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# Chinese Yuan: Up or Down?

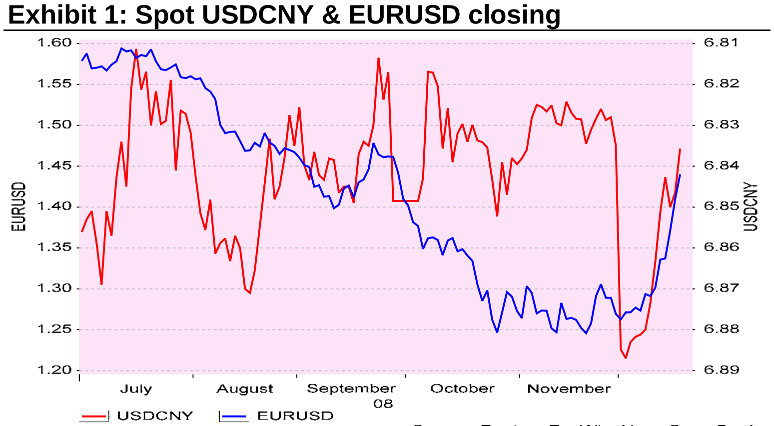
- **The noticeable weakening of the spot Chinese yuan (CNY) against the US dollar (USD) in the first few days of December fanned expectations that the Mainland authorities would reverse their policy of CNY appreciation against the greenback. A marked slowdown in domestic and external demand since 3Q 2008 has put the authorities under great pressure to devalue the CNY as a means to stimulating exports.**

- **But devaluing the CNY would be a difficult choice for the Mainland. With export growth responding more to changes in overseas demand than exchange rates, the benefit from devaluing the CNY may be marginal. The Mainland is also under constant pressure from the US and Europe governments to strengthen the CNY as a means to eliminating the huge trade surplus of the country with the two regions. Moreover, a change of market expectation from appreciation to depreciation of the CNY could also trigger sudden capital outflow, which could destabilise the domestic economy.**

- **It is most probable that the Mainland would stabilise the CNY at around 7.0 against the USD in the coming year, and simultaneously widen the daily trading limit to +/-3.0% from the present +/-0.5%, in line with the trading bands for CNY rates versus non-USD currencies, to increase flexibility of the exchange rate.**

The CNY closed 0.7% weaker at 6.8848 against the USD on the spot market on 1 December, the biggest one-day loss for the CNY since July 2005 when mainland China began pegging its currency to a basket of currencies (Exhibit 1). The rate continued to trade near the 6.88 level in the following six days.

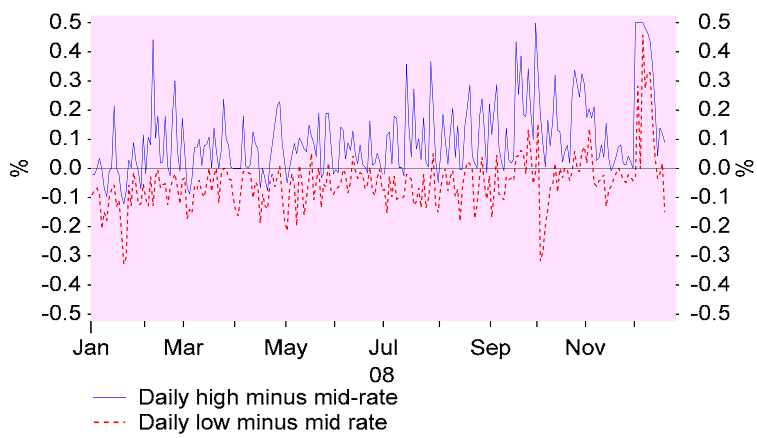
**Exhibit 1: Spot USDCNY & EURUSD closing**




*Source: Reuters EcoWin; Hang Seng Bank*

Not only did the CNY depreciate markedly against the USD on December 1, it also touched the upper bound of the +/-0.5% daily floating limit for the first time. The upper limit was hit again on the two subsequent days (Exhibit 2). The daily band is the permitted trading range of the spot CNY rate against the USD compared with the mid-rate set by the People Bank of China (PBOC) each morning. The band for the CNY rate against the USD was widened from +/-0.3% to +/-0.5% in May 2007.

**Exhibit 2: USDCNY high-low deviation from PBOC mid-rates**




*Source: Reuters EcoWin; Hang Seng Bank*

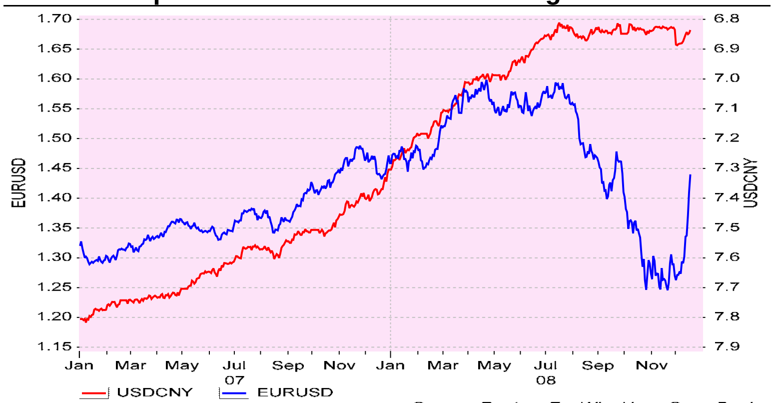
The CNY's sudden weakness was not expected. The pace of CNY appreciation against the dollar in fact accelerated in the first half of 2008, to 1.06% per month, compared with that of 2007, at 0.56% per month. While the rate of appreciation slowed to only 0.2% per month from July to September and the CNY actually reversed trend in both October and November, a 0.7% daily decline was beyond anyone's imagination.

The CNY's sudden loss of favour was reportedly triggered by the central bank's decision to set the CNY mid-rate at 6.8505 against the USD on December 1 from 6.8349 in the previous day. This reignited worries that the Mainland authorities might be opting to reverse the CNY's 3 year uptrend against the greenback. Market expressed similar concern in August 2008 when the CNY weakened against the USD for 10 days in a row.

To be sure, there are strong reasons for the Mainland authorities to devalue the CNY against the USD:

- The USD has strengthened by about 30% against the euro in the foreign exchange market since hitting a trough in July 2008, but the CNY has remained stable against the USD during the period (Exhibit 3).

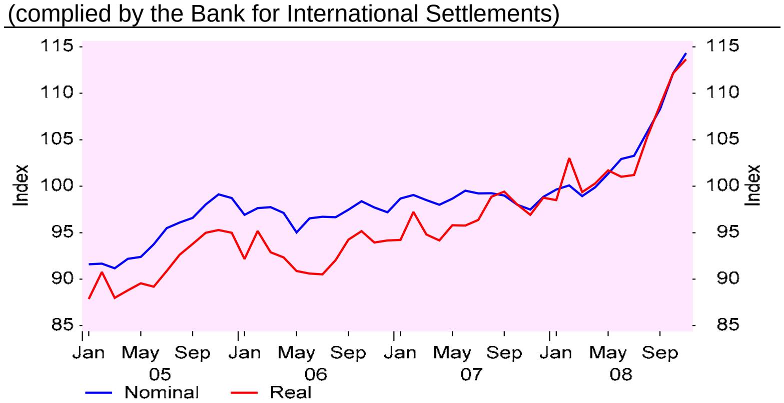
**Exhibit 3: Spot USDCNY & EURUSD closing**




*Source: Reuters EcoWin; Hang Seng Bank*

- Had the central bank adhered to its previous policy of linking the CNY to a basket of currencies, the CNY effective exchange rate index (EERI) should have remained stable and the CNY depreciated notably against the US dollar (Exhibit 4).

**Exhibit 4: CNY Nominal effective exchange rate index**
(complied by the Bank for International Settlements)




*Source: Reuters EcoWin; Hang Seng Bank*

- Sharply slower economic growth since Q3 2008, mainly as a result of marked slowdown in external demand, also put the Mainland authorities under great pressure to devalue the CNY. The real growth of the Mainland's industrial output decelerated to only 5.4% in November ([1]), the slowest since record began in 1994 ([2]). Many believed that the persistent rise of the CNY EERI over the last two years was among the major reasons for the weakening of the Mainland's export growth.

[1] All growth rates are year-on-year except specified otherwise.
[2] Though industrial output growth did slow to below 8% in Feb 1999, Jan 2001, Feb 2002, Jan 2004 and Feb 2005 respectively, these were all due to seasonal (the Lunar New Year) factors (see Exhibit 2).

- The unexpected contraction of the Mainland's exports by 2.2% in November, the first such contraction since June 2001, will put the authorities under even more pressure to devalue the CNY. The World Bank forecasts that global economic growth will slow to only 0.9% in 2009 from an estimated 2.5% in 2008. More alarmingly, the Bank expects world imports to contract by 1.8% in 2009, for the first time since 1982. For the Mainland, the World Bank expects real GDP growth to decelerate to only 7.5% in 2009, from an estimated 9.4% in 2008 and the lowest since 1990 (Exhibit 5).

**Exhibit 5: World Bank's economic projections**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| World GDP real growth, % (1) | 2.5 | 0.9 | 3.0 |
| World import real growth, % (1) | 5.4 | -1.8 | 7.3 |
| China GDP real growth, % (2) | 9.4 | 7.5 | Not available |
| China export real growth, % (2) | 11.0 | 3.5 | Not available |

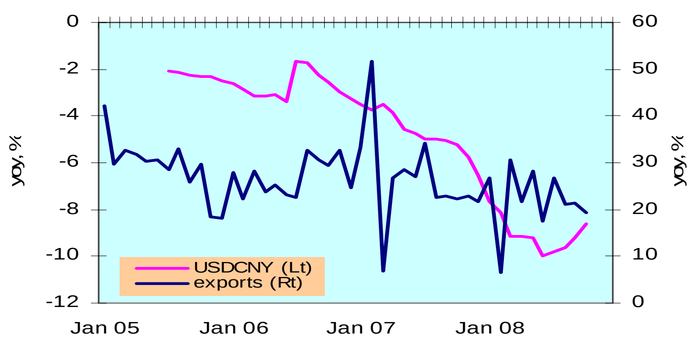
Sources: (1) "Global Economic Prospects, 2009", World Bank, 9 December 2008.World Bank; (2) "China Quarterly Update", World Bank, December 2008.

**But devaluing the CNY would be a tough decision for the authorities**

Faced with a grim economic prospect, the Mainland authorities have resorted to various macroeconomic tools to stimulate growth, including monetary easing and massive fiscal expansion. Exchange rate is one of the few remaining tools yet to be employed. But devaluing the CNY versus the greenback could be a difficult choice for the government, for several reasons:

- One is that the resulting gain might be marginal. Until recently, the Mainland's export growth appeared to be driven more by the strength of external demand than exchange rate changes. As Exhibit 6 shows, the persistent appreciation of the CNY versus the USD since 2005 appeared to have had only a minor impact on the Mainland's export growth. A weaker currency might help, but the extent of the gain is doubtful given the severity of the global recession.

