CAPITAL ECONOMICS

FX MARKETS UPDATE

Another look at the renminbi, the yen & FX intervention

- **While policymakers' efforts to prop up the renminbi and the yen alone are not enough to generate a lasting turnaround, they will probably do enough to buy time until US interest rate expectations and Treasury yields fall back and the dollar depreciates of its own accord.**
- Over the past couple of weeks, the authorities in both China and Japan have stepped up their defense of the renminbi and the yen in the face of higher US yields and a generally strong dollar. The PBOC's strongly worded statement earlier this week is its most explicit threat, so far, of direct exchange rate intervention. And, according to multiple reports, there was another round of "proxy intervention" via China's state-owned banks at the same time. Meanwhile, Japan's Ministry of Finance had already escalated its jawboning in support of the yen to the point that the next step would probably be outright intervention.
- **These measures have helped to stabilise the yen and the renminbi (aided by another soft(ish) US CPI print on Wednesday putting a lid on US Treasury yields)**. But both currencies are still near their weakest levels against the dollar on the year, and not far off their lows last autumn, when heavy-handed intervention and a fall in US bond yields sparked a temporary rebound. (See Chart 1.)
- Both China and Japan have ample firepower to defend their currencies through direct intervention, and China has a wide range of other tools to use as complements to intervention. But, as the experience over the summer (and last year) shows, while those measures can buy time they are not enough to drive a sustained rebound whilst the gap between short-term US yields and those in China and Japan continues to increase. Those gaps are now at their widest levels since the mid-2000s. (See Chart 2.) Until that changes pressure on the renminbi and the yen will probably continue.
- Two key factors have changed over the past couple of months, which suggest to us that the renminbi is now at greater risk of further deprecation than the yen.
- **First, the outlook for monetary policy in China and Japan has started to diverge**. Both the PBOC and the BoJ remain outliers in pursuing loose policy in a global tightening cycle. But the slowdown in China's economy has led the PBOC to ease policy over recent months, including yesterday's cut to banks' required reserve ratios, and it is likely to take further steps to support its ailing economy. Such measures widen the policy divergence vis-à-vis the US and other major economies, creating a tension with the aim to prevent further renminbi weakness. (See Chart 3.) In our view, worries about the exchange rate weakening is a key reason why the PBOC has held back from easing monetary policy more aggressively.
- By contrast, Japan's economy has proven more resilient than we and many others had anticipated and the BoJ loosened its long-standing Yield Curve Control (YCC) policy in July. It now appears to be inching towards further policy normalization: Governor Ueda suggested recently that interest rate hikes might be considered by the end of the year – which would the first rate hike in Japan since 2007. While some officials have since sought to row back on those comments, and such steps would most likely prove slow and gradual, they suggest to us that the yen will have some support from the BoJ.
- **Second, since July most other major currencies have fallen against the dollar (whereas earlier in the year they were, for the most part, rising or stable against the dollar). So, in trade-weighted terms, the renminbi has actually been *appreciating* even as it has weakened against the greenback**. (See Chart 4.) That is arguably unhelpful for Beijing's attempts to revive its struggling economy, and it increases the chance that policymakers conclude that further renminbi depreciation against the dollar is the least bad option available. Doing so would run the risk of a destabilizing cycle of depreciation expectation and capital outflows like that in 2015-16 – the key reason, in our view, that PBOC has sought to limit renminbi depreciation in recent years, especially around symbolic levels such as the current ~7.25-35 zone in USD/CNY. Judging by past periods of renminbi deprecation, that would probably also lead to the currencies of other economies in the region weakening further.
- **We continue to think that the Fed will call time on its tightening cycle sooner rather than later and turn to rate cuts next year, thereby relieving much of the pressure on both the renminbi and the yen. But should the Fed persist with its "higher for longer" approach for longer than we anticipate, pressure on the renminbi (and the yen) would intensify. In that case, our end-year forecasts for USD/CNY and USD/JPY (7.3 and 135, respectively) would probably prove too optimistic. That said, over the past couple of weeks economic data out of China has offered some hope that the cyclical downturn there is starting to bottom out, suggesting that the risks around our forecast are becoming more balanced.**

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Chart 1: USD/JPY & USD/CNY

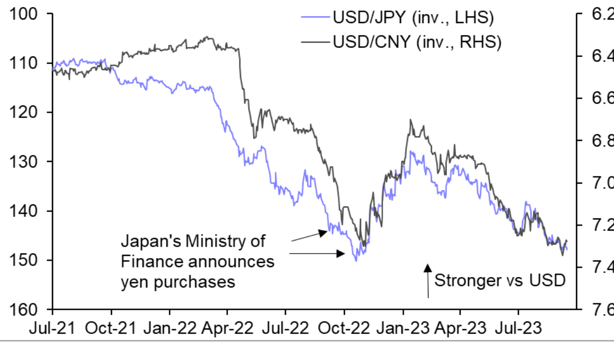


Chart 2: 2-Year Government Bond Yield Gaps (%)

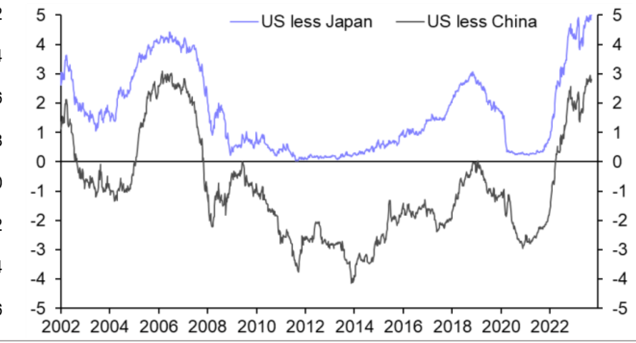
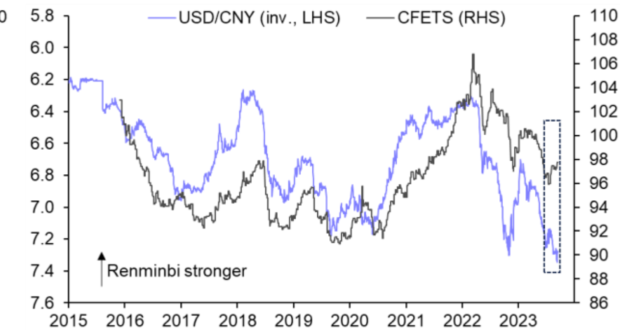


Chart 3: USD/CNY & China 1-year Benchmark Rate

Chart 4: USD/CNY & CFETS



Sources: Refinitiv, Capital Economics

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