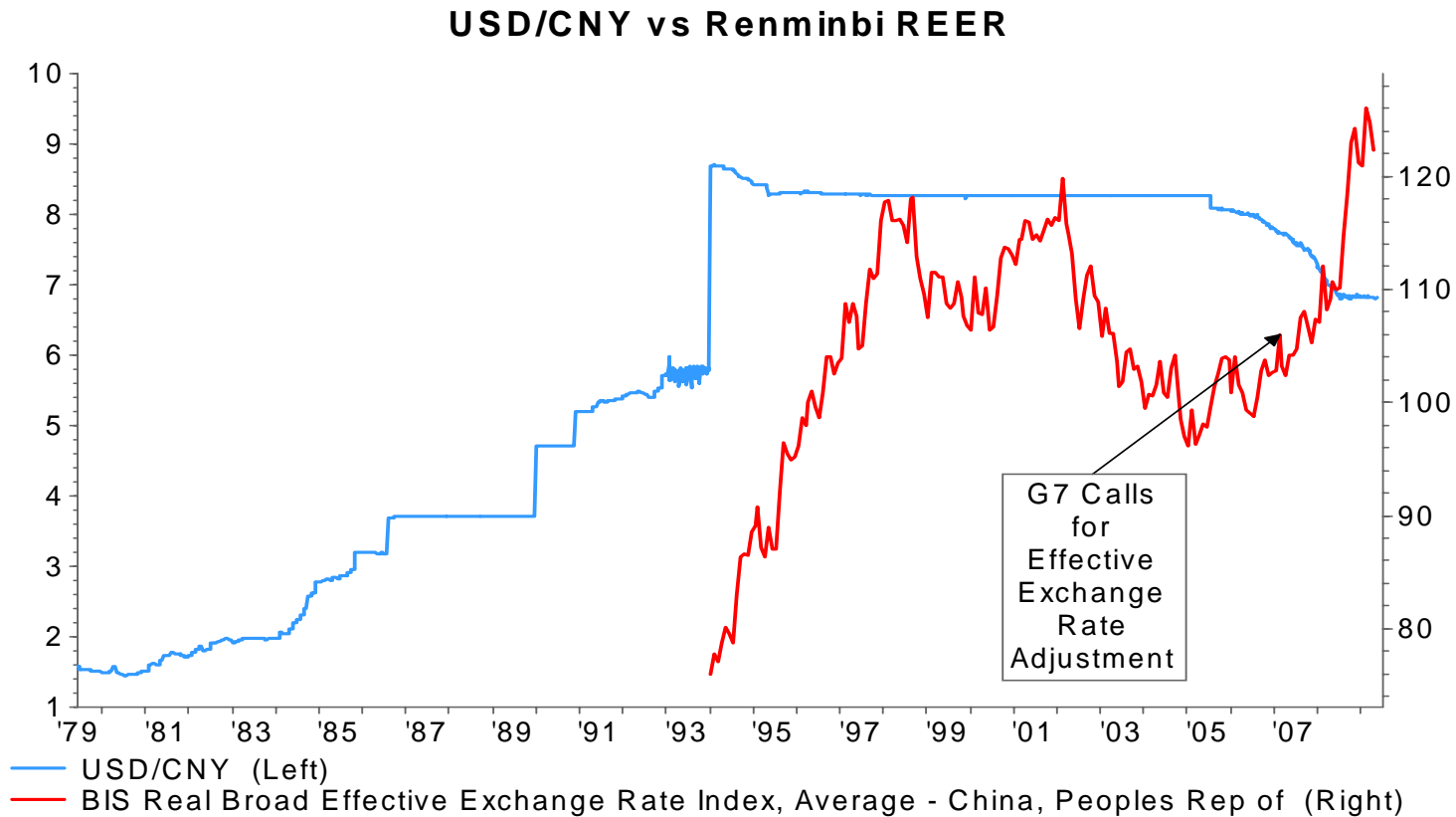

The USD/CNY Adjustment – Is It Complete?

