

- Rhetoric on China's currency valuation has risen significantly in recent weeks, as both US and Chinese leaders commented on the issue, and US lawmakers and multilateral agencies fanning the debate.
- One main contention for China to revalue/appreciate centers on the relationship between currency and trade balances. This argument is flawed as the correlation between currency and trade balances is tenuous and not consistent, as shown in Japan's experience.
- However, the RMB issue will be kept on the boil for sometime in the run-up to Pres Hu's visit to US in Apr, US-China dialogue late May, and the G20 summit in late June. We see low probability of a RMB revaluation, while a band widening is a possibility. We look for gradual RMB appreciation to begin by second half of the year, and maintain our USD/RMB forecast at 6.77 by end-2010.

Rising Tension Over the Value of RMB

Recent rhetoric on China's exchange rate policy has become significantly heated and tense, as both American and Chinese leaders commented on the issue. Others such as multilateral agencies and US lawmakers also pressured China to revalue/appreciate the RMB.

One main argument for a RMB revaluation/appreciation is that China is pursuing a mercantilist trade policy. By deliberately keeping its currency undervalued, China is subsidizing its exports and giving an unfair advantage to Chinese producers. Global trade is therefore tilted in favour of China and thus resulting in the current situation of global imbalances, according to this argument. Therefore, China should let its currency to be determined by market ("float") to resolve global imbalances.

Recently, US lawmakers have proposed a bipartisan bill ("Schumer-Stabenow-Graham Currency Exchange Rate Oversight Act of 2010") that would punish any country with a "fundamentally misaligned" currency, just ahead of the US Treasury's "Semiannual Report on International Economic and Exchange Rate Policies", to be issued on 15 April. However, the Treasury report has been postponed, as Chinese Pres Hu Jintao has agreed to attend the international nuclear summit in the US on 12-13 Apr.

Would a Revalued RMB Solve Global Imbalances?

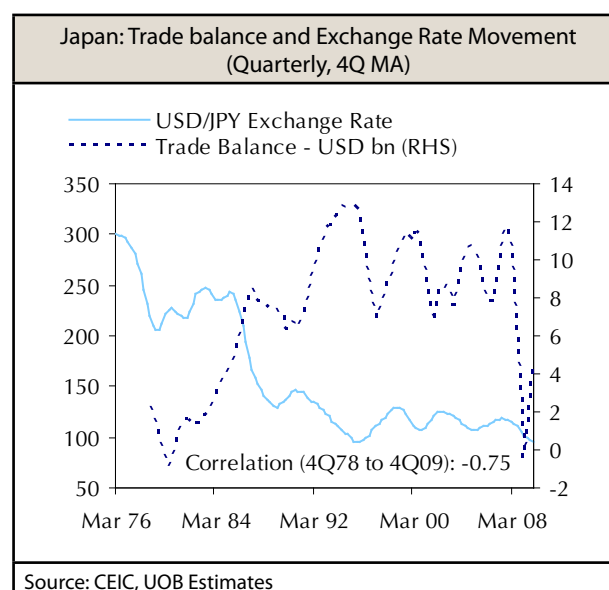
The key factor as argued above centers on the role of currency and its impact on international trade. Going by conventional wisdom, strengthening (or revaluation) of the RMB would make China-produced goods to be more expensive and imports to China cheaper, thus solving the current global trade imbalances situation, where China persistently runs an external surplus and most of western world runs persistent external deficits.

However, this "conventional wisdom" is simplistic and

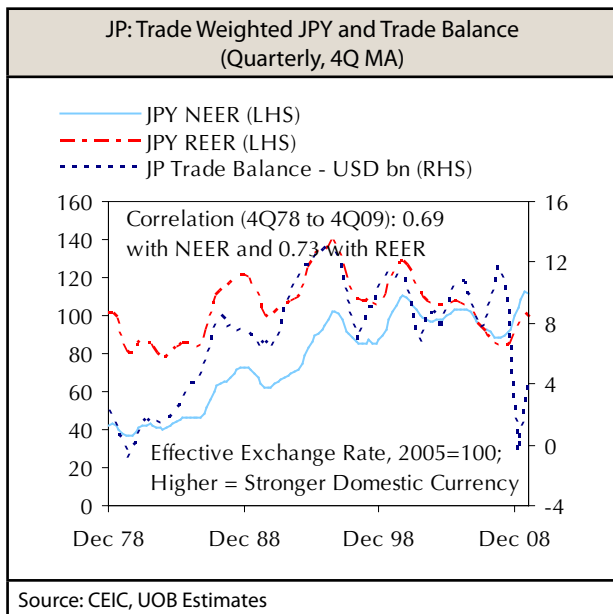
tenuous at best, and is not supported by historical evidence. As explained in the next section, exchange rates typically do not correspond on a one-to-one basis with trade competitiveness. If that were the case, Congo would be an export powerhouse, after its currency depreciated at an annual rate of 40% since 2001 against the USD. Or that Japan's persistent trade surpluses would not be possible as JPY has appreciated more than 240% against the USD since late 1975 (and nearly 300% on trade-weighted basis). It is a simplistic notion to just blame currency values in the current global imbalances, which are caused by myriad reasons, such as consumer savings/spending patterns, degree of leverage, outsourcing of production, among others.

