FX Forecasts

Desjardins Economic Studies

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# China's yuan depreciates despite global economic imbalances

### HIGHLIGHTS

- The Federal Reserve's fairly optimistic tone and the fact that its leaders anticipate a few additional interest rate increases by the end of 2016 gave the greenback a boost, but that was not enough to completely mop up the losses of previous weeks.
- The euro's level is still unsustainable and we expect it to drop closer to US$1.35 in the next few months.
- The Canadian dollar will remain highly sensitive to shifts in economic data, especially inflation, and Bank of Canada signals for several more months.
- On a rare occurrence, the Chinese exchange rate went higher than its target. The People Bank of China stopped gradually lowering its exchange rate target and even raised it slightly as of February. The yuan's recent movements should not be seen as a lasting trend, however.

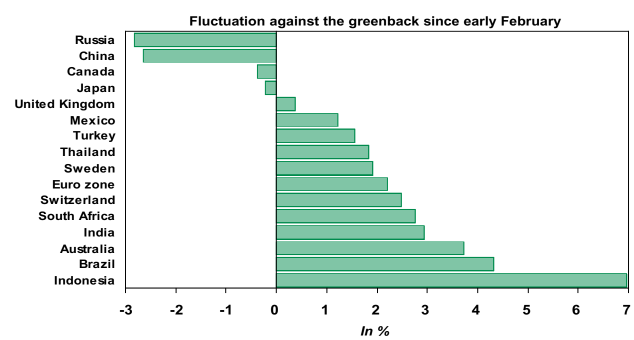
### Contents



## Editorial

Since the start of February, the currencies of many advanced and emerging nations have risen against the U.S. dollar. The Federal Reserve's fairly optimistic tone on March 19 and the fact that its leaders anticipate a few additional interest rate increases by the end of 2016 gave the greenback a boost, but that was not enough to completely mop up the losses of previous weeks. Nevertheless, the U.S. dollar did do better at least against two currencies: the Russian rouble and Chinese yuan (graph 1). While the rouble's slide can easily be chalked up to the strains between Russia and the West, what has happened with the yuan is harder to grasp.

**Graph 1 – Several currencies have appreciated against the U.S. dollar, but not Russia's rouble or China's yuan**




Sources: Datastream and Desjardins, Economic Studies

### ONE MORE STEP TOWARDS A FLOATING EXCHANGE RATE

Unlike the U.S. dollar, euro and other currencies this publication deals with on a regular basis, China's yuan does not move in a floating exchange system. Every day, the People's Bank of China (PBoC) sets a target for the exchange rate, but tolerates fluctuation within a predetermined band. As of March 17, this band is ±2% around the exchange

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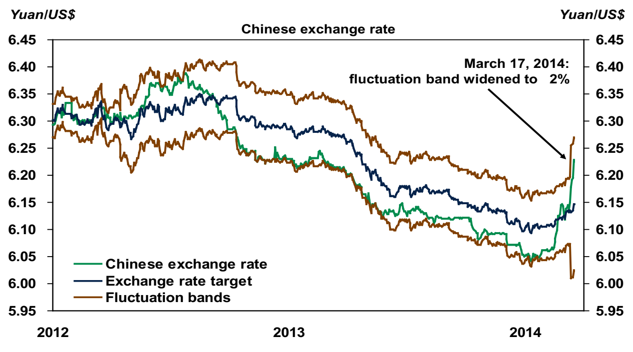
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

rate target, twice as wide as the band tolerated since April 16, 2012. Before that, it was even narrower, at ±0.5%. By tolerating greater fluctuation, the PBoC is taking one more step towards a floating exchange system; however, it still has a ways to go. Among other things, Chinese authorities will have to permit a fully convertible yuan and ease restrictions on capital flows.

### REVALUATION REMAINS JUSTIFIED

Before doubling the yuan's fluctuation band, the PBoC stopped gradually lowering its exchange rate target and even raised it slightly as of February. Those who can trade yuan construed that as a signal that the PBoC no longer wanted to revalue the yuan and, on a rare occurrence, the Chinese exchange rate went higher than its target (graph 2). However, the PBoC might simply have wanted to moderate expectations to keep the yuan from being revalued too quickly after the band was widened. In that case, the yuan's recent movements should not be seen as a lasting trend.