Derek Halpenny
European Head of Global Currency Research

European Central Bank
June 2009

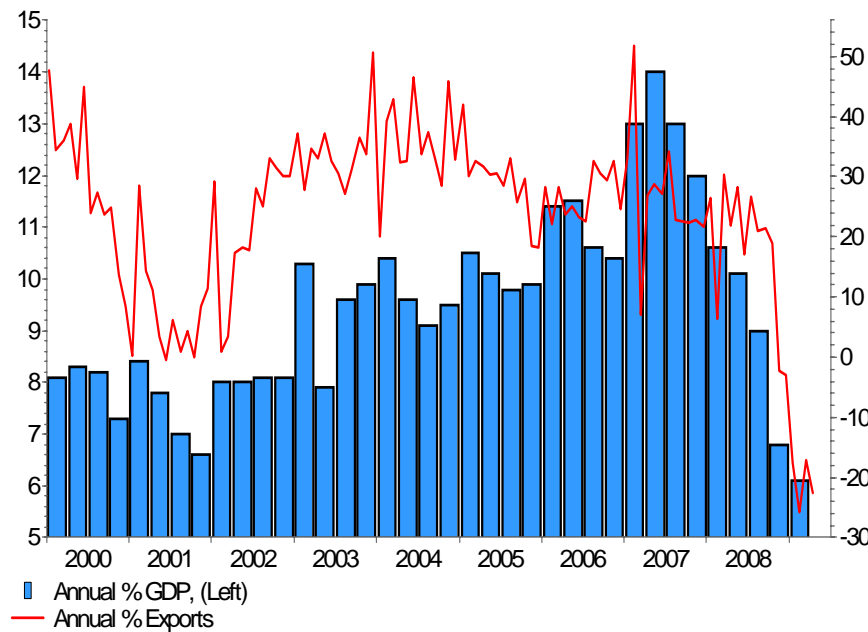


Substantial REER Appreciation



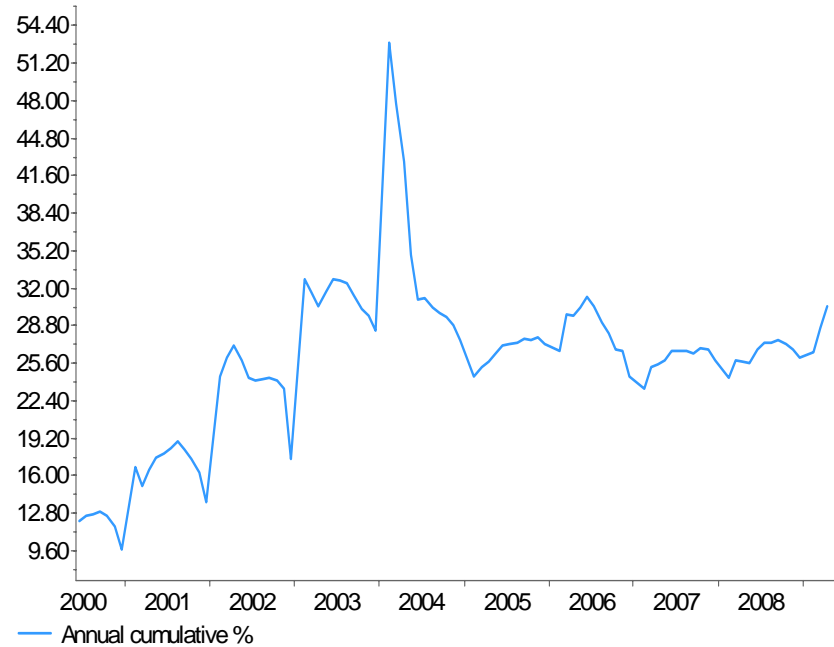
Investment Surge to Limit Real GDP Drop

China Real GDP vs Export Growth



➤ The worst export performance on record

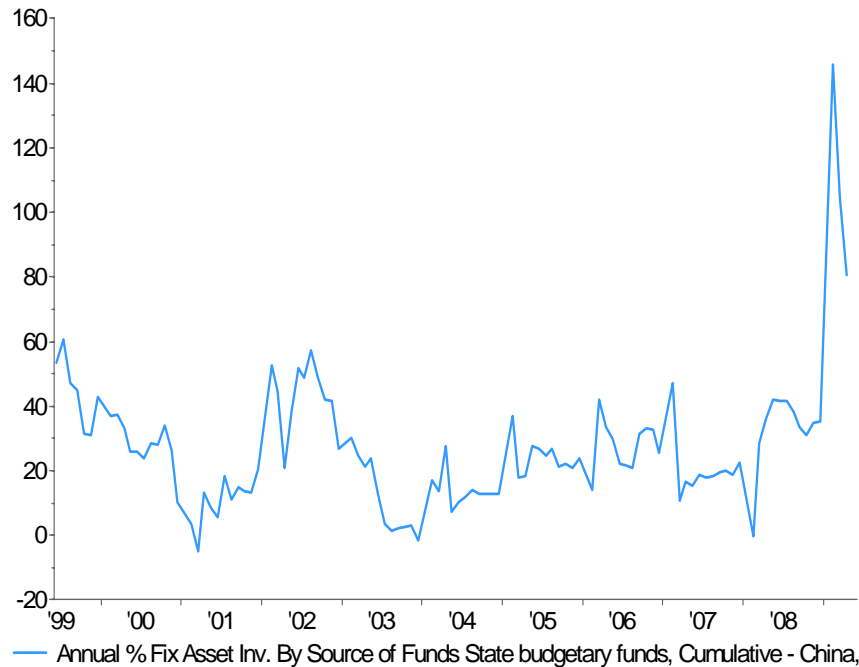
