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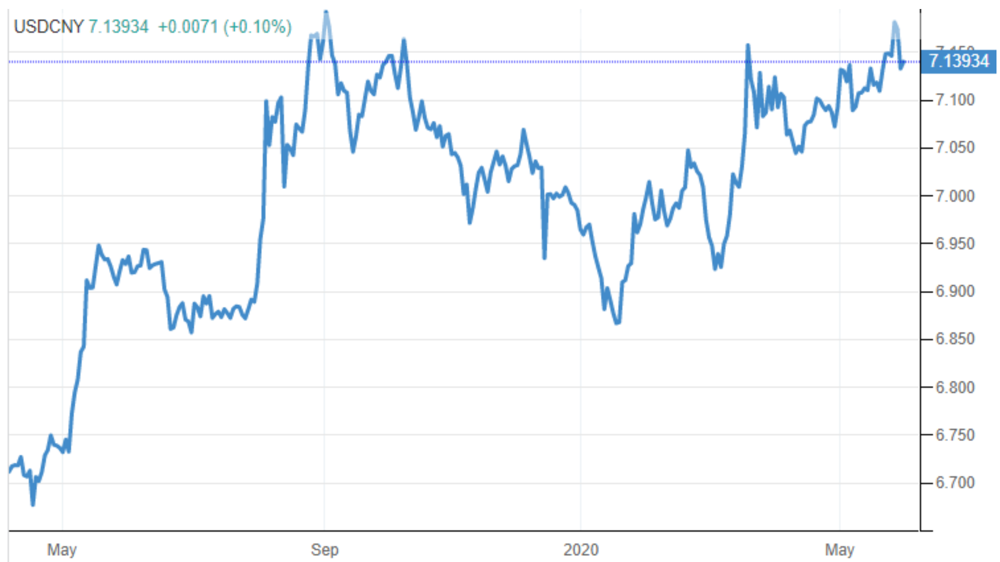
Opting for currency stability

Heightened tensions between the US and China are weakening the Chinese yuan.

We at FlatRock just love debating global currency moves and what nations around the world do to safeguard financial stability. Over the past week tensions between the US and China are exerting a strain on the Chinese yuan. Relations between the two superpowers had already been sour over China's handling of the COVID-19 pandemic but then Beijing's announcement of a national security law targeting Hong Kong took things a step further thereby causing the yuan to weaken.



Could China use its currency as political ammunition?

The deteriorating relations between the United States & China is clearly pressurizing the renminbi whereas the US greenback has remained relatively stable. One can't help but think that China is using currency depreciation as potential political ammunition. However, upon close examination it is clear that the currency is falling prey to increasing tensions, but the notion that China is nuclearizing its currency is reasonable since historically they had done so during the trade war. Until now the re-escalation of tensions has been limited to Twitter threats and some restrictions on the tech sector, but no new rounds of tariffs have been announced so currency moves have been less severe when compared to 2018-19.

Currency stability works in China's favor because it will prevent massive investor outflows.

The reason that the Chinese government will not move for depreciation, or to put it precisely rapid depreciation, is because this move will embed distrust. Given the deleterious circumstances engulfing economies around the world opting for depreciation would encourage capital outflows from the country. The PBOC pushed for relative currency stability by changing the daily reference rate. It even moved the interbank interest rates upwards just before announcing the national security legislation regarding Hong Kong. This move made the holding of Chinese currency more tempting for investors.

The Chinese central bank has several tools at its disposal to ensure currency stability. They just unveiled a $60 billion plan in which they would temporarily purchase loans made to small businesses to spur up confidence. As a result, we can expect the yuan to go down further, albeit "moderately" especially if US-China relations continue to degenerate.

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