**Graph 2 – China's exchange rate is currently above its target**



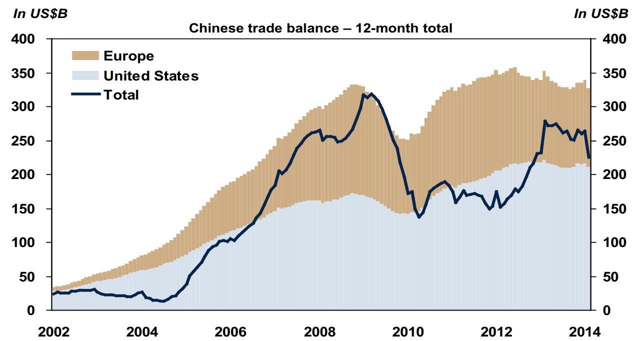

Sources: Datastream and Desjardins, Economic Studies

The recent disappointments delivered by Chinese economic data could also prompt the yuan to pull back, but there is reason to wonder whether a weaker yuan will really help China's economy pick up speed. Note that China's growth potential has declined from the previous decade. Growth of 7.5%, the target set by the country's authorities, seems more realistic and sustainable for the coming years. In fact, growth is currently close to that mark.

Structurally, there is reason to worry about overinvestment in some sectors of China's economy, as well as growth by credit outside the regulated banking sector. That being said, a weaker currency is not the answer. Reforms are needed in China's banking sector, as well as in the rest of the economy. In general, change must come at the level of growth drivers, with consumers making a bigger contribution. Among the levers available, improving the social safety net would decrease the need for household savings and, in turn, improve their propensity to spend. As for the exchange rate, the benefit of a stronger currency is that it increases consumers' buying power.

Some might worry that continued yuan revaluation could hurt Chinese exports. It is interesting to note, however, that, despite the revaluation seen in the last few years, the trade surplus with the United States has kept growing, although more slowly, while the surplus with Europe has only edged down (graph 3). These surpluses contribute to global macroeconomic imbalances, forcing countries such as the United States to keep taking on more debt to finance their trade deficit. Given these imbalances, the yuan still seems to be quite undervalued.

**Graph 3 – China continues to have very large trade surpluses with the United States and Europe**

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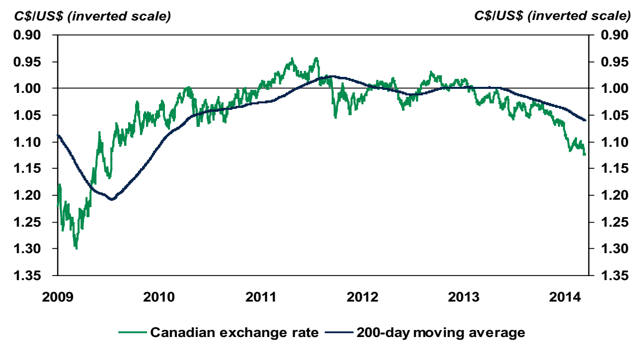
# CANADIAN DOLLAR (CAD)

## The markets still very sensitive to Bank of Canada signals

- The worst of the Canadian dollar's dive seems to be over. Since the start of February, the exchange rate has even been converging somewhat at close to US$0.90. The Canadian dollar is still fairly volatile around that mark, swayed by economic numbers and the signals sent by the Bank of Canada (BoC).
- The exchange rate's convergence at US$0.90 seems shaky, however, when looking at market indicators. The 200-day trend remains sharply tilted to the downside and the 3-month momentum is very negative. Net speculative positions have improved a little recently, but still attest to negative sentiment about the loonie.
- This attitude may seem strange given that, for 2013, Canada posted the best economic performance of any G7 nations. But the past has little influence on investors' current mood: they are paying more attention to the looming challenges facing Canada's economy. Among other things, economic growth is taking its time in rebalancing towards exports and non-residential investment. Without that shift, it will be hard for growth to stay on track, given that governments are still working on deficit reduction and households will have a hard time taking on additional debt.
- The BoC is also playing a big role in weakening the Canadian dollar by showing its concern about the movement by inflation, which is currently at 1.1%. Moreover, In a recent speech, Governor Stephen Poloz was unwilling to rule out the chance of a rate cut. As markets are still very sensitive to these kinds of signals, the loonie fell back below US$0.90 after that speech. The movement was magnified by the greenback's surge after the Federal Reserve meeting, pushing the Canadian dollar to a new cyclical low of US$0.8867.