China Urban Fixed Asset Investment



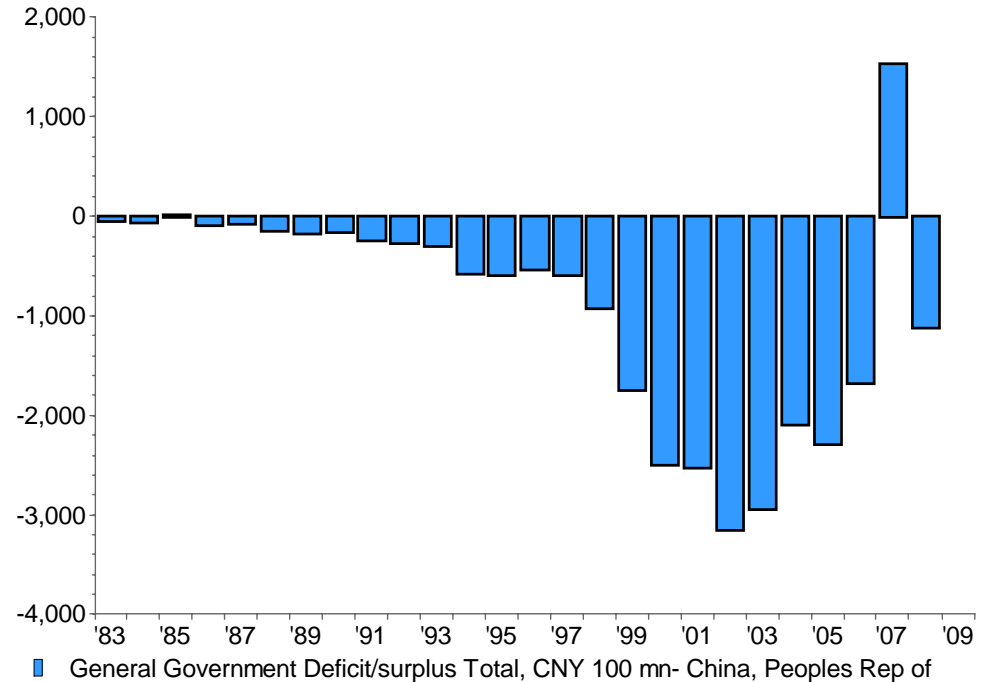
➤ Strongest pick-up since 2004

Fiscal Stimulus Already Impacting Growth

Fixed Asset Investment Growth - Government Sourced Funds



General Government Fiscal Balance



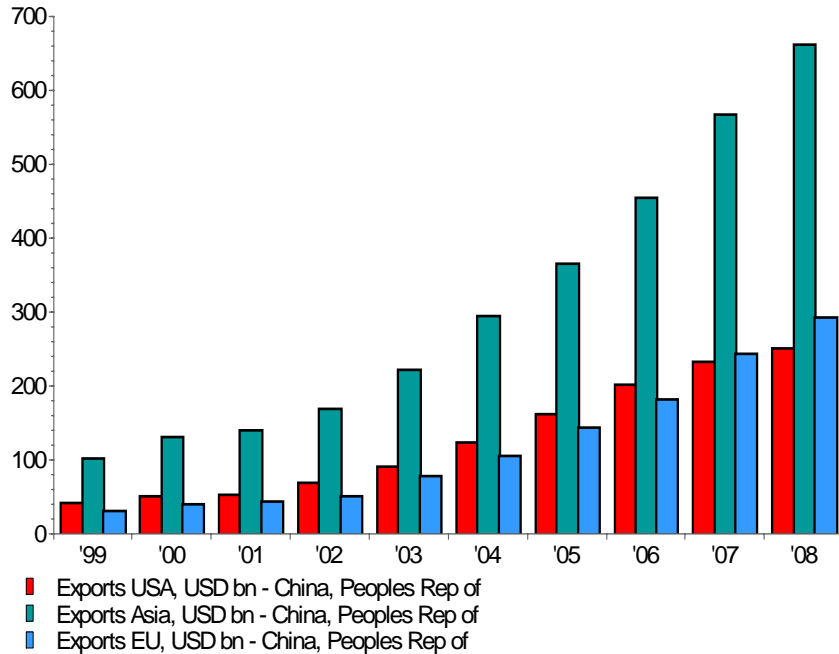
➤ **Government financed investment surges**

