China's exchange rate set to further strengthen

The renminbi has already appreciated against the US dollar and the People's Bank of China widened its trading band in a sign of market liberalisation. But the currency has further still to rise, as Andy Ji, Asian currency strategist and Richard Grace, chief currency strategist and head of international economics at the Commonwealth Bank of Australia (CBA) explain.

PBOC WIDENS USD/CNY TRADING BAND

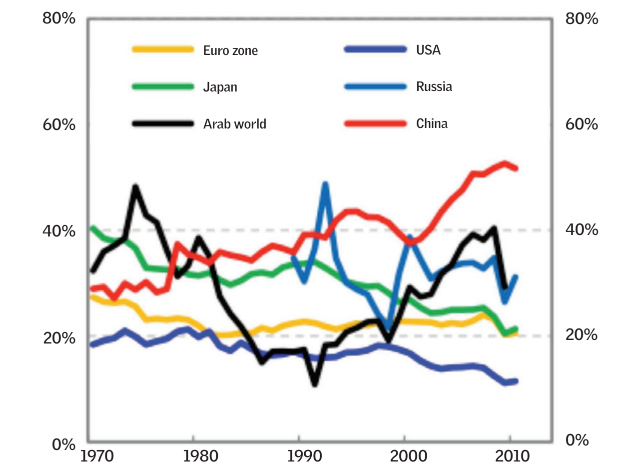
The People's Bank of China (PBoC) increased the daily trading band of USD/CNY to +/- 1.0% effective 16 April, 2012. Previously, the pair was allowed an intra-day fluctuation of +/- 0.5% from its previous day's mid-point. It was the second widening to the USD/CNY trading band since the central bank shifted to a managed float regime in July 2005.

The CNY daily trading band has been considerably wider for other major currencies, than it has against the US dollar. More specifically, the CNY is allowed to fluctuate by +/- 3% versus EUR, JPY, GBP, CAD and AUD, and +/- 5% against RUB and MYR on the onshore Clearing House Financial Markets system (CHFM).

With the wider CNY daily trading band implemented against non-US dollar currencies, the previous policy prior to 16 April of maintaining a much tighter trading band in the USD/CNY cross, became not only obsolete, but also inconvenient.

A more flexible exchange rate regime is in China's own interest because it allows the central bank to move towards operating a truly independent monetary policy. The PBoC maintains an adamant assertion that it has indeed abolished a rigid US dollar peg almost seven years ago.

GLOBAL SAVINGS RATE (% OF GDP)

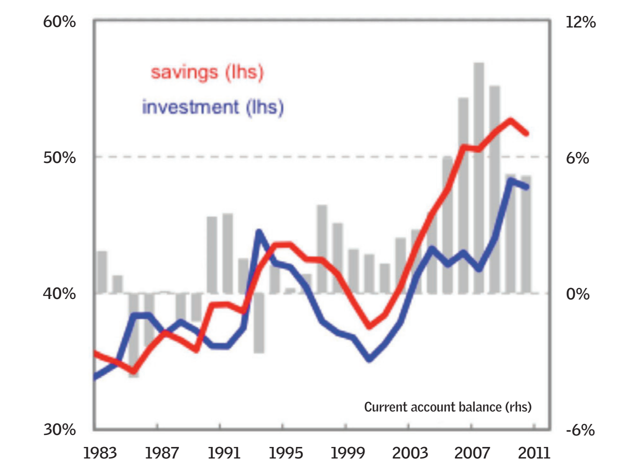


SOURCE: CBA

OLD WINE IN A NEW BOTTLE?

While we acknowledge the exchange rate regime is more flexible, since the official adoption of a managed float in July 2005, evidence of a truly diversified currency basket, has been inconsistent at best. Our estimation suggests that the domestic currency has remained mostly a de facto soft peg to the US dollar. In fact, until recently, the intra-day movements of USD/CNY rarely approached the original July 2005 intra-day limit of +/- 0.3%, let alone +/- 0.5% or +/- 1.0%.

SAVINGS, INVESTMENT AND CURRENT ACCOUNT BALANCE



SOURCE: CBA

Beginning last September, and at the height of the US dollar strength, the upper bound of the USD/CNY trading band began being repeatedly tested. However, the near breaches of the upper limit of the USD/CNY trading band, reflected primarily weak fixings, rather than increased flexibility. On that note, the largest intra-day deviation was just a tad above 0.6%, which remained just outside the old band width of +/- 0.5%. But, it should be noted, a wider trading band does not necessarily equate to reduced foreign exchange market interventions from the central bank, so reserve accumulation has continued.

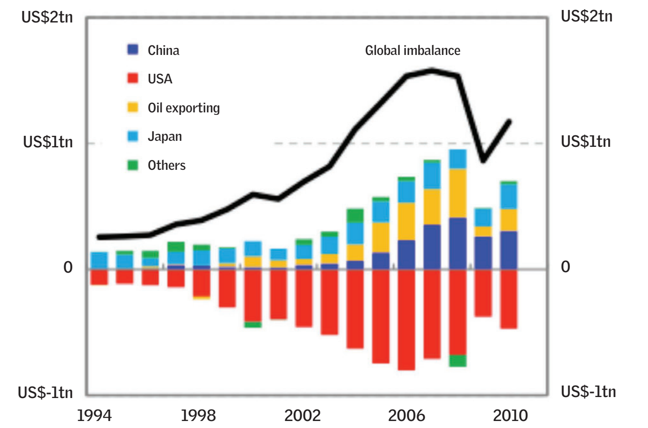
SHORT-TERM PAIN, LONG-TERM GAIN

The global financial crisis (GFC) arguably added urgency to the implementation of a more flexible exchange rate regime, because a flexible exchange rate can act as an absorber to external shocks. The Chinese authorities may have gained some first-hand experience on the impact of a non-flexible currency, after they chose to temporarily return to US dollar peg during the height of the GFC between mid- 2008 and mid -2010.