**Exhibit 6: Change of USDCNY and the Mainland's exports**

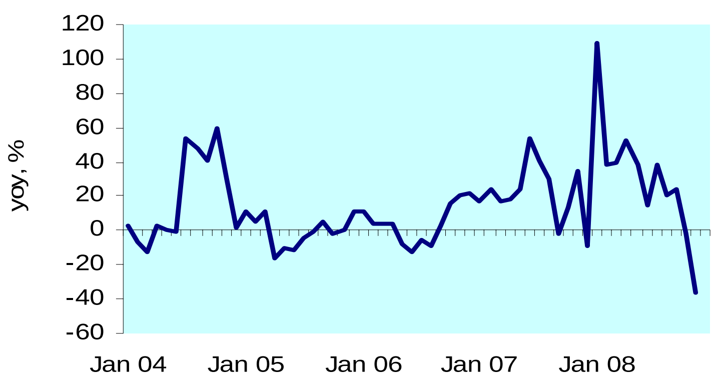



Source: Hang Seng Bank

- A more important reason is that the CNY exchange rate has never been adjusted on the basis of economic factors alone. The Mainland's huge trade surplus with the US and Europe has put the country under constant pressure from the two regions to appreciate the CNY as a means to eliminating the trade imbalance. With US President-elect Obama likely to press for "a change in China's currency practices", claiming that China "pegs its currency at an artificially low rate"([3]), the Mainland's task of defending its exchange rate policy will not be easy under the new US government. The possibility of triggering competitive depreciation in the Asian region may also limit the Mainland authorities' desire to devalue the CNY by any noticeable amount.

- The Mainland authorities also may not want the market to have an expectation for a sustained depreciation of the CNY for fear of triggering a sudden outflow of capital. Mainland China's utilised foreign direct investment (FDI) already dropped markedly by 36.5% in November after declining by 2.3% in October (Exhibit 7). FDI inflow could fall further in the months ahead given the deepening of the global recession. While reduced capital inflow would lessen the pressure on the Mainland to appreciate the CNY, too sharp a reversion of capital flow could destabilise the domestic economy.

**Exhibit 7: Growth of utilised foreign direct investment**

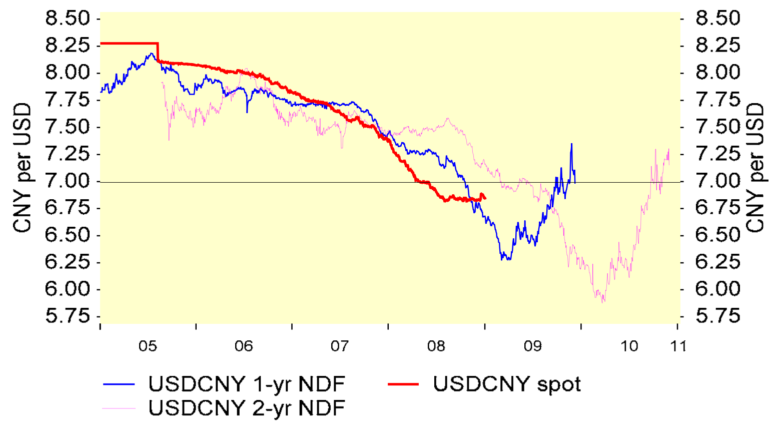



Source: Hang Seng Bank

The one-year Non-deliverable Forwards (NDF) for the USDCNY once traded as high as 7.3550 on December 4, implying an over 7% depreciation of the CNY against the USD a year from now (Exhibit 8). While the rate has since come down to 6.9850 on December 17, investors are still expecting a 2% decline in the CNY exchange rate.

[3] "US-China Policy Under An Obama Administration", Barack Obama, China Brief, October 2008, American Chamber of Commerce, China.

**Exhibit 8: Spot USDCNY vs 1-yr and 2-yr USDCNY NDF**




*Source: Reuters EcoWin; Hang Seng Bank*

Our view is that a balancing of economic and political benefit would probably force the Mainland to continue to stabilise the CNY rate at around 7.0 in the coming year. The daily trading limit of the CNY rate against the USD, however, could widen, possibly to +/-3% from the present +/-0.5%, so that it is in line with the trading bands for CNY rates versus non-USD currencies. Such a change would increase flexibility of the exchange rate.

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