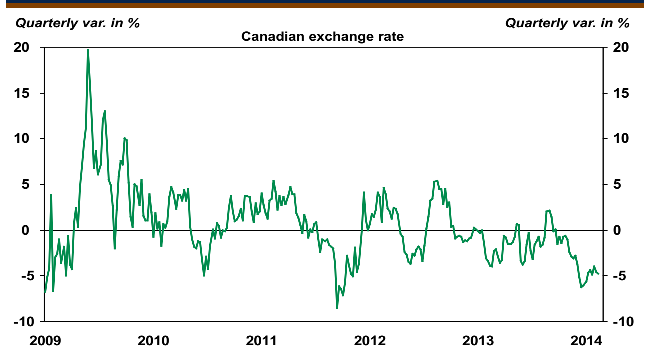
**Forecasts:** The Canadian dollar will remain highly sensitive to shifts in economic data, especially inflation, and BoC signals for several more months. After that, the anticipated strengthening of the global and Canadian economies, an expected rise by inflation, and a central bank that could be less worried should help the Canadian dollar. Our target for the end of the year is US$0.92 (C$1.087/US$).

**Canadian dollar and trend**



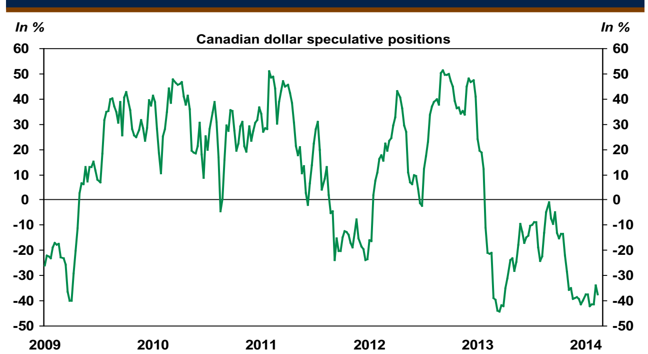

Sources: Datastream and Desjardins, Economic Studies

**Canadian dollar: momentum**




Sources: Datastream and Desjardins, Economic Studies

**Canadian dollar: net speculative positions**




Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

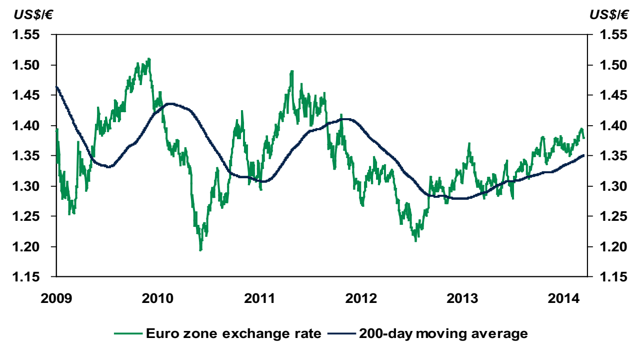
# EURO (EUR)

## The euro is trying the European Central Bank's patience

- The euro's uptrend has held up in the last few weeks. The March decision by the European Central Bank (ECB) to once again opt for the status quo was especially good for the euro, which jumped above US$1.39 in the days that followed, a peak that dates back to fall 2011. It return around US$1.38, however, after the Federal Reserve's (Fed) meeting.
- The euro's strength is also a reflection of positive investor sentiment towards this currency, as the problems in emerging nations seem to be overshadowing those in the euro zone. Demand for bonds from euro zone fringe nations continues to strengthen, and the spread with German bonds are at their narrowest since at least the summer of 2011. Italy and Spain's financing costs even tumbled to their lowest point in almost 10 years; this will help the two countries continue to get their public finances into order, particularly if the signs of an economic upswing are confirmed. With the crisis in the Ukraine prompting investors to flee Russia and Eastern Europe, the euro seems to be playing a safe-haven role.
- After opening the door to additional monetary stimulus in March, in the end, the ECB opted for the status quo even though it expects inflation to remain very weak in the coming quarters. The release of fairly encouraging economic figures explains the decision. Even the labour market is showing some promising signs, with the stabilization of the unemployment rate. The ECB also stressed the fact that its inflation outlook is based on assumptions of exchange rate stability and falling energy prices. Mario Draghi returned to this point at the press conference, saying that the euro's strength is currently trimming 0.4 percentage points from the inflation rate. It thus seems that ECB leaders hope that a slide by the euro will help inflation close in on its target more quickly. Unfortunately for the ECB, its decision to sit on its hands while the Bank of Japan and Fed continue with quantitative measures is putting new upside pressure on the euro, a situation that could erode the growth and inflation outlooks in the euro zone.

