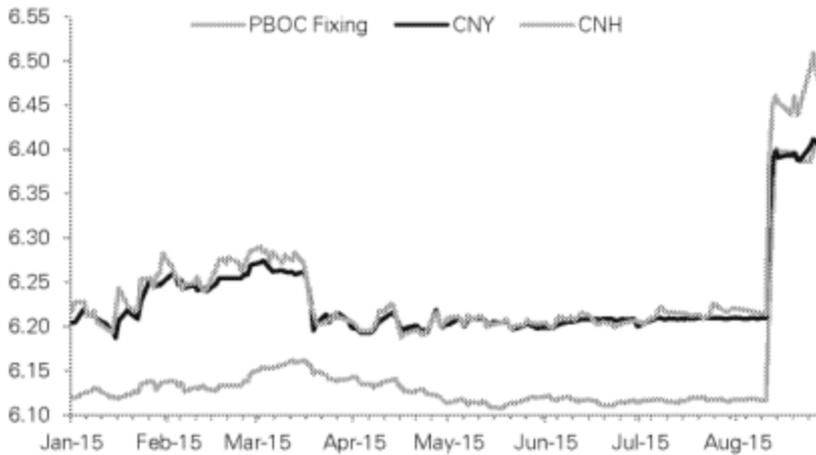




previous day's close – the PBOC found itself chasing the market higher until after three days and a cumulative 4.7% devaluation they reportedly began intervening to stabilize the exchange rate.

Figure 2: Renminbi exchange rates



Sources: Reuters and Deutsche Bank Research

While the authorities may have viewed this as a step towards a more flexible exchange rate, the effect for the time being appears to have been the opposite. Press reports offer estimates of daily intervention magnitudes far higher than China has in the past had to provide to maintain an orderly market. And the CNH/CNY basis is the widest it has been in four years.

Remarkably, market commentary now questions the ability – not the willingness – of the Chinese authorities to continue to support the currency. Officially, China had USD3.6tn in foreign exchange reserves at the end of July, down from USD4tn in June 2014. Even if some of this has been lent out to government enterprises and agencies to support offshore investments, we are confident the authorities have more than enough reserves to support the renminbi at current levels if that is their aim.

But along with a growing number of investors, we wonder whether this is their aim. Following the August 13 devaluation we raised our end-2015 forecast for the CNY/USD exchange rate to 6.5. But after the mid-July statement from the State Council that seemed to suggest a weaker currency was desirable and now with the new fixing mechanism, we are worried that the intention may be to allow a gradual depreciation of the currency at a faster rate than historically has been viewed as acceptable. Indeed, the currency has already moved much more against the dollar than we had thought likely.

Our view is that at least for the time being, the PBOC will maintain a stable currency. But we do see the currency depreciating by about 5% in 2016. But it appears to us that the risk that a bigger move is in store has risen.

We are not especially concerned about what this might mean for China. But this exchange rate surprise reinforced long-standing declines in EM currencies. The ringgit and rupiah, for example, had already depreciated 20-25% over the past year or two. Any further depreciation of the renminbi would lead, we expect, to at least a comparable depreciation in these and other regional currencies – affording China no lasting competitiveness advantage versus regional competitors but increasing risks to external creditors to countries like