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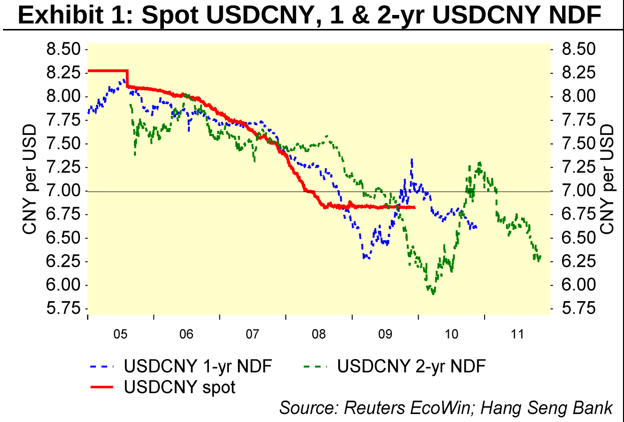
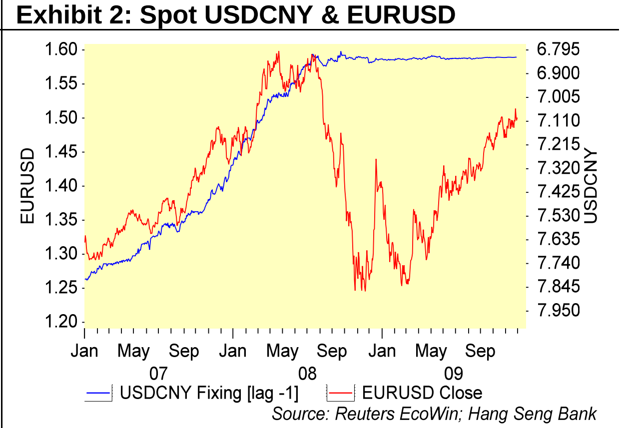
The Chinese Renminbi to Resume Modest Appreciation

- **The Chinese renminbi exchange rate has remained virtually unchanged against the US dollar since July 2008, after having appreciated some 20% in the previous three years following the Mainland authorities' abandonment of their decade-old fixed exchange rate to the U.S. dollar in favour of a link to a basket of currencies.**
- **The renewed peg to the US dollar reflected the authorities' attempt to maintain the competitiveness of the Mainland's exports amidst a global recession brought on by the financial crisis.**
- **Despite growing pressure from the US and the European Union for a stronger renminbi, the chance of a large one-off revaluation by the Mainland is slim. However, as the global recovery gathers momentum and the Mainland's export prospects improve, the authorities might allow the renminbi to start rising again some time next year. But the pace of appreciation is likely to be gradual and modest. We see the renminbi rise to about 6.65 against the US dollar by the end of 2010 from 6.83 presently, an appreciation of about 3%.**

The currency market has been speculating in recent months about a stronger Chinese renminbi versus the US dollar. The one and two-year non-deliverable renminbi forwards fell to a 15-month low of 6.5865 and 6.2500 per US dollar respectively on 13 November, implying an appreciation of about 3.7% for the renminbi in one year's time and 9.2% in two years' (Exhibit 1). The expected appreciation of the renminbi reflects rising pressure from the US and the European Union (EU) for a stronger renminbi as well as anticipation of a weakening US dollar in the longer-term.

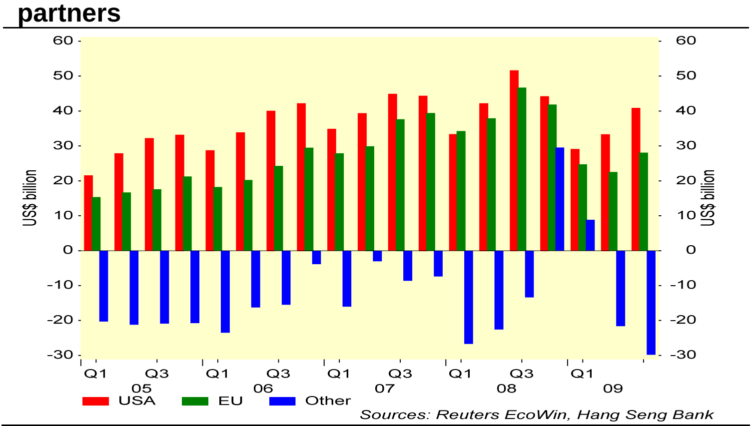
The Mainland authorities have been keeping the renminbi exchange rate at about 6.83 per US dollar since July 2008 after letting it strengthen some 20% in the previous three years following Mainland authorities' abandonment of their decade-old fixed exchange rate to the U.S. dollar in favour of a link to a basket of currencies (Exhibit 2). With the US dollar having depreciated about 16% against a basket of major currency between March and November 2009, the renewed peg to the US dollar meant that the renminbi has also tracked the downward trend of the greenback during the same period. The renminbi's weakness has led to growing unease among some of mainland China's major trading partners.





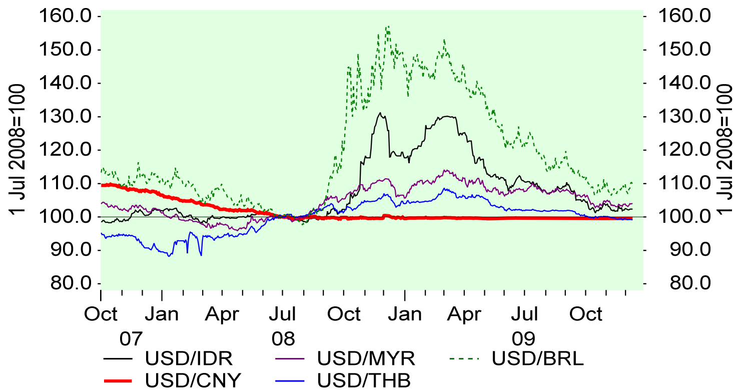
The US and the EU, mainland China's two most important export markets, have long believed that the renminbi is undervalued, as evident by the country's growing trade surpluses with them. After dropping steadily from the peak of US$46.5 billion in the third quarter of 2008 to US$22.4 billion in the second quarter of 2009, the Mainland's trade surplus with the EU rebounded to US$27.9 billion in the third quarter (Exhibit 3). The Mainland's trade surplus with the US rebounded even earlier, in the second quarter, and then rose further to US$40.7 billion in the third quarter.

Exhibit 3: Mainland China's trade balance with trading partners



Some of the advanced countries believe that the Mainland is deliberately preventing the renminbi from appreciating in order to maintain the competitiveness of its exports. Adding to their dissatisfaction is the fact that the currencies of other emerging market economies have appreciated markedly versus the greenback since March 2009 (Exhibit 4). The Indonesian rupiah, for example, has strengthened by some 30% against the greenback since March 2009, while the Brazilian real has risen by about 40% in the same period.

Exhibit 4: USD vs major emerging market currencies



Sources: Reuters EcoWin, Hang Seng Bank

The US and the EU also reckon that global imbalance is one of the main causes of the present recession. They believe that an undervalued renminbi will lead to further widening of the Mainland's trade surplus, delaying the rebalancing and hence the recovery of the global economy.

In its semi-annual report to the US Congress on foreign exchange policy in October 2009, for example, the US Treasury did not think that mainland China manipulated its currency, but did consider the renminbi to be undervalued, that both the rigidity of the renminbi and the Mainland's rapid pace of reserve accumulation should be corrected to help ensure a stronger, more balanced global economy consistent with the Group of 20 framework. The European Central Bank and finance ministers from the euro zone countries also expressed similar views on the renminbi on numerous occasions recently.

To press for a stronger renminbi, both the US and the EU have placed more restrictions on imports from the Mainland in recent months (Exhibit 5). The imposition of an emergency duty by US President Obama in September 2009 on the imports of the Mainland's tyres was an example. Though the goods involved amounted to less than 1% of the Mainland's total exports, the incidents are not encouraging.

Exhibit 5: Recent restrictions on selected mainland China's exports

Date	Restrictive measures on mainland China's exports
10 September	US imposed preliminary countervailing duties of 10.9-30.6% on China's oil pipes
11	US imposed safeguard tariffs of 35% on China's tyres
24	EU imposed antidumping duties of 39.2% on China's seamless steel pipes for 5 years
6 October	EU imposed antidumping duties of 17.7-39.2% on China's seamless steel pipes
7	US initiated antidumping and anti-subsidy investigation into China's exports of seamless steel pipes
2 November	US imposed preliminary countervailing duties of 2-438% on China's steel wire decking
4	US imposed preliminary antidumping duties of 36.55-99.14% on China's oil pipes

Source: Various newspaper clippings; Hang Seng Bank

Arguments for a stronger renminbi not all convincing

Not all the reasoning for a stronger renminbi by the US and the EU is convincing, however.

In the first place, the Mainland's current account surplus has already fallen sharply to less than 7% of GDP in the first half of 2009 from a peak of 11% in 2007. The recent rebound in mainland China's current account surplus partly reflected a sharper fall in the prices of the country's imports than exports rather than an increase in outward shipment. In the first 10 months of 2009, import prices dropped 16.8%, mainly reflecting plunging crude oil prices in the global market, while export prices fell only 8.7%. Had import prices contracted at the same rate as that of exports, the Mainland's trade surplus would have been 37% smaller.

It is also unclear if a stronger renminbi would help reduce the overall trade deficits of the US and the EU. For a start, there is the question of whether the current account deficits of the US and the EU are structural and can be solved through exchange rate changes. Even if the renminbi is adjusted upwards, US and European consumers might just replace the more expensive imports from the Mainland with that from other emerging countries.

While it is true that the renminbi has remained basically unchanged against the US dollar this year when other emerging market currencies have risen sharply, this is not the full picture. A look back in 2008 shows that the Mainland held its currency steady throughout the global financial crisis, while others plunged. In fact, the renminbi has strengthened against every currency except the Japanese yen since the start of 2008.

It can be said that by keeping the renminbi basically stable against the US dollar, the Mainland had probably helped lessen the volatility of the foreign exchange market during the worst period of the global financial crisis.

No one-off revaluation but gradual appreciation of the renminbi

Many in the West have called for a one-off revaluation of the renminbi. However, it is difficult to determine whether the renminbi is undervalued, let alone the extent of undervaluation. Numerous studies have been conducted on the subject but leading to wide-ranging or even contradictory results[1]. There is also fear that too small a revaluation would fuel expectations of further changes, leading to more inflows of speculative capital, while too big a revaluation could potentially put many Mainland exporters out of business. As such, the Mainland authorities are likely to resist calls for any one-off revaluation for the time being.

[1] In a paper in June 2009, for example, Cline and Williamson found the renminbi to be undervalued by some 40% against the greenback, while a paper by Bineau recently reckoned that valuation of the renminbi differed greatly from under to overvaluation depending on the underlying real equilibrium exchange rate models, empirical methodology, choices of variables, etc. Please see "2009 Estimates of fundamental equilibrium exchange rate", William R. Cline & John Williamson, Peterson Institute of International Economics, June 2009, and "Renminbi's misalignment: a meta-analysis", Yannick Bineau, University of Lille, France, November 2009.

While the mainland authorities prefer to maintain currency stability, there is room for some loosening of the peg and moderate revaluation of the renminbi if the global recovery gathers momentum and export prospects improve. The case for renminbi appreciation would be even stronger if the US dollar slides further, causing unwanted inflationary pressures on the Mainland. But the pace of appreciation is likely to be gradual and modest. We see the renminbi start rising again sometime next year, to about 6.65 versus the US dollar by the end of 2010 from about 6.83 presently, an appreciation of about 3%.