**Forecasts:** Since Mario Draghi took the helm, the ECB has gotten us used to fairly abrupt changes in stance. Such a change, which could come with further monetary policy easing, can be expected shortly if the upside pressures on the euro fail to reverse. The euro's level is still unsustainable and we expect it to drop closer to US$1.35 in the next few months.

**Euro and trend**

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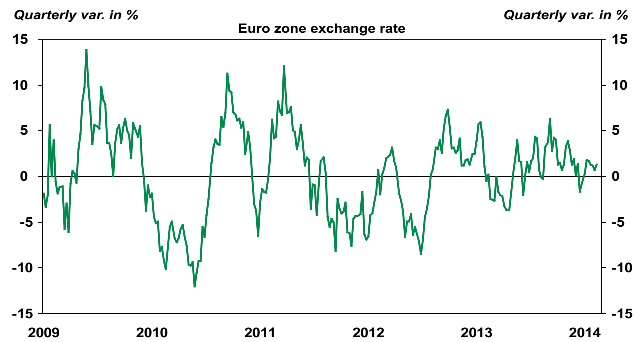
**Euro: momentum**

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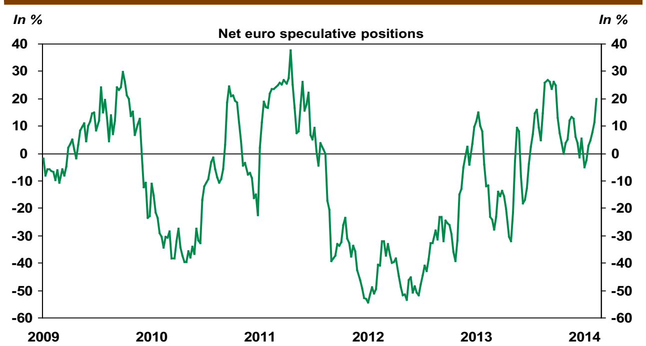
**Euro: net speculative positions**



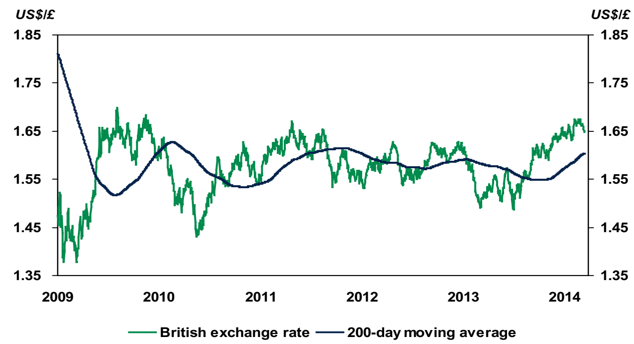

Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

# BRITISH POUND (GBP)

## The pound will remain strong

- The pound has been strong in the last few weeks, oscillating generally in the neighbourhood of US$1.66–1.67. On the other hand, it retreated against the euro on the European Central Bank's decision to maintain the status quo at its March meeting. Like the euro, the pound is also benefiting from the safe-haven effect arising from the worsening conflict in the Ukraine.
- The latest economic account numbers show that British economic growth was lively in the last three quarters. Better yet, they indicate that the economy's advance was supported by more than consumption and residential investment: business investment also accelerated. The Bank of England (BoE) took this development favourably. The British government's new budget, which features measures to encourage saving by households and business investment, and measures to support exporters, could also help the recovery move ahead on a sound basis. **As the United Kingdom's economic prospects will be better than those of its main trading partners, the BoE notes that the pound could continue to rise slowly.** This suggests that the BoE will not fight the pound's slow appreciation, which would have the benefit of curbing inflation pressures and allow the Bank to keep its key rate at its floor for a longer period.

