

China Focus

FX Policy Shift Finally In Place But Aggressive Moves Unlikely

China	2008	2009	2010F	2011F
GDP	9.6	8.7%	10.0%	8.3%
CPI (average, y/y)	5.9	-0.7	3.9	4.7
Current account (% of GDP)	9.3	6.1	3.5%	3.4%
Fiscal balance (% of GDP)	-0.4%	-2.2%	-2.7%	-1.9%

Summary

- China finally announced its FX policy shift on 19 Jun, promising more flexibility for the RMB but effectively ruling out a one-off large reval, which has not been our base case. Taking into considerations of EUR continued weakness, trade-weighted RMB, impact on exporters, and past trend, we expect the currency's appreciation trend to be a multi-year and modest process. We maintain our USD/RMB forecast at 6.77 by end-2010, and further down to 6.58 by end-2011.
- The shift in FX policy now allows PBoC to regain initiative and move on with its interest rate policy. We expect PBoC to raise its benchmark interest rates, in modest steps, as part of overall normalization in monetary policy. We look for key interest rates to be raised twice in the second half of 2010.
- We adjust slightly China's full year growth forecast to 10.0% (vs. 9.5% previously) for 2010, to take into account the 1Q report although tighter policy measures earlier are beginning to take hold and asset prices cool off, moderating growth momentum in the second half.

RMB: FX Policy Shift Announced

In a long anticipated move in RMB policy change, People's Bank of China released a statement on 19 Jun (a Saturday evening) 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 quite clearly any significant revaluation at least for now, 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 RMB daily floating bands will remain the same as previously announced, and PBoC concludes the statement by noting 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".

The announcement has long been anticipated and came barely a week before the G-20 Summit in Canada (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 was scheduled to meet at the G-20 Summit with US President Barack Obama and leaders of other major economies, and the RMB policy shift effectively reduced much tension ahead of the meeting.

Why now? Notwithstanding the unrelenting external push for a stronger RMB, a far more important reason 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 being the widespread demand for workers' wage increases that is spilling across China's factories. 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.

How flexible would the RMB get? Our take is that the RMB will move away from its current 6.83 peg to the USD to fluctuating pattern that existed pre-July 2008. This means that the daily central parity fixings will be one important guide for the market. Also, a more "flexible" RMB also means it will now be subjected to either depreciation or appreciation. Note that the USD/RMB fluctuations are

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limited to 0.5% on either side of the daily fixings (+/-3.0% against non-USD currencies). On the first trading day post-19 Jun announcement, the USD/RMB central parity was set unchanged at 6.8275 on 21 Jun, to much surprise. This was followed by a relatively sharp drop to 6.7980, and then went back up to 6.8102 on Wed (23 Jun) as the RMB euphoria and excitement flamed out in global markets. This highlights the fact that RMB movements are likely to be unpredictable.

Keep in mind that despite its peg to the USD, the RMB has strengthened by about 4% on a trade-weighted basis between July 2008-May 2010, which is largely in line with the 12% gain for the trade-weighted RMB during July 2005-Jun 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 fixing value of 6.8275 on 21 Jun.



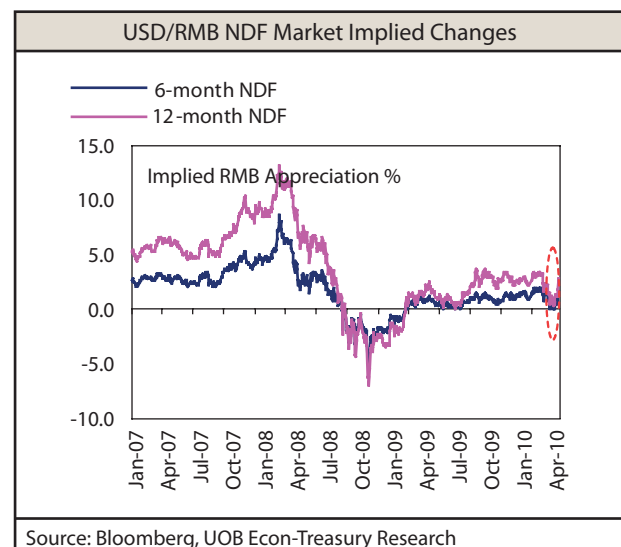
There appears to be some tacit agreement at least among some Chinese officials that the RMB is undervalued. The question is how “undervalued” and how fast should this be addressed/corrected? On a trade-weighted basis, the RMB has actually strengthened by about 5% between July 2008 to Apr 2010. YTD, the trade-weighted RMB has gained a smaller 1%.

