

## What's happening in the Chinese Yuan (CNY)?

Chinese authorities are currently stemming the tide of CNY depreciation but a closer look reveals a clear bias towards weakening.

**The CNY has weakened far more than the overall DMFX and EMFX baskets of late.**

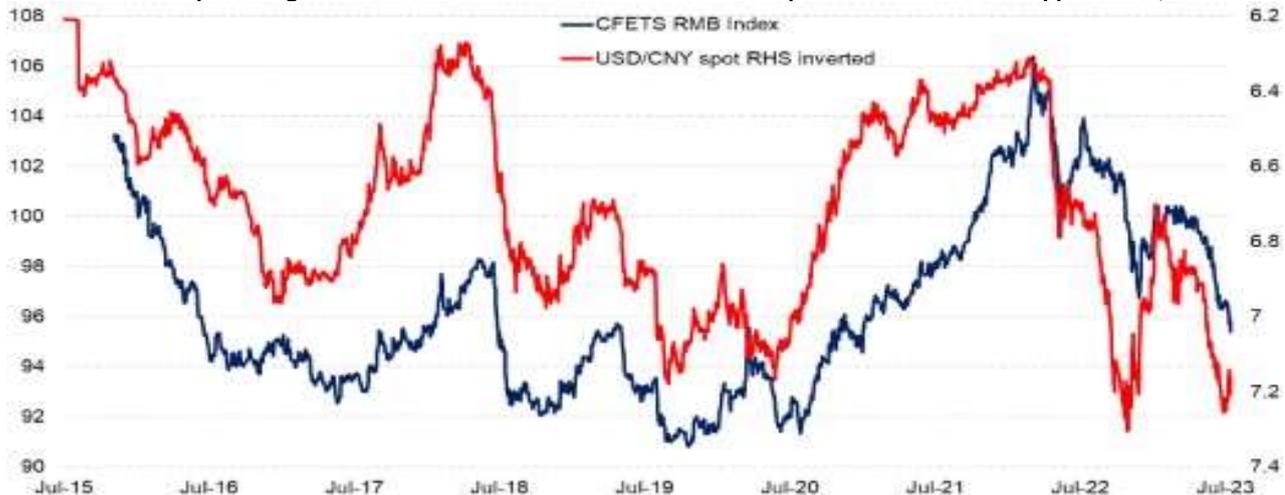
- The CNY is known to track broad FX benchmarks and has followed trends fairly faithfully until May'23.
- Even here, the CNY has not appreciated significantly after the USD came off peaks in late 2022.
- Since 2015, the Chinese authorities have tracked the CNY through an nominal effective exchange rate (NEER) basket called the China Foreign Exchange Trade System (CFETS RMB) index (chart 2).
- A clear depreciation intent is observed when this is looked at for the period after May'23 when the recent CNY appreciation is not replicated in the index.

Chart 1: CNY vs other FX benchmarks against the USD, indexed



Source: Axis Bank Business and Economic Research Team

Chart 2: USD/CNY plotted against the CFETS RMB index - note that a move up in the index indicates appreciation, and down depreciation



Source: Axis Bank Business and Economic Research Team

**A look at the fixing mechanism corroborates the bias seen above.**

- The SAFE (State Administration of Foreign Exchange) fixes the CNY on a daily basis using computations of the CFETS RMB index and market levels along with a trend factor to denote appreciation and depreciation bias, as well as a countercyclical factor which smooths for large fluctuations.
- A smoothed version of the daily fix (note that this guides actual movements, the People's Bank of China (PBOC) would earlier intervene if the CNY moved a certain percent away from the fix) shows the bias around appreciation and depreciation the authorities are comfortable with.
- Steady appreciation bias during the pandemic and reversal of this with the drop of zero-COVID in late 2022 are both visible.

**There is also a factor by which the SAFE adjusts the daily fix to provide signals to the markets.**

- This has been used when the authorities would like to convey more limited momentum of moves underway to markets.
- The bias here is more to limit depreciation which has in the past been a concern owing to mobility of Chinese capital under the guise of trade or remittances.
- The countercyclical factor is now once again being used, given rapid moves of the CNY past the 7.00 level coupled with high private sector savings over the zero-COVID period - lest private capital not move out rapidly.
- The mini-devaluation in 2015 caused just this problem leading to a heavy drawdown in Chinese FX reserves which have to this day not recovered.

**Why is the market looking at rapid CNY depreciation?**

- A major factor in the weakening of the CNY is the divergence in policy cycles. The Fed is nearing the end of a hike cycle but markets expect Chinese rate cuts.
- Another reason is disappointment over stimulus expectations. Amid weak demand, when stimulus measures are not materializing and it is hurting not just investor sentiment, but also industrial sentiment with private sector capex at a standstill for many months now.
- Stimulus was expected following a June state council meeting, then after the dragon boat festival and a visit to France, and now after the semiannual economic conference at end July.
- However, stimulus expectations are being pared back following talk of strategic composure by president Xi.
- The last factor is a potential weakening of the CNY to neutralise trade barriers to the Chinese economy given the geopolitical developments. The CHIPS act and inflation reduction act are examples of trade barriers, with future barriers also potentially in the offing.

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