British pound and trend



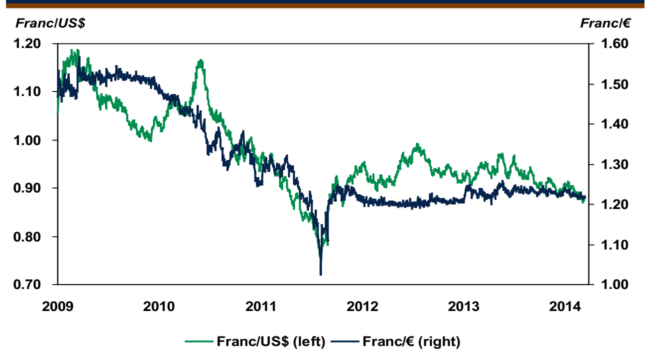

Sources: Datastream and Desjardins, Economic Studies

# SWISS FRANC (CHF)

## Uncertainty still favours the franc

- Although, overall, strains have ebbed in the financial markets since the start of February, the worsening situation in the Ukraine has continued to favour the Swiss franc. The USD/CHF pair dropped below 0.87 francs in mid-March, its lowest point since fall 2011. This movement reversed somewhat following the Federal Reserve meeting, however. The franc has also generally moved upwards against the euro, closing in on the floor price of 1.20 francs/€. With the inflation rate back just below zero and mixed economic statistics, the Swiss National Bank has reiterated its determination to defend the floor price and keep its key rate at 0.00% for a considerable period. **The franc should edge down in the coming quarters as long as international risks decline.**

Swiss franc



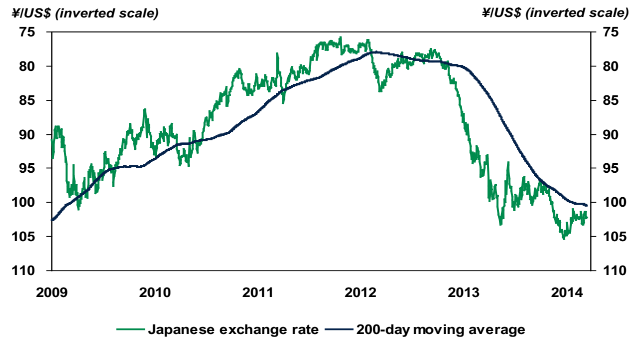

Sources: Datastream and Desjardins, Economic Studies

# YEN (JPY)

## The yen is struggling to keep depreciating

- The yen fell in the first week of March but, once again, this movement quickly ran out of steam and the exchange rate fell back to about ¥102/US$. Since the start of the year, the yen has tended to capitalize on a safe-haven effect; at this point, the effect primarily comes from Chinese figures and the tension between Russia and the West.
- Fundamentally, the outlook for the yen remains negative. On one hand, the forecast improvement to the global economy should lessen the safe-haven effect. On the other, the Bank of Japan (BoJ) should be accommodative for much longer than the other major central banks. In February, the BoJ announced that it was extending three bank lending programs that were elapsing, along with some enhancements. It did not change its securities purchase program, but that could come in the second half of the year if Japan's economy slows too much following the sales tax hike. The BoJ is still some way from getting inflation back to 2% on a lasting basis. **Japan's exchange rate should be around ¥110/US$ by year's end.**