The decision to temporarily return to the US dollar peg appeared to accelerate the pass through of rising global commodity prices to China's domestic inflation in the immediate post-crisis period. The temporary return to the US dollar peg also appeared to generate a more subdued recovery in the external sector, when compared to the external sector recovery experienced by China's regional peers.

The recently announced and sooner-than-expected CNY band widening, suggests the PBoC have gained some experience, and remain cautious about the short-term outlook on the global economy. The PBoC appears to have taken a more sombre view of necessary medium-term renminbi appreciation, particularly as China's current account surplus has narrowed to a more modest 2.75% at the end of 2011, from 10% in late 2007.

GLOBAL IMBALANCE (US$ TRILLION)



SOURCE: CBA

But we believe the PBoC doesn't have to worry too much, because we anticipate that China's current account surplus will again widen over coming months and years. The sharp fall in China's current account surplus since late 2007 (the GFC period) appears to reflect the ramifications of sluggish global exports, higher import costs, led by rebounding commodity import prices, and expansive domestic stimulus measures adopted by the Chinese authorities.

The likely widening in China's current account surplus should begin to occur once the Eurozone recovers from its current mild recession later this year. Also assisting the widening in China's current account surplus will be some headwinds preventing a sharp rise in China's commodity import bills. Non-energy commodities are unlikely to bounce significantly because neither the Eurozone economic recovery nor the US domestic expansion is likely to be terribly exciting. In other words, we believe that the narrowing in China's current account surplus during the 2008-09 GFC was largely cyclical in nature and hence transitory.

With respect to long-term structural drivers of the current account surplus, China's prevailing saving/investment trends point to a persistent and substantial long-term current account surplus. Precautionary motives, such as the lack of a sufficient social security system, are likely to keep China's national savings rate at its elevated level. China's efforts to rebalance the domestic economy towards private consumption, suggest that the investment share of China's GDP should begin to fall back towards its pre-crisis level. At the margin, a lower investment share, implies a wider current account surplus, if savings are maintained.

With respect to the academic literature, the "external balance" approach toward exchange rate valuation, suggests China's structural current account surplus should be around 1.5% – 3.0% of GDP over 2013 – 14. This implies that the current 2.75% external surplus is about right. Perhaps this is an additional reason why the Chinese authorities have adopted a wider, more flexible CNY trading band.

RENMINBI INTERNALISATION SHOULD BOOST THE CURRENT ACCOUNT SURPLUS

We anticipate that the ongoing renminbi internationalisation will result in strengthening pressure on China's exchange rate. This is because internationalisation opens up avenues for domestic liquidity to invest overseas. A higher level of net foreign assets (NFA) generates a lift in net interest income, and in turn, a widening in the net income surplus, and a widening in the current account surplus. Real exchange rate appreciation is generated via the net income surplus widening the current account surplus.

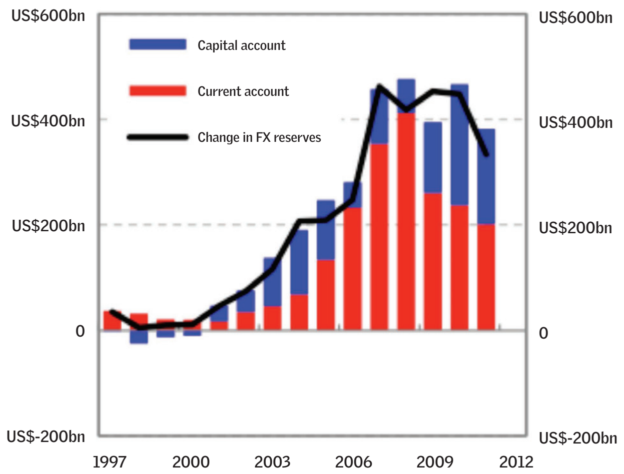
China's real exchange rate, similar to China's NFA position, has been on an uptrend over the past decade. China's NFA has lifted from 5% of GDP in 2000, to its current level of almost 40% of GDP. Past experience suggests, that over the long-run, a 10% increase in NFA as share of total exports, should lead to 1.0% of real exchange rate appreciation.

We expect China's NFA position to strengthen in both the short-run and the long-run. In the short-run, the PBoC is poised to further expand the existing Qualified Domestic Institutional Investor (QDII) program to US$100 billion over the first half of 2012. Already the composition of China's Balance of Payments (BoP) has shifted since the PBoC embarked on its internationalisation efforts. Capital account transactions have risen quickly over recent years; and last year, they accounted for some 50% of China's current account surplus.

CONCLUSION – MORE RENMINBI APPRECIATION

We maintain that the CNY remains undervalued. The combination of a European economic recovery, a modest-only bounce in commodity

BALANCE OF PAYMENTS (US$ BILLION)



SOURCE: CBA

(import) prices, and further renminbi internationalisation, leading to a lift in China's net foreign assets and hence net interest income, should combine to widen China's current account surplus over the next twelve months or so. In tandem with our expectation of a mildly softer US dollar during late 2012, we anticipate further CNY appreciation and maintain our year-end forecast for USD/CNY of 6.0700. This implies another 3.8% of appreciation over the next seven months.

The increased flexibility in the CNY's daily trading band recently adopted by the PBoC, suggests the risks are skewed towards an even faster pace of appreciation over our forecast time frame. ◢