

Hedging RMB Exposures

Treasury Division
11 August 2005

From Soft Peg to Managed Float

- “Sudden” announcement on July 21
- Shift from a soft US dollar peg to a managed float
- Exchange rates are set with reference to a basket of currencies
- USD/CNY on July 22 was set at 8.11, a 2% revaluation from 8.28
- Daily fluctuation is within +/- 0.3% of central rate

What is in the Basket?

- PBOC has just disclosed the composition of the basket as follows:-
 - Main currency : USD, EUR, JPY, KRW
 - Others : SGD, GBP, MYR, RUB, AUD, CAD & THB
- However, their relative weights are unknown
- The choice of currencies and their weights in the basket is based on the importance of China’s trading partners.

Impact on CNY

- SAFE to announce USD/CNY each day
- CNY could move up or down against the basket depending on
 - movements of currencies within the basket
 - weights of different currencies within the basket, and how often these weights are changed
 - intervention by PBOC
- In sum, PBOC has great flexibility in CNY rate

CNY Outlook

- 1-year CNY NDF is trading at around 7.8420
 - partly reflecting interest rate differentials between US and mainland China
 - partly reflecting expectations of further appreciation in CNY

Non Deliverable Forward (NDF)

- A FX forward contract to hedge risks in currencies where regulatory constraints do not allow easy access to the local market.
e.g. CNY, TWD, KRW

NDF Features

- No exchange in principal amount
- No physical transfer of currencies
- Settlement of net amount in USD
- This derivative is not subject to local foreign exchange regulations.

NDF Mechanism

Example

An exporter is due to pay CNY (in equivalent of USD5Mn) for goods manufactured in PRC in 6 months. In order to hedge his CNY exposure against appreciation, he may consider to enter into NDF to fix a 6-month forward rate with the Bank.

NDF Mechanism

- Assume the exporter enters into a NDF contract with the Bank at forward rate of 7.990 (USD1 = CNY7.990) value 11Feb06 (6mths from today).
- Upon the forward contract expiry date, net settlement amount under various scenarios are as below:-

NDF Mechanism

	Scenario 1	Scenario 2	Scenario 3
USD/CNY	CNY appreciates	CNY unchanged	CNY depreciates
Fixing spot rate	7.85	7.99	8.10
Equivalent Amt	USD5,089,172	USD5,000,000	USD4,932,098
Settlement	Bank pays customer USD89,172	No payment	Customer pays Bank USD67,902

- Scenario 1: The customer has to pay more to buy CNY in the spot market but the extra cost is compensated by Bank's payment under the NDF
- Scenario 2: No action
- Scenario 2: The customer can buy CNY at a better rate in the spot market, however the benefit is offset by its payment to the Bank under the NDF.

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