➤ **Favourable government debt position**



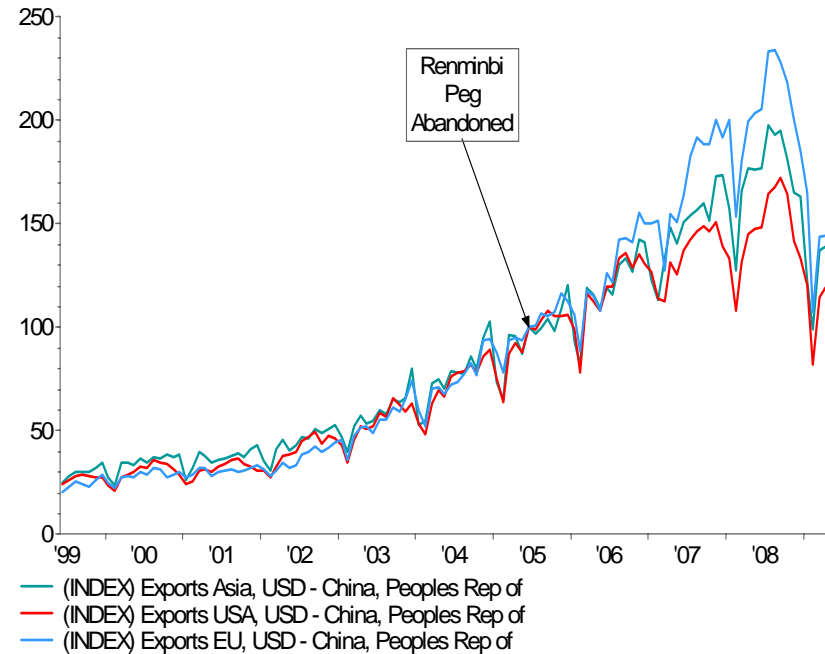
China Exports - US Share Reduced

China Exports by Main Regions



➤ EU as export destination surpasses US

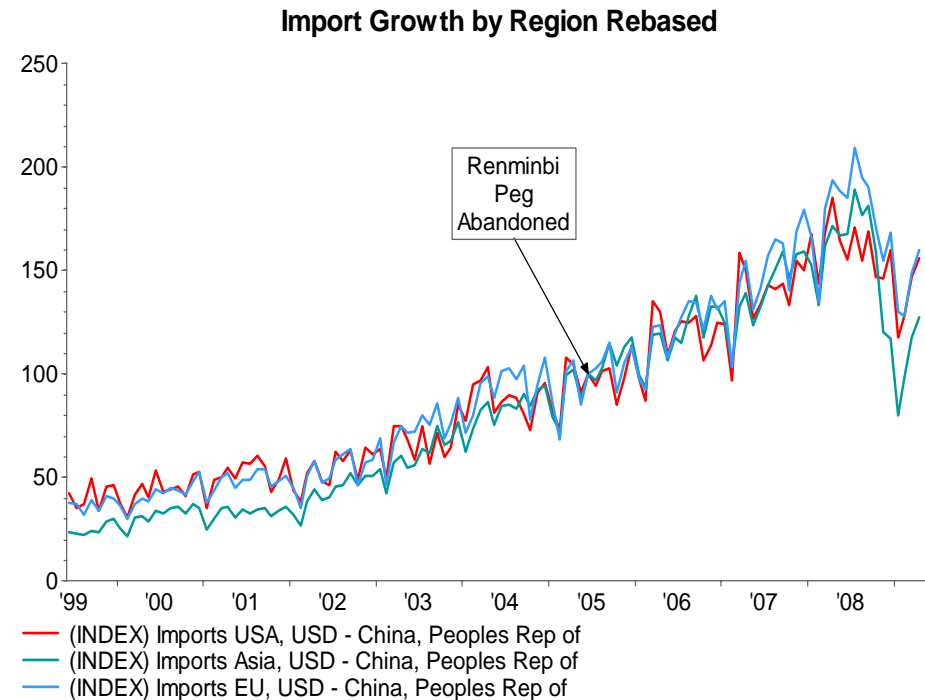
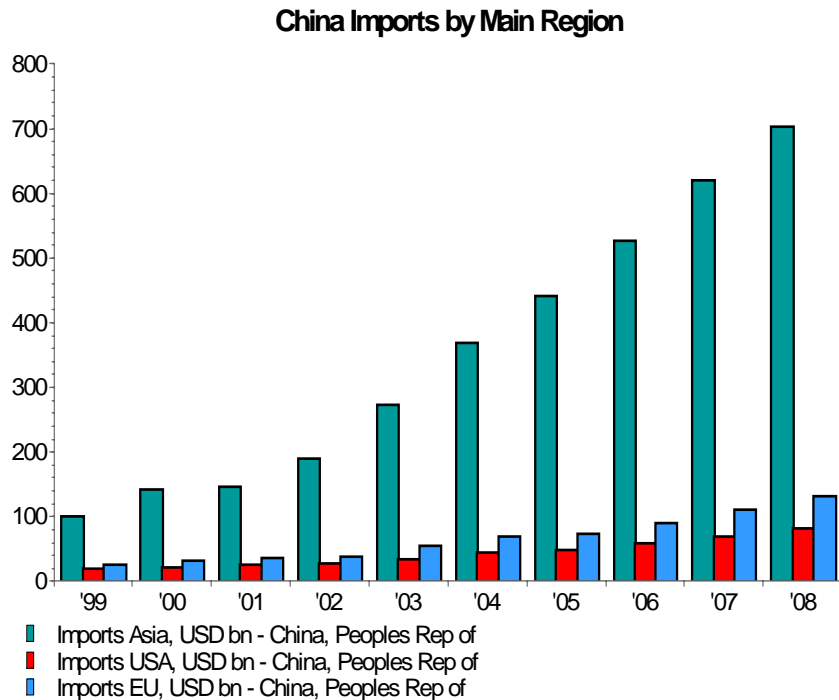
Exports by Region Rebased from June 2005