Taking A Look at Experiences in Japan and China

Using Japan as an example, we found that that correlations between exchange rate and trade balances are generally not consistent (i.e. signs change depending on the



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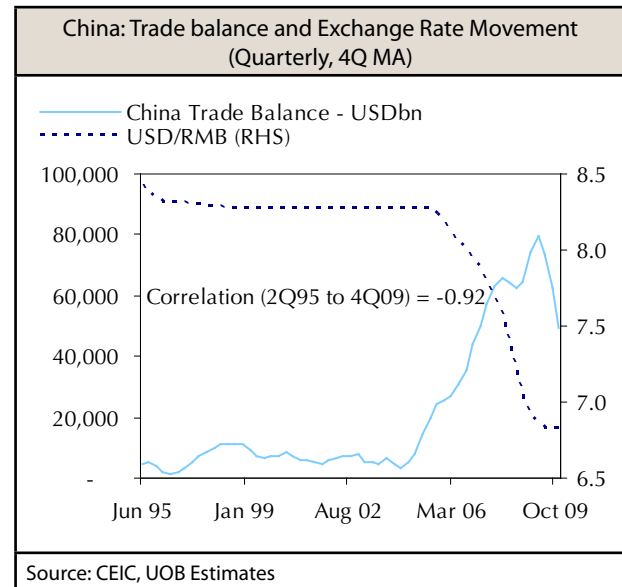


period of measurement) and at times insignificant, thus weakening the argument that currency is responsible for trade imbalances.

As shown in the charts below, the correlation is a negative 0.70 for the period of 1980 to 2009, i.e. as USD/JPY declines, Japan's trade balance actually improves. However, the correlation is not stable, and changes depending on the periods used, which means that exchange rate and trade do not correspond on a one-to-one basis.

Looking from an effective (i.e. trade-weighted) exchange rate perspective, the result is similar with the bilateral USD/JPY rate. The chart shows that as the trade-weighted JPY (both nominal and real) improves, Japan's trade balances also move along. This is reflected by the correlation of about 0.7 between JPY NEER/REER and Japan's trade balances (for the period of 1978-2009), and is contrary to widespread belief that as the currency strengthens, trade balances

should deteriorate. Again, the correlation is not stable over time, thus raising the question of using currency as a cause of trade imbalances.



For China, revaluation of the RMB in July 2005 and subsequent appreciation against the USD during 2005-early 2007 in fact coincides with significantly higher trade balances during that period. This again weakens the argument that a firmer domestic currency could help to reduce trade surplus. As indicated in the chart below, with USD/RMB stabilizing at around 6.83 since July 2008 at the onset of the global recession, China's trade surplus has actually declined along with weaker demand.

In the table below, we summarize briefly the correlations of JPY with Japan's trade balances in different periods, as Japan's data has a longer history than China's and has gone through significant revaluation during the 1980s. It is clear that the correlations are not stable and not consistent during these periods, and often go against "conventional

Correlations of JPY with Japan's Trade Balances			
Quarterly Data with 4Q Moving Average	USD/JPY*	JPY NEER**	JPY REER**
1970s	0.47	0.95	0.97
1980s	-0.78	0.93	0.90
1990s	-0.64	0.67	0.85
2000s	0.43	-0.25	0.23
All data: 1970s to 2000s	-0.75	0.69	0.73
Source: CEIC, UOB Estimate			
* Conventional wisdom: correlation should be POSITIVE, i.e. as USD/JPY rate falls, Japan's trade balance should deteriorate			
** Conventional wisdom: correlation should be NEGATIVE, i.e. as JPY effective exchange rate index rises, Japan's trade balance should deteriorate			

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wisdom". What is also significant is that the trade weighted indices (both nominal and real) behave significantly different from conventional wisdom.

Overly Simplistic to Blame Currency Value

Based on the observations above, one could argue that the heated rhetoric on RMB vs. trade balances is overly simplistic and ignores other factors that contribute to the current state of global imbalances. In particular, the data on Japan do not support the conventional wisdom that a stronger currency would reduce trade balances.

While the above data may refute conventional wisdom, this is the exact argument pushed by many outside Asia, given the recent noises out of the US where a trade bill is pending in Congress that seeks to punish countries with "misaligned" currencies. The US Treasury has postponed its semiannual report on currency, which was originally due on 15 April, and this has somewhat lessened the tension on this issue, as Chinese Pres Hu Jintao is slated to attend the international nuclear summit in the US on 12-13 Apr. In China, Premier Wen Jiabao had said at the end of the annual NPC session on 14 March that the RMB is not undervalued and that external pressures on the RMB

issue are not helpful. Soon after, US and China top officials would meet in Beijing in the annual Strategic and Economic Dialogue meeting around late May, while the G20 Summit is scheduled for late June in Canada.

With these event risks lined up, chances of China's currency actions have been elevated in the next two months especially now that overt pressures from the US govt have been reduced somewhat. We see low risk of a RMB revaluation in the near term, as that option has basically been ruled out by the Chinese government earlier. Even if there was one, the magnitude would probably be similar to the 2.1% reval back in Jul 2005. Another risk is that band widening may be on tap, enlarging the current +/-0.5% band to possibly around +/-0.75% to +/-1.0%, although in practicality this move may not be meaningful as the band limits are seldom tested. For now, we expect USD/RMB to remain steady and then move towards some "crawling appreciation" in the second half of the year. We continue to maintain our USD/RMB forecast at 6.77 by end-2010, or just about 1% lower from current level of 6.827. The non-deliverable forwards (NDF) market is pricing in about 3% pace of appreciation for the RMB against the USD in the 12 month horizon, and 1.6% for the 6-month timeframe.