renminbi against the US dollar. While the USD/CNY was stable during the first three weeks of Oct, USD/CNY fixing increased this week, in keeping with the trend of the spot FX rate. In our view, the PBoC does not aim to maintain USD/CNY at a particular fixed level, but instead wants to manage volatility. Regulators have given verbal support for the renminbi and they aim to anchor currency expectations against rapid depreciation. The Required Reserve Ratio was hiked on forward FX sales to increase the cost of selling CNY months ago. In addition, on 25 Oct, the PBoC announced new measures to allow cross-border borrowing by financial sectors.

We expect the PBoC will continue to tolerate greater currency flexibility to avoid large misalignments, while still dampening excessive volatility through verbal signaling, stronger USD:CNY fixing, and other potential policy tools, such as the formal re-introduction of countercyclical factors in its daily fixing.

USDCNY outlook

The US dollar trend remains crucial. Rapid Fed rate hikes have pushed US dollar strength this year. The FOMC aims to contain inflation pressure with front-loaded rate hikes this year after having sat on its hands for most of 2021. However, inflation remains stubbornly high against the Fed's expectations. Financial markets expect 125-150bp rate hikes to be announced at the Nov and Dec policy meetings, which will bring the mid-point of Fed Funds rates to 4.4-4.6%. Such high Fed Funds rates would be significantly higher than the Fed's neutral rate estimate of 2.50-2.75%, indicating a restrictive policy stance. At the same time, US growth has slowed as suggested by recent data, and concerns about a recession and rising unemployment have dominated headlines.

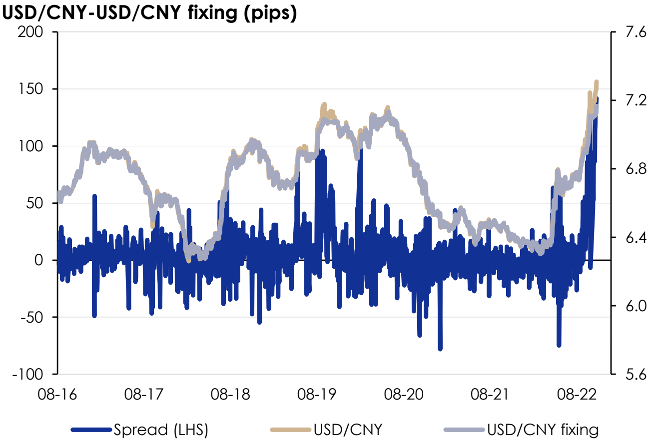
We expect the Fed will slow the hiking pace in 2023F to assess the impact of early hikes and the economy's ability to cope with its restrictive policies. We expect inflation to slow meaningfully from mid-2023F onwards. Housing inflation, a driver of recent inflation surprises, is likely to fade in 2023F against a backdrop of softening property activity. However, the downtrend in inflation may well be slower than the Fed or the market expect (read here for details), suggesting upward risks to rates remain.

Meanwhile, the economic outlook for Europe has darkened markedly. Various indicators point to a deep recession in the EU if it isn't in a recession already (Fig 6). By contrast, US economic growth held up relatively well despite the recent slowdown. Labor markets remain tight despite signs of softening.

Thus while we expect the US dollar to soften eventually as the Fed slows its hiking pace, US dollar strength is likely to persist in the next 3-6 months as the Fed maintains its hawkish stance and as global uncertainty continues.

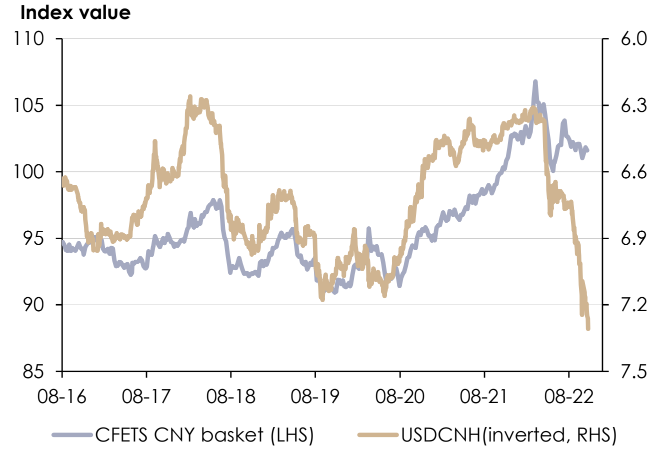
Continued strength in the US dollar is likely to be mirrored by a soft USD/CNY, which is likely to hover within the recent range of 7.0-7.3. Improvement in the cyclical economy in China led by the industrial sector has supported an economic rebound (read here for details), but consumption remains a soft spot. We expect the PBoC to maintain supportive monetary policy amid the continued domestic economic recovery. Meanwhile, sharp FX weakness could add to domestic cost pressure and financial fragility. We do not rule out more direct support for the currency should volatility increase.

Fig 1: Persistent RMB depreciating pressure



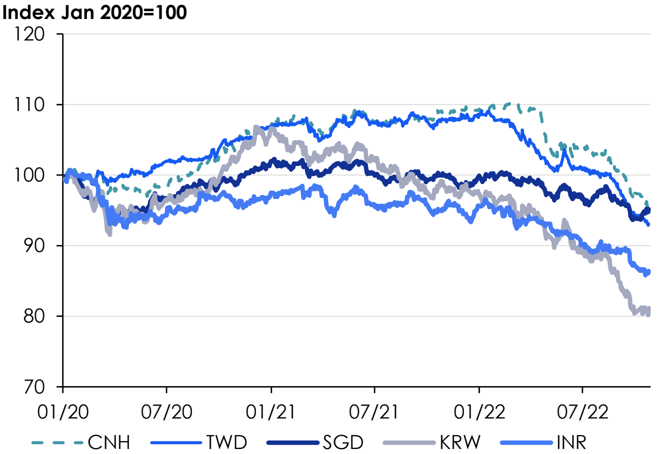
Source: CEIC, CCBIS

Fig 2: The CNY index remains solid



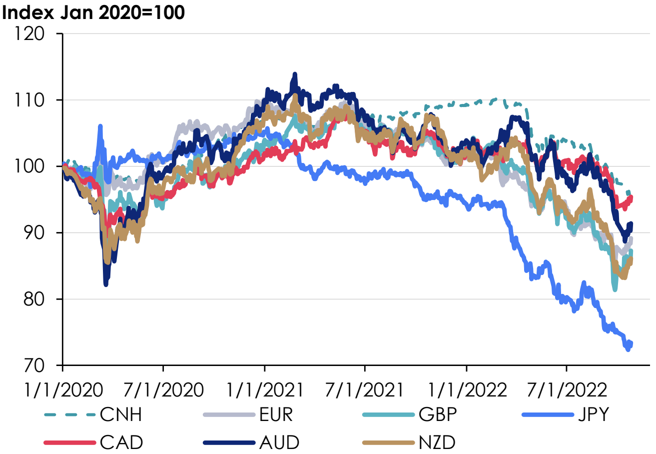
Source: CEIC, Bloomberg, CCBIS

Fig 3: CNY performance in line with other Asian currencies



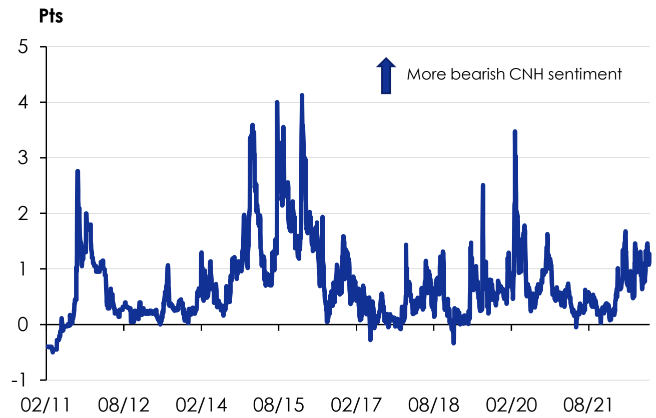
Source: Wind, CCBIS

Fig 4: CNY outperformed major G7 currencies



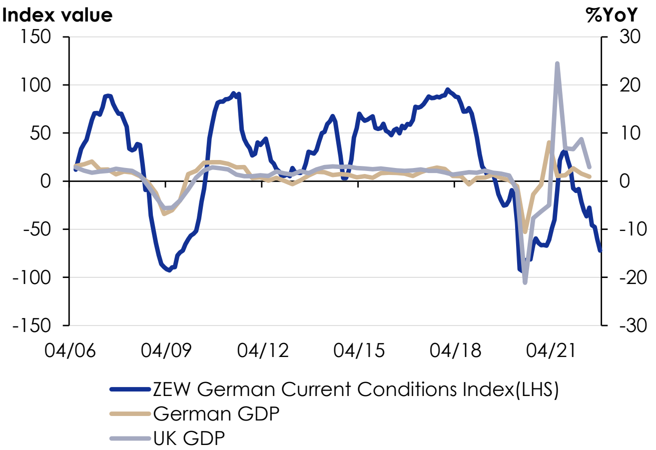
Source: Wind, CCBIS

Fig 5: Market participants are not as bearish as in 2015



Source: Bloomberg, CCBIS

Fig 6: The economic outlook for the EU and UK darkened



Source: CEIC, CCBIS

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