**Yen and trend**



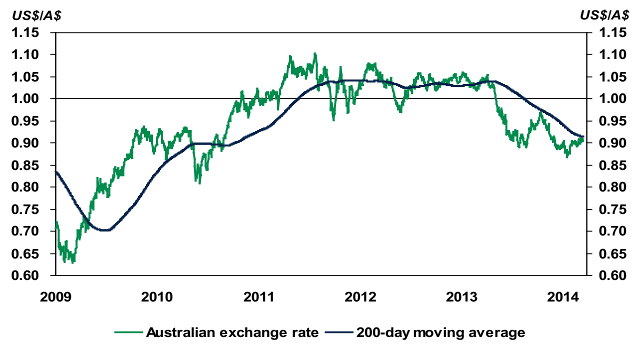

Sources: Datastream and Desjardins, Economic Studies

# AUSTRALIAN DOLLAR (AUD)

## Boosted by better economic figures

- The Australian dollar made several incursions above US$0.90 in recent weeks and is now trading close to US$0.91. The currency is getting a boost from the generally more encouraging economic figures in Australia. GDP was a little stronger than forecast in Q4 2013, consumer spending is picking up, and a surprising 47,000 jobs were created in February.
- The signs of an improving economy and the recent upswing by inflation no longer justify maintaining a downside bias for the monetary policy. The Reserve Bank of Australia (RBA) is now sending fairly clear signals that the status quo, in effect since August 2013, will continue. Nonetheless, since the beginning of March, the RBA has been asserting that the exchange rate is high, historically speaking, once again suggesting that it would prefer a weaker currency. Fundamentally, Australia's economy is still in the process of restructuring, while investment in natural resources is on the wane. In this context, the aussie should instead oscillate below the US$0.90 mark in the coming quarters.

**Australian dollar and trend**




Sources: Datastream and Desjardins, Economic Studies

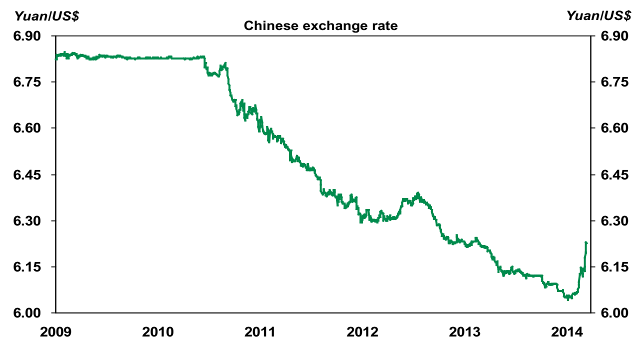
# EMERGING CURRENCIES

## Weaker potential for yuan revaluation

### CHINESE YUAN (CNY)

- Although most of the emerging currencies have appreciated recently, the Chinese yuan beat a retreat instead. China's latest economic figures were generally disappointing; something that could justify a little more caution in managing the exchange rate. Exports tumbled in February and the trade balance was -US$22.99B. February's numbers are often misleading, however, and we think a rebound is quite likely in the coming months. That being said, retail sales and industrial output also underperformed, increasing fears of a real slowdown in China's economy. The news that the benchmark rate's fluctuation band was being increased to ±2% will introduce a little more volatility, but monetary authorities will continue to steer the general trend. **We have raised our year-end target to 6.00 yuan/US$, on the assumption that revaluation will resume next summer.**

Chinese yuan and trend




Sources: Datastream and Desjardins, Economic Studies

### MEXICAN PESO (MXN)

- Like most emerging currencies, Mexico's peso has recovered somewhat from its retreat at the end of January. The USD/MXN pair had reached 13.60 pesos; it quickly returned to around 13.25 pesos, although it continues to react to shifts in international strains. Mexico's economy posted disappointing growth last quarter; it only expanded by 1.1% for 2013 as a whole, its worst performance in four years and much slower than 2012's 3.9% increase. Although inflation is slightly above the 4.0% target, nothing points to a Mexican key rate hike. Mexico's economy is expected to accelerate in 2014 thanks, among other things, to stronger demand from the United States. In this context, **the peso should slowly appreciate**.

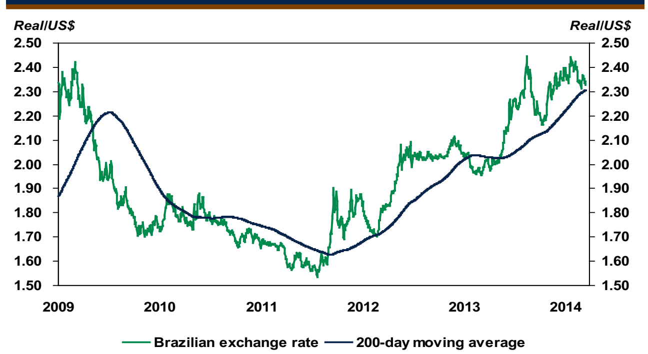
Mexican peso and trend


Sources: Datastream and Desjardins, Economic Studies

### BRAZILIAN REAL (BRL)

- The real has risen along with most of the other emerging currencies. In the fourth quarter of 2013, Brazil's growth was faster than forecast, helping consolidate the exchange rate below 2.40 reals/US$. The Central Bank of Brazil (CBB) announced another increase to its key rate at the end of February, taking it to 10.75%. However, unlike the previous 50 basis point increases, the key rate was only raised 25 basis points; this may signal a looming end to the firming cycle. The inflation rate has also dropped, but remains in the top of the CBB's target range. **Monetary firming is still a near-term threat to Brazil's economic growth; in turn, a rapid rise by the real is unlikely in the coming quarters.**