➤ Export growth to the US has lagged since peg abandoned



But Import Growth from Asia Underperforms



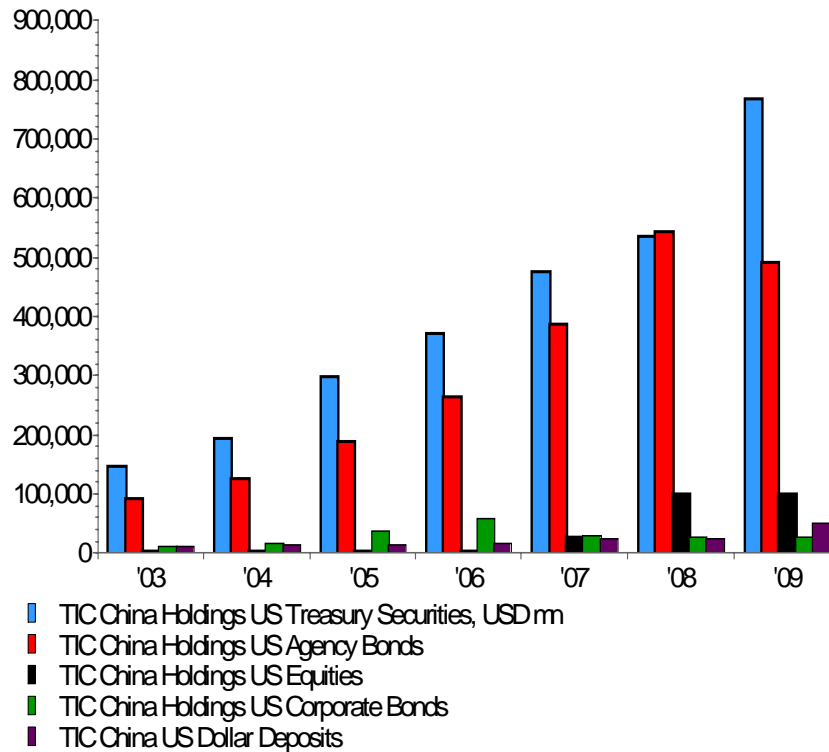
➤ **China imports from Asia account for 62% of all imports**

➤ **Import growth from Asia lagging**
➤ **Lack of diversification in Asian imports**