There is no single answer to this seemingly simple question of “undervaluation”. Instead of looking for a point estimate - which varies widely depending on the method used, base period, etc - a range of estimates would be more helpful.

According to a recent academic study (“Measuring misalignment: Latest estimates for the Chinese renminbi”, Cheung, Chinn, and Fujii, in “The US-Sino Currency Dispute: New Insights from Economics, Politics and Law,” Simon Evenett, ed; Centre for Economic Policy Research, Apr 2010), the extent of RMB undervaluation ranges from low of 13% to as much as 67% against the USD.

Given the wide range and non-objectivity of these estimates, it is hardly surprising that the RMB valuation issue has been contentious. Even if everyone agreed on a single number, the pace of getting there would still be debatable. Note that in the three years between July 2005 depeg and July 2008 repeg, the RMB has risen by about 18% against the USD (or 5.7% p.a.), after the one-off 2.1% revaluation in July 2005. This would be a good guide as to the pace of RMB appreciation going forward, although the “good old days” of this era would probably not return anytime soon.

While the RMB has become flexible, it also means that its value will become more unpredictable. Going by the past trend, its appreciation trend is likely to be modest and a multi-year process. We maintain our USD/RMB forecast at 6.77 by end-2010, or just about 0.8% lower from current level of 6.827. The offshore NDF market turned up again after the depeg announcement, with expectations of a 2.8% gain over the next 12 months, but still down from the 3.5% high priced in around mid Apr.

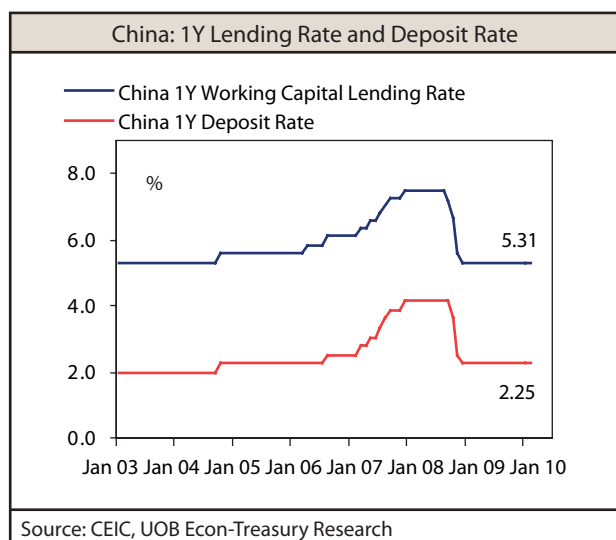


Monetary Policy to Tighten but Pace Limited

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

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preferred instrument has been the reserve requirement ratio (RRR) due to the fixed exchange rate system. The RRR has been hiked three times so far in 2010 at 50bps apiece, to 17.0% (last move was announced on 2 May). One advantage of the RRR route – instead of interest rate – is that it is the least disruptive to the fixed RMB regime as interest rate differentials with USD are preserved. In addition, changes in RRR could also limit banks' credit creation process, in combination with other tightening policies. Indeed, new loans created have fallen by 30%/y to RMB4tn YTD in May (Target of new loan for 2010: RMB7.5tn). We continue to see PBoC hiking RRR further in second half, although the pace may be moderate given the headwinds from external environment. We look for just two additional increases in RRR in second half (one each in 3Q and 4Q) to 18.0%, as the focus is likely to shift to FX and interest rate space in second half of 2010.



Assuming no major disruptions in the global financial markets, PBoC will be on track to raise its benchmark interest rates, in modest steps. We look for two increases in interest rates in the second half, bringing the 1Y working capital interest rate to 5.85% (from 5.31% currently) and 1Y deposit rate to 2.79% (from 2.25% currently) by end 2010.