Brazilian real and trend




Sources: Datastream and Desjardins, Economic Studies

## Table 1
## Currency market

| Country – Currency* | *Spot price* March 21 | *Percentage return since* 1 month | 3 months | 6 months | 1 year | *Last 52 weeks* Higher | Average | Lower |
|---|---|---|---|---|---|---|---|---|
| **Americas** | | | | | | | | |
| Argentina – peso | 7.9675 | 1.6587 | 23.9788 | 38.3367 | 56.1872 | 8.0400 | 6.0413 | 5.1013 |
| Brazil – real | 2.3218 | -1.4370 | -2.6152 | 5.1922 | 16.4368 | 2.4513 | 2.2418 | 1.9738 |
| Canada – dollar | 1.1193 | 0.5841 | 4.8183 | 8.8077 | 9.2964 | 1.1252 | 1.0512 | 1.0024 |
| Canada – (CAD/USD) | 0.8935 | -0.5807 | -4.5968 | -8.0947 | -8.5057 | 0.9977 | 0.9513 | 0.8888 |
| Mexico – peso | 13.2213 | -0.3599 | 1.9431 | 3.4527 | 6.9533 | 13.5050 | 12.8905 | 11.9901 |
| **Asia and South Pacific** | | | | | | | | |
| Australia – (AUD/USD) | 0.9082 | 1.1716 | 1.7982 | -3.3239 | -12.9961 | 1.0543 | 0.9340 | 0.8684 |
| China – yuan renminbi | 6.2251 | 2.1932 | 2.5316 | 1.6966 | 0.1730 | 6.2276 | 6.1183 | 6.0412 |
| Hong Kong – dollar | 7.7581 | 0.0348 | 0.0458 | 0.0632 | -0.0567 | 7.7673 | 7.7576 | 7.7516 |
| India – rupee | 60.9000 | -1.9955 | -1.7742 | -2.1451 | 11.8457 | 68.8050 | 60.2657 | 53.6650 |
| Japan – yen | 102.2650 | -0.2536 | -1.7391 | 2.9703 | 7.7665 | 105.3150 | 100.0174 | 93.0550 |
| New Zeland – (NZD/USD) | 0.8536 | 3.0559 | 3.9693 | 2.0060 | 2.6803 | 0.8629 | 0.8197 | 0.7708 |
| South Korea – won | 1,080 | 0.7696 | 1.7951 | -0.3482 | -3.1817 | 1,161 | 1,092 | 1,050 |
| **Europe** | | | | | | | | |
| Denmark – krona | 5.4118 | -0.3627 | -0.8228 | -1.8535 | -6.3378 | 5.8361 | 5.5753 | 5.3568 |
| Euro zone – (EUR/USD) | 1.3782 | 0.2728 | 0.8193 | 2.0208 | 6.6303 | 1.3928 | 1.3382 | 1.2781 |
| Norway – kroner | 6.0507 | -0.4459 | -1.8174 | 1.9546 | 3.6097 | 6.2863 | 5.9862 | 5.7073 |
| Russia – ruble | 36.2354 | 1.7927 | 9.8454 | 13.8762 | 17.2836 | 36.6510 | 32.8801 | 30.8042 |
| Sweden – krona | 6.4252 | -1.5823 | -2.4712 | 1.0252 | -0.9695 | 6.7935 | 6.5206 | 6.3189 |
| Switzerland – swiss franc | 0.8838 | -0.4954 | -1.3397 | -3.0551 | -6.5359 | 0.9796 | 0.9193 | 0.8712 |
| United Kingdom – (GBP/USD) | 1.6495 | -1.1536 | 0.8530 | 3.0874 | 8.6630 | 1.6759 | 1.5863 | 1.4831 |

* In comparison with the U.S. dollar, unless otherwise indicated.
Note: Currency table base on previous day closure.

