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Thursday, 02 September 2010

Flash Notes

China: Tracking The Trade-Weighted RMB

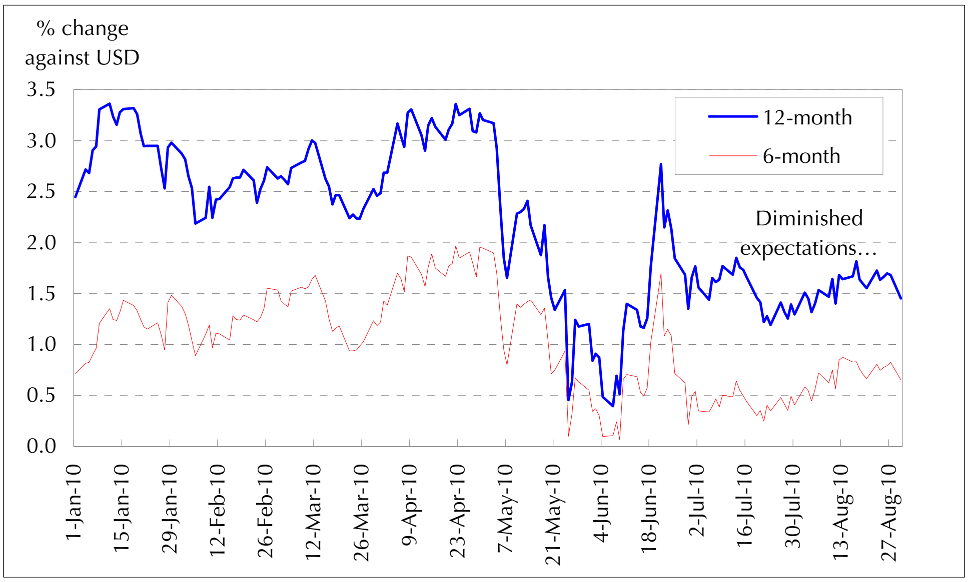
A "More Flexible" Chinese Currency

Since China's PBoC announced its "flexible" RMB policy on 19 Jun - effectively ending the de facto USD peg that was in place since July 2008 - the focus quickly returned to how much RMB would appreciate, especially against the USD.

Many were puzzled by the seemingly muted USD/RMB moves since then, with RMB falling 0.5% against the USD in the month of August, as reported by Bloomberg. Except with a burst of activities in early Aug, the RMB has reduced YTD gain to 0.3% with USD/RMB hovering around 6.80 level, compared to 6.83 before the June announcement.

Recall that during the July 2005 to July 2008 period, the USD/RMB pair has declined by about 16% (excluding the 2.1% one-off), or about 3% compounded annually. This picture is much ingrained into market participants' minds, as reflected in non-deliverable forwards prices in the aftermath of the June announcement. In the days after the 19 Jun announcement, 1-year NDF prices were factoring in RMB appreciation of around 2.3-2.7% against the USD. But these expectations have since dwindled to average of 1.6% over the past 2 months, as indicated in the chart below. This is a huge contrast to the average of 2.6% appreciation priced in the 1Y NDF prices in the Jan-May period this year.

6-Month & 12-Month Non-deliverable Forward (NDF) Implied RMB's Appreciation



Source: Bloomberg; UOB Econ-Treasury Research est

The lackluster spot USD/RMB is reinforced by uninspiring daily USD/RMB fixings of late (6.8105 on 31 Aug vs. 6.8025 in prior day). As shown in the table below, the standard deviation of the daily fixings has fallen sharply in recent months compared to the period from July 2005 to June 2008, a sign of the authorities' intentions to shift focus away from the USD/RMB pair. In particular, the standard deviation of USD/CNY fixing has fallen from 0.36 to just 0.01, a drop of 98%! This is mirrored in the moves on the USD/CNY spot. Other daily fixings also saw across the board decline in volatility in the past few months.

RMB Daily Volatility Has Decelerated Sharply Since June

Standard Deviations	USD/CNY Fix	USD/CNY spot	HKDCNY Fix	EURCNY Fix	JPYCNY Fix	GBPCNY Fix
Jul 2005--end-Jun 2008	0.3617	0.3637	0.0465	0.3751	0.2422	0.5846
21 Jun 2010 to Present	0.0136	0.0121	0.0019	0.1841	0.1528	0.2090
% Change	-96.2%	-96.7%	-96.0%	-50.9%	-36.9%	-64.2%

Source: Bloomberg; UOB Econ-Treasury Research est

Why The Muted USD/RMB Moves?

This lackluster USD/RMB moves should not surprise, as it was set out in the original July 2005 press statement on RMB liberalization and further emphasized in the June 2010 announcement, that the RMB will be “managed proactively” on a “trade-weighted/ multilateral” basis, rather than a pure focus on USD/RMB.

This last point was also highlighted in the Q&A section of the 19 June statement, citing the diversified trade flows in addition to the US, as well as broad sources and destinations of capital flows, and therefore unwise for China to peg to a particular currency and for the RMB to be valued against one single currency.

With this as a backdrop, it is little wonder the rather lackluster move for both the spot and offshore NDF prices for USD/RMB after the initial euphoria back in June.

Focus Should Be On Trade-Weighted RMB

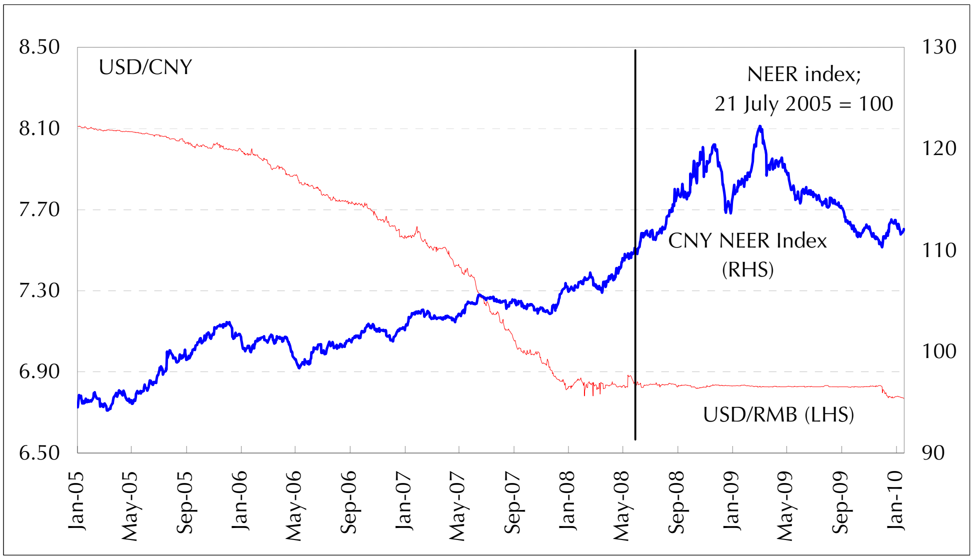
With PBoC's clear emphasis on a trade-weighted/multilateral basis, it is therefore necessary to examine how the trade-weighted RMB has been performing through the years, against that of the bilateral USD/RMB exchange rate.

The question of course is what PBoC's "basket of currencies" actually contains. Consistent with most methodologies in this area, we approach this by using China's external trade data as a basis to derive a RMB NEER index (nominal effective exchange rate, i.e. trade-weighted index) to assess China's FX policy stance.

Note that just like Singapore's case in earlier years, China has yet to publish any references on the trade-weighted index, such as components, weights, bands, midpoint, or any other pertinent information, rendering such formulations difficult to assess with any degree of certainty (although PBoC has in early Aug indicated that it may in the future provide more information on its FX policy. See for example Deputy Governor Hu Xioalian's statements in July on the PBoC website). In Singapore’s case, the MAS did not provide a formal exposition on the trade-weighted S$ policy until February 2001 (please refer to http://www.mas.gov.sg/resource/publications/monographs/exchangePolicy.pdf), two decades after the adoption of exchange rate as a policy tool.

Nevertheless, as shown in the charts below, the USD/RMB bilateral rate has fallen by about 18% since July 2005. Based on our NEER model, the trade-weighted RMB has strengthened by 16% since then, or about 3% compounded annually. Since beginning of 2010, the RMB NEER has risen about 0.7%, ahead of RMB appreciation of about 0.4% against the USD despite a largely flat USD/RMB trade in the past two months.

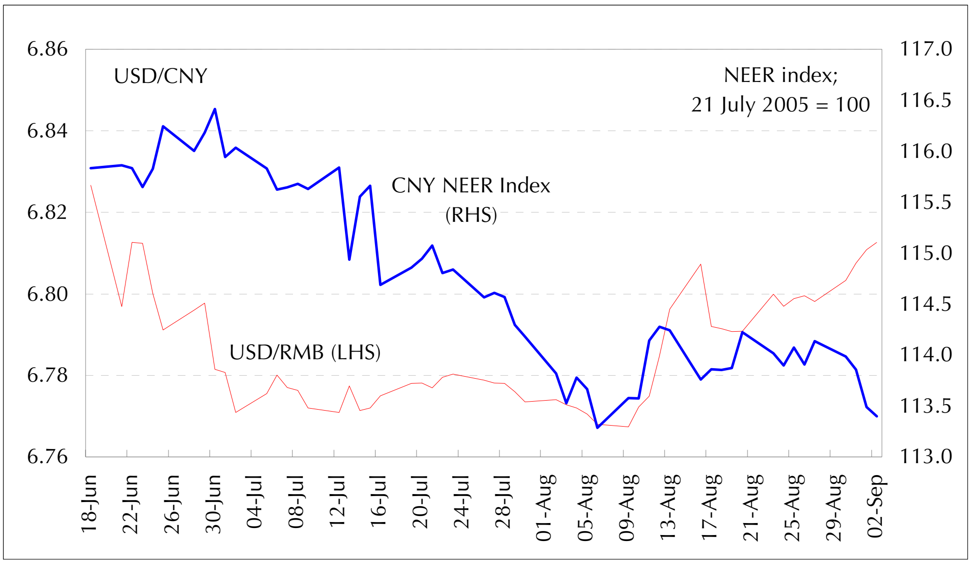
CNY NEER Vs USD/CNY



Source: Bloomberg; UOB Econ-Treasury Research est

As shown in the chart below since the 19 Jun announcement, the RMB NEER has actually fallen about 1.6%. This is possibly as a result of the volatility in financial markets in recent months, as concerns intensified of a double dip recession in the US, possibility of quantitative easing from the US Fed, and large moves seen in the USD/JPY and EURUSD.

CNY NEER Vs USD/CNY Since 19 Jun 2010



Source: Bloomberg; UOB Econ-Treasury Research est

Implications: A Slow Drift In USD/RMB For Now

With a much firmer RMB NEER to-date compared to the USD/RMB, as well as restrained central parity fixings, it should be clear the PBoC intends to steer attention way from the bilateral USD/RMB exchange rate.

Another China FX issue that warrants far closer attention is the internationalization of the RMB, which is progressing rapidly pace in recent months and the pace is likely to accelerate in the months ahead. This suggests opening of China's capital account/full convertibility of the RMB is now drawing closer than before. As a recap, China started in a modest pilot program in July 2009 to allow settlements of external trade in RMB with southeast Asia and HK. Today, RMB internationalization has now expanded to expanded usage of RMB in financial products in HK, re-channeling back of offshore RMB to China's onshore interbank bond markets, and daily CNYMYR fixings (note that this is the only fixing quoted against CNY, compared to the other five pairs which have foreign currencies as a unit).

In the near term and based on our NEER framework, we continue to see RMB firming on a trade-weighted basis, but likely to less than the 3% pace seen in the past due to the current weak global growth environment. **On the bilateral USD/RMB basis, we continue to see limited downside for the pair given the focus on RMB NEER. We maintain our end-2010 target of 6.77 for the pair and at 6.58 at end-2011, which translates to about 2.5% gain on the trade-weighted RMB this year if EURUSD and USDJPY hover at current levels.**