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Focus: China Announced FX Policy Shift

In a significant step towards the long anticipated change in RMB policy, People's Bank of China released a statement last Saturday evening (7pm, 19 Jun) on its website that it "has decided to proceed further **with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility.**" However, it has ruled out a significant revaluation, noting that the **"basis for large-scale appreciation of the RMB exchange rate does not exist"**. In line with its usual language, the RMB will now be driven by market forces, referencing a basket of currencies, and moving within the present +/-0.5% daily fluctuation bands against the USD: " ... continued emphasis would be placed to reflecting market supply and demand with reference to a basket of currencies. The exchange rate floating bands will remain the same as previously announced..." PBoC concludes that it will "further enable market to play a fundamental role in resource allocation, promote a more balanced BOP account, **maintain the RMB exchange rate basically stable at an adaptive and equilibrium level**, and achieve the macroeconomic and financial stability in China". (See below for links to PBoC statements and Q&As).

Implications

The announcement has long been anticipated and came just a week before the G-20 Summit in Canada on 26-27 June, which was among the possible announcement dates outlined in our earlier report "Monitoring The RMB Calendar" (26 April). Chinese President Hu Jintao is scheduled to meet at the G-20 Summit with US President Barack Obama and leaders of other major economies.

Why now? Notwithstanding the unrelenting external push, a far more important catalyst for this policy shift is the build up of domestic pressures within China. Property prices and "hot money inflows" have been well known indications of an undervalued currency. The other symptom is the now widespread demand for wage increases that is spreading across China. These domestic price stresses are inevitable under a fixed exchange rate system, which means that China would have to let its currency shoulder part of the price changes sooner, and not later.

What would be the form of RMB flexibility look like? Our take is that the RMB will move away from its current 6.83 peg to the USD to fluctuating value pattern that existed pre-July 2008. **This means that the daily central parity fixings - from as early as today - will be one important guide for the market, possibly with moves of at least 10 pips. Also, the RMB will now be subjected to either depreciation or appreciation on a daily basis.** Note that the USD/RMB daily fluctuations are limited to 0.5% either side, and +/-3.0% for other non-USD currency pairs.

Keep in mind that despite its peg to the USD, the RMB has strengthened by about 4% on a trade-weighted basis since July 2008. YTD, the RMB has risen about 13% against EUR. Additional considerations such as impact on valuation of its forex reserves and exporters/ importers also act as constraints on the RMB. **As such, we still see little headroom for the RMB against the USD at least initially. For now, we are keeping our view that there would be no major one-off revaluation and our USD/RMB forecast is unchanged at 6.77 for end-2010, or about 0.8% from Friday's fixing value of 6.8275.**

With the RMB becoming more flexible, PBoC's interest rate policy will be freed from the exchange rate shackle and is expected to be the next to move. So far, the central bank's preferred instrument has been the reserve requirement ratio (RRR) due to the fixed exchange rate system. **We expect PBoC to begin hiking its key interest rates starting in 3Q as part of the policy exit, with two hikes of 27bps each for the rest of the year to bring the 1Y lending rate to 5.85% and 1Y deposit rate to 2.79% by end-2010.**

Overall, China's FX policy shift is considered a tightening move as it is an extension of the policy stance since early this year as China's economic growth and asset prices move into overheating territory. **While these changes may have already been priced into China's stock prices, it would still likely to elicit largely negative reaction in equity markets given that currency value will now be an additional uncertain factor especially for exporters.**

Given the low likelihood of a revaluation on the RMB, the impact on Asian currencies is likely to be limited. **However, Asian units are expected to firm initially against the USD in this event, especially for SGD and MYR, the two currencies that are closest proxy to the RMB.** With risk taking appears to be making a comeback in recent weeks, look for USD/SGD and USD/MYR to dip in early trade today.