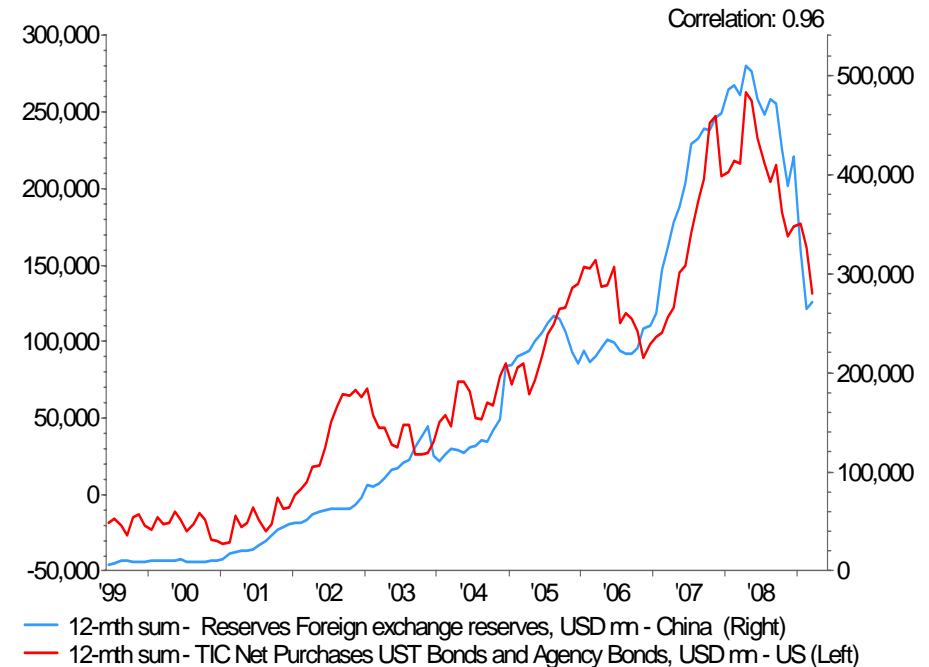


China demand for US assets persists

China Holdings US Securities and Deposits



China Reserves vs US Treasury Purchases - UK

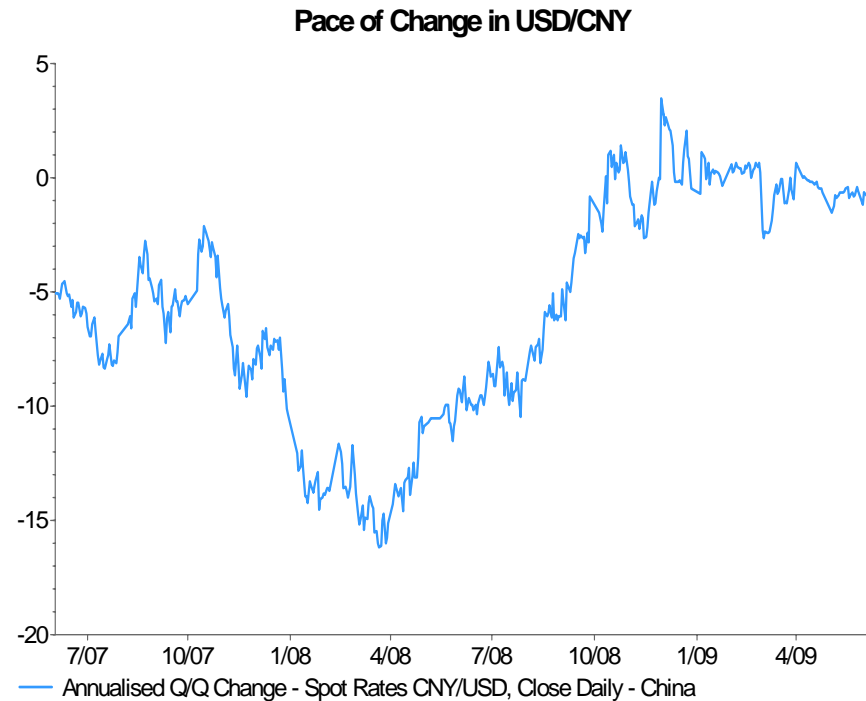
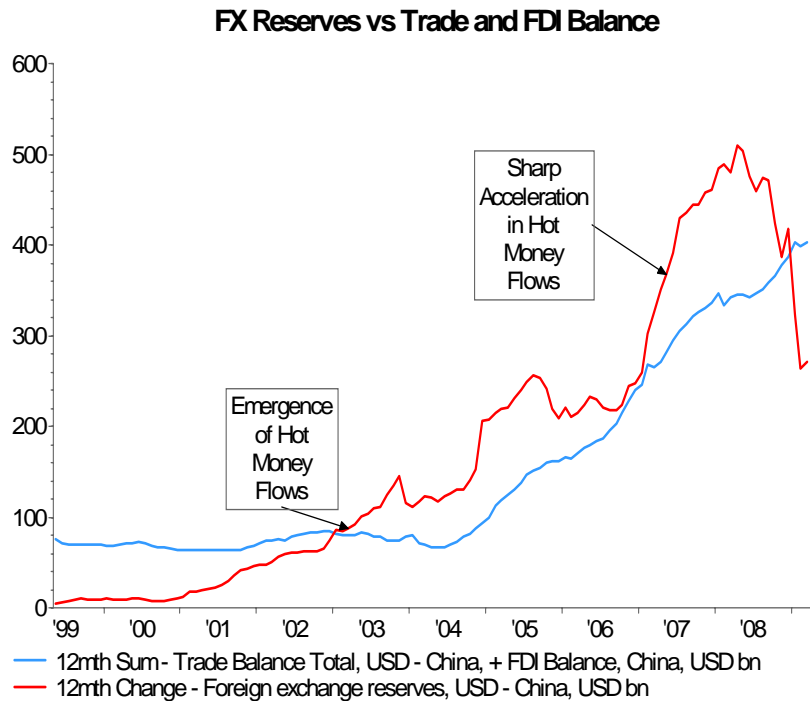


➤ Risk appetite shifts dramatically

➤ Official TIC data a considerable under-estimate



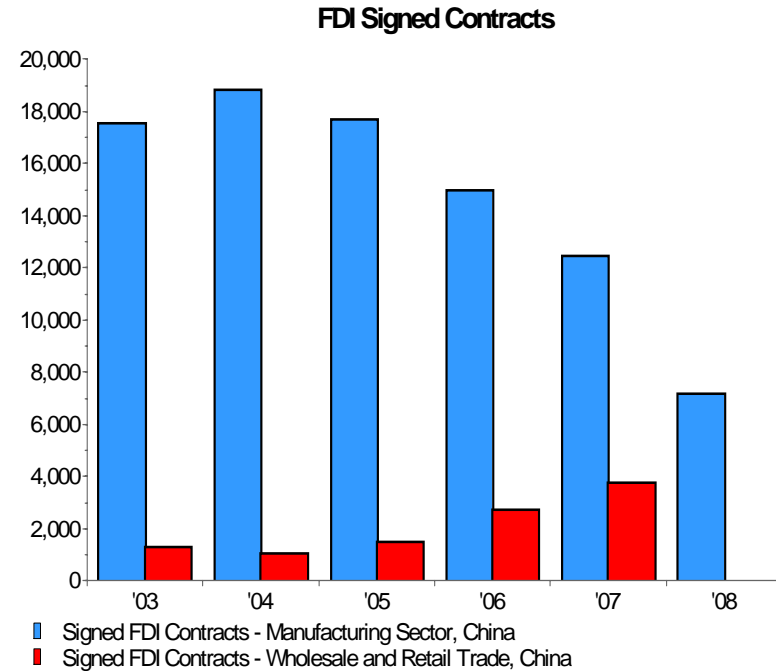
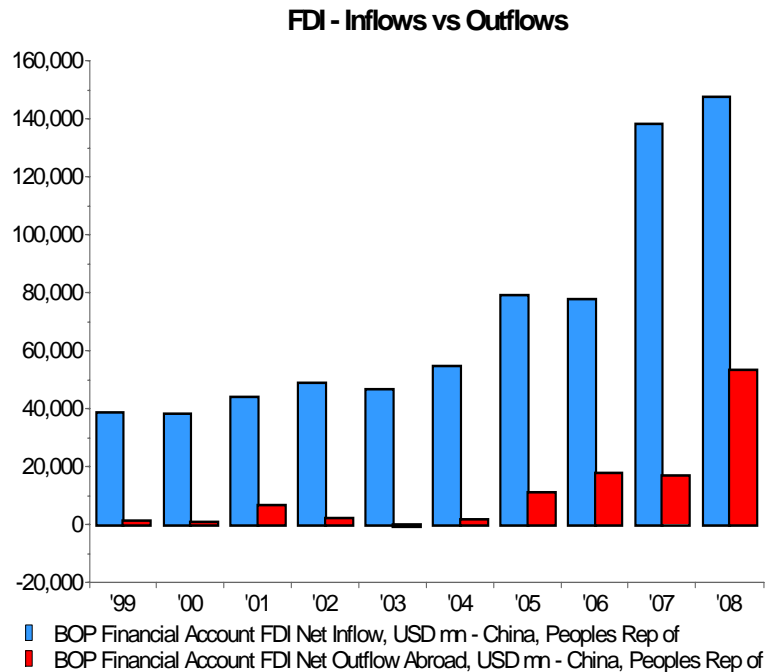
Hot Money Flows Reverse Sharply



➤ **Speculative pressures turn to outflows**

➤ **Peak in CNY appreciation pace coincides with peak speculation**

FDI Flows to Become More Balanced

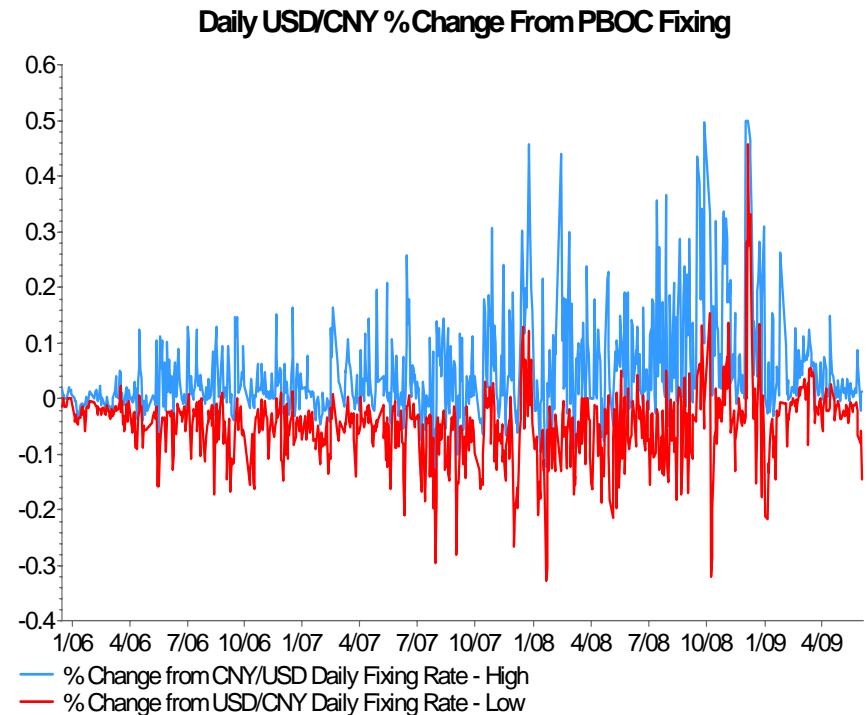
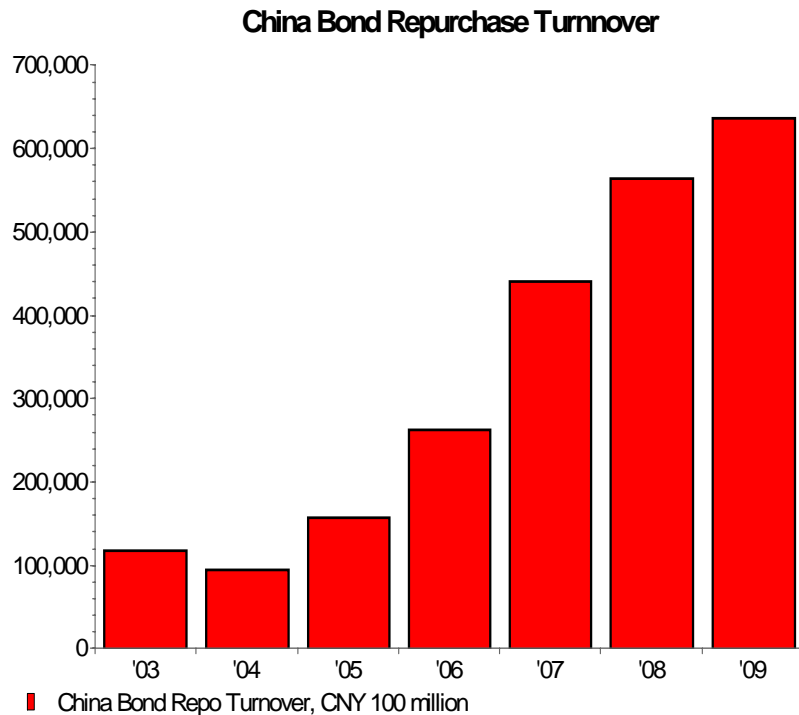


➤ **FDI outflows up 194% in 2008**

➤ **Manufacturing FDI inflow still around 50% of total**



Financial Market Development Progressing



➤ **Market