## Table 2
## Currency market: history and forecasts

| End of period | | *2013* Q3 | Q4 | *2014* Q1f | Q2f | Q3f | Q4f | *2015* Q1f | Q2f | Q3f | Q4f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **American dollar** | | | | | | | | | | | |
| Canadian dollar | (USD/CAD) | 1.0310 | 1.0623 | 1.1236 | 1.1111 | 1.0989 | 1.0870 | 1.0753 | 1.0753 | 1.0638 | 1.0526 |
| Euro | (EUR/USD) | 1.3536 | 1.3780 | 1.3700 | 1.3500 | 1.3300 | 1.3200 | 1.3100 | 1.3000 | 1.2900 | 1.2800 |
| British pound | (GBP/USD) | 1.6194 | 1.6563 | 1.6500 | 1.6500 | 1.6600 | 1.6700 | 1.6800 | 1.7000 | 1.7000 | 1.6800 |
| Swiss franc | (USD/CHF) | 0.9052 | 0.8908 | 0.8900 | 0.9000 | 0.9200 | 0.9400 | 0.9500 | 0.9600 | 0.9800 | 1.0000 |
| Yen | (USD/JPY) | 98.23 | 105.32 | 103.00 | 105.00 | 108.00 | 110.00 | 111.00 | 112.00 | 114.00 | 115.00 |
| Australian dollar | (AUD/USD) | 0.9317 | 0.8918 | 0.8900 | 0.8800 | 0.8800 | 0.8900 | 0.9000 | 0.9000 | 0.9100 | 0.9200 |
| Chinese yuan | (USD/CNY) | 6.1215 | 6.0540 | 6.2000 | 6.1500 | 6.0500 | 6.0000 | 5.9500 | 5.9000 | 5.8500 | 5.8000 |
| Mexican peso | (USD/MXN) | 13.09 | 13.04 | 13.30 | 13.20 | 12.95 | 12.80 | 12.65 | 12.50 | 12.40 | 12.30 |
| Brazilian real | (USD/BRL) | 2.2297 | 2.3423 | 2.3500 | 2.4000 | 2.3500 | 2.3000 | 2.2500 | 2.2500 | 2.2000 | 2.1500 |
| Effective dollar* | (1973 = 100) | 75.19 | 76.44 | 77.60 | 78.10 | 78.70 | 79.00 | 79.00 | 79.30 | 79.50 | 79.90 |
| **Canadian dollar** | | | | | | | | | | | |
| American dollar | (CAD/USD) | 0.9700 | 0.9414 | 0.8900 | 0.9000 | 0.9100 | 0.9200 | 0.9300 | 0.9300 | 0.9400 | 0.9500 |
| Euro | (EUR/CAD) | 1.3955 | 1.4638 | 1.5393 | 1.5000 | 1.4615 | 1.4348 | 1.4086 | 1.3978 | 1.3723 | 1.3474 |
| British pound | (GBP/CAD) | 1.6695 | 1.7594 | 1.8539 | 1.8333 | 1.8242 | 1.8152 | 1.8065 | 1.8280 | 1.8085 | 1.7684 |
| Swiss franc | (CAD/CHF) | 0.8780 | 0.8386 | 0.7921 | 0.8100 | 0.8372 | 0.8648 | 0.8835 | 0.8928 | 0.9212 | 0.9500 |
| Yen | (CAD/JPY) | 95.28 | 99.14 | 91.67 | 94.50 | 98.28 | 101.20 | 103.23 | 104.16 | 107.16 | 109.25 |
| Australian dollar | (AUD/CAD) | 0.9605 | 0.9473 | 1.0000 | 0.9778 | 0.9670 | 0.9674 | 0.9677 | 0.9677 | 0.9681 | 0.9684 |
| Chinese yuan | (CAD/CNY) | 5.9377 | 5.6989 | 5.5180 | 5.5350 | 5.5055 | 5.5200 | 5.5335 | 5.4870 | 5.4990 | 5.5100 |
| Mexican peso | (CAD/MXN) | 12.70 | 12.27 | 11.84 | 11.88 | 11.78 | 11.78 | 11.76 | 11.63 | 11.66 | 11.69 |
| Brazilian real | (CAD/BRL) | 2.1628 | 2.2049 | 2.0915 | 2.1600 | 2.1385 | 2.1160 | 2.0925 | 2.0925 | 2.0680 | 2.0425 |

f: forecasts; * Trade-weighted against major U.S. partners.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies