The hazardous transition of the Chinese yuan to free-floating exchange

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Financial markets worried about China's capacity to maintain economic growth and to control its currency depreciation

Bearish speculation on the yuan recently stepped up and some analysts no longer exclude the possibility of joint action between central banks to head off a crash of the Chinese currency in the months ahead.

The evolution of 3 indicators underlies this hypothesis:

- An increase in options premium on put (sell) options on the yuan.
- Tensions between the domestic yuan’s rate (CNY) controlled by the Chinese central bank and the off-shore yuan's rate (CNH) quoted in Hong Kong: the gap between these two rates grew from 0,3 to 0,6% between November and December 2015.
- An historic drop in China's foreign exchange reserves that are consumed by the People’s Bank of China (PBOC). Reserves dropped by $513bn in 2015 (including $108bn just in December, the biggest monthly drop since 2004) to reach $3,300bn at the end of 2015, compared to $3,990bn in June 2014. Some analysts estimate that the security threshold for the reserves is around $2800bn.

Moreover, the PBOC should carry on loosening its control on the CNY, due to the requirements of the renminbi’s integration into the IMF’s SDR (Special Drawing Rights) basket, which will take place in September 2016. The renminbi will have a 10.92% share in the basket, along with the dollar (41,73%), the euro (30,93%), the yen (8,33%) and the pound (8,09%).

A double objective for 2016: enhanced independence and gradual devaluation against the dollar.

In this new context, there is every reason to believe that China’s goal is two-pronged: to unpeg the yuan from the US dollar, and gradually devalue its currency to support its economy that is experiencing a downturn (the magnitude of which is hard to assess).

To this end, China announced in December 2015 that it wanted to pilot its currency exchange rate using a basket of international currencies and not only the dollar any longer. China also asked the country’s main bank to start quoting raw materials in CNY rather than in USD (as a reminder, China is the world biggest purchaser of raw materials).

This intent contributes to increasing the renminbi’s volatility against the USD, and other ups-and-downs are to be expected, like those that occurred in August when the PBOC surprisingly devaluated the CNY. As a result, the CNY has depreciated around 6.5% against the dollar since August 2015 (USD/CNH 6.20 to 6.60) and could reach 7 in 2016 according to the market consensus, with the risk of a market panic. Morgan Stanley and Goldman Sachs, among others, expect several devaluations of the yuan in the months ahead.

Any consequences for European companies?

For European companies, the renminbi’s exchange rate volatility is a constraint, whether their contracts are denominated in CNY or in USD. Unpegging the CNY from the USD means that it will no longer be enough to hedge in USD to offset FX risk in CNY. Volatility can also become a major downside for contracts denominated in European currencies, in case prices are not fully indexed to the renminbi’s fluctuations. Indeed, if such conditions sound reassuring for European companies, clients or suppliers in China will, on their part, demand adverse fluctuations to be compensated, in order to safeguard their profitability, or just to survive. In the end, European companies will have incurred the major negative movements without being able to hedge them, and will not have benefitted from the favorable ones.

Moreover, several studies showed that denominating suppler contracts in CNY can lower prices from Chinese suppliers by several percentage points, as they do not have to manage the FX risk. It then seems sound to waive contracts denominated in EUR, GBP or CHF with Chinese counterparts, and switch to CNY-denominated contracts, in order to hedge it against your own currency. Indeed, standard hedging products are starting to become available for the CNY, and will only be more and more common in the future with the internationalisation of the currency. Hence, the methodology we discussed in our last article could also be applied to the renminbi.

USDCNH and EURCNH exchange rates since 1st January 2015