Amidst all the tightening measures on China's property sector, one overhanging concern is the amount of debt undertaken by local governments via special purpose vehicles (estimated at 7,000 SPVs, with at least 70% at county levels) in the name of infrastructure and property development. The source of this debt actually came from the RMB4tn stimulus package announced in 2008, of which the central government contributed only around RMB1.2tn, or about one quarter of the stimulus package. The remainders were to come from local governments. Since then, it is estimated that local government debt has ballooned from about RMB1tn at end-2008 to RMB7tn by end-2009. With market's focus on sovereign debt, one worry is that ultimately China's central government may have to support this local debt, which would raise China's debt to GDP ratio from 26% of GDP to 41% of GDP. If 20% of the local government debt goes bad, this would result in RMB1.4tn in bad debt, or about 3% of China's bank loans. China's banking sector may be able to support this amount, but it shows the sector and China is exposed to the risk of a disorderly unwinding of this debt and property bubble. As such, the central government is likely to tread cautiously in its tightening policy.

Growth Trend Moderating in Second Half

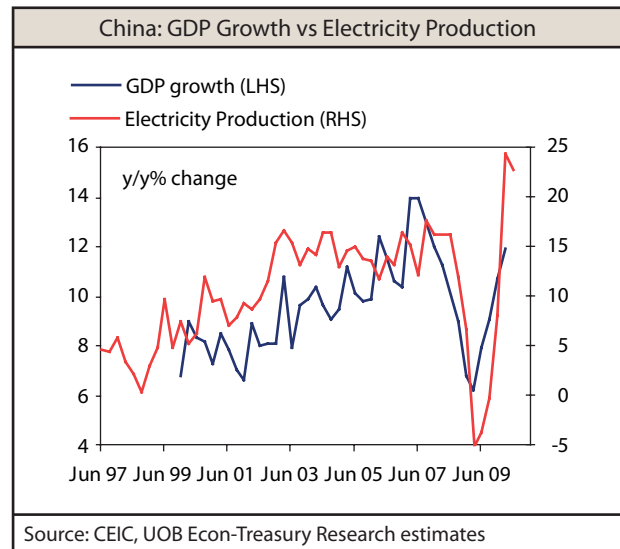
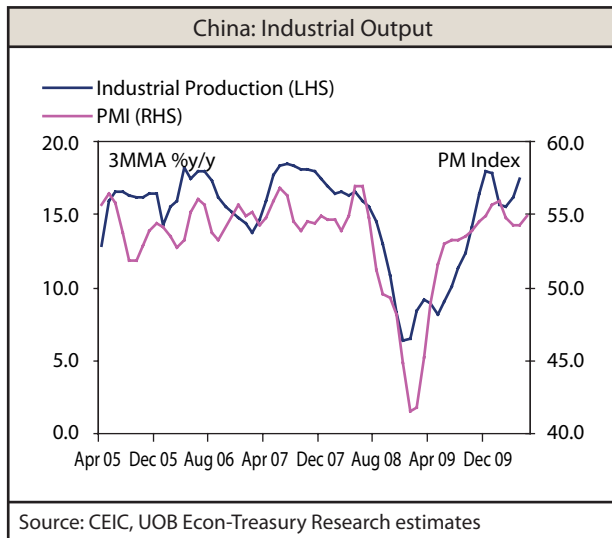
Most recent data continues to show robust external demand and domestic economic activities in China. The sharp jump in May exports of nearly 50%/y vs. 30.5% in Apr is unlikely to sustain as base effect diminishes in the months ahead and the impact of austerity in Europe takes hold. Adding to this mix is the currency component, which will be an uncertain factor after China announced that the RMB will become more "flexible".

Retail sales, industrial production, fixed asset investment, and other macro data continue to maintain similar pace as in previous months, which mean that headline GDP growth pace should stay at around 10%/y in 2Q10 vs. 11.90% in 1Q10.

We adjust slightly China's full year growth forecast to 10.0% (vs. 9.5% previously) for 2010 from 8.7% in 2009, to take into account the 1Q report although tighter policy measures earlier are beginning to take hold and asset prices cool off. The more important question, however, is how 2011

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would shape up, given the confluence of developments in European debt crisis, prospects of a weaker-than-expected recovery in the US, possibility of monetary policy shifts in China and elsewhere in Asia, as well as higher base in 2010.



Inflationary pressures in China have been building up as well, on a combination of fiscal-led domestic activities and low base in 2009. As such, it is not surprising to see headline consumer prices rising above 3% in May, and potentially head above 4% by end-3Q. The key driver in consumer prices has been the food component (particularly vegetable and food prices), which is about 1/3 of the consumer price basket. The non-food component remains well behaved despite low base last year, as excess capacity is likely to be the main reason keeping prices checked. For the full year, we expect China's inflation to rise about 4%, which is below average 5% rate seen during the "overheating" phase in 2007/08.