CAPITAL ECONOMICS

FX MARKETS UPDATE

Intervention time: what next for the yen and the renminbi?

- **China has stepped up its support of the renminbi and Japan appears to be edging closer to direct intervention to prop up the yen. While pressure from higher US interest rates may well continue in the short term, we think that both currencies will rebound over the second half of the year.**
- To recap, both the yen and the renminbi have depreciated significantly this year, and are now close to the levels at which Japan's and China's authorities intervened in support of their currencies last autumn. (See Chart 1.) The fall in these currencies stands in contrast to other major currencies, most of which have continued to rebound against the US dollar over the first half of 2023. (See Chart 2.)
- The main driver of these developments, in our view, is the continued widening of expected interest rate differentials as the FOMC (and most other major central banks) have tightened monetary policy further, even as the BoJ and the PBOC have kept their policy settings accommodative. (See Charts 3 & 4.)
- **Over recent weeks, the authorities in both Japan and China have signalled growing discomfort with the ongoing depreciations of their currencies**. They have followed a similar approach as last year, gradually ratcheting up their rhetoric with the apparent aim of supporting their currencies through the threat of intervention. The PBOC has also been setting the daily USD/CNY "fix" at a stronger level than the market has been trading at, a tool it has used in the past to indicate its preferences about the exchange rate.
- What's more, earlier this week there were reports that China's large state-owned commercial banks were selling dollars directly, and have reduced the interest rates they offer on dollar deposits. This marks another step up from jawboning: in effect, the state banks appear to be acting as auxiliaries for the PBOC.
- **These measures appear to be having some effect. Even though US yields have risen sharply this week in the wake of the hawkish FOMC minutes and robust US data, the renminbi is roughly flat on the week** (although it has given up its gains from earlier in the week), while the yen has appreciated (in addition to the threat of intervention, it also appears to have benefitted from unwinding of carry trades in recent days).
- Whether this new-found stability proves a turning point depends on two key questions:
- **The first is how determined are policymakers to prevent further depreciations?** While FX intervention has a decidedly mixed track record, in the current situation there are several reasons to think the authorities are in a position to, at least, slow down, and perhaps even stop, the slides of the yen and the renminbi.
- For one, China and Japan have ample firepower for intervention, should policymakers chose to deploy it. Indeed, if they were to act at the same time, the effect might be amplified. As with monetary policy, the effectiveness of FX intervention depends as much, if not more, on signalling effects as it does on the mechanical financial flows involved. Two major economies (and the world's two largest FX reserve holders) pushing back at the same time would be a powerful signal (as proved the case back in October, when intervention from Japan, China, and several other countries helped put an end to the dollar's surge).
- In addition, both countries run current account surpluses, and their terms of trade have actually improved over recent months as commodity prices have fallen. At this point, the yen and, to a lesser extent, the renminbi look undervalued relative to fundamentals and to their recent pasts. (See Charts 5 & 6.) So policymakers have some of the underlying economics (though not the cyclical situation) on their side.
- **The second, and probably most important, is what happens to US Treasury yields and, by extension, yield differentials?** If yields in the US (and other advanced economies) keep rising, that would heap further pressure on the yen and the renminbi, since the BoJ and the PBOC appear determined to stick to their accommodative monetary stances, come hell or high water.
- Our base case is that US interest rate expectations will start to fall back later this year as slowing growth and fading inflation pressures prompt the Fed to reassess and shift towards easing policy. That would probably relieve much of the pressure on the yen and the renminbi. That is the key reason why we forecast rebounds in both the renminbi and the yen by the end of this year (to 130/$ and 6.9/$ respectively)
- That said, in the short term, upward pressure on US interest rate expectations could continue. That would test the resolve of the authorities in Japan and China. **In our assessment, the current levels (~145 & ~7.3) are probably best thought of a first line of defence that they will try to hold onto with the tools deployed so far (verbal intervention and, in China's case, some auxiliary intervention). Should those levels break and deprecations continue, more forceful and direct intervention would likely follow (probably around the 150 & 7.5 levels), especially if market conditions showed signs of becoming disorderly.**

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Chart 1: USD/JPY & USD/CNY

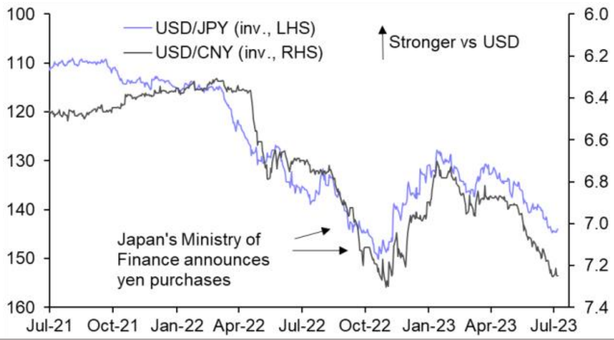

Chart 2: Vs USD (Jan. 2014 =100)

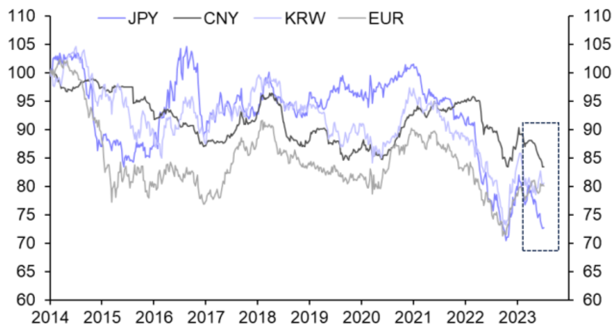

Chart 3: USD/JPY & US Less Japan 5-year Government Bond Yield

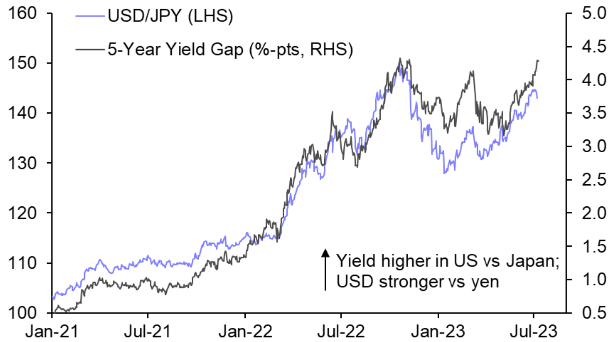

Chart 4: USD/CNY & US Less China 5-year Government Bond Yield

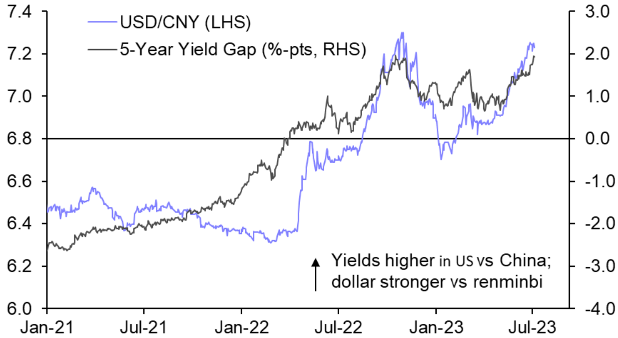

Chart 5: Japan Real Trade-weighted Exchange Rate (Jan. 1994= 100)

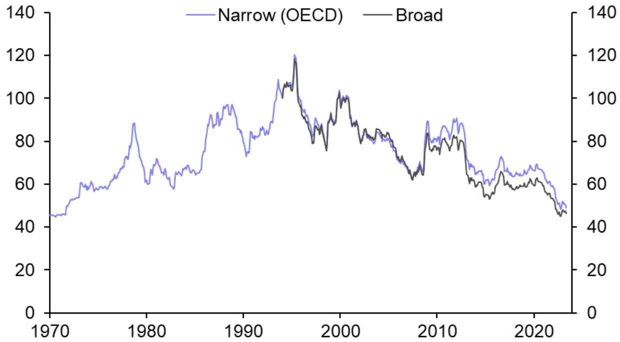

Chart 6: China Real Trade-weighted Exchange Rate (Jan. 1994= 100)

Sources: Refinitiv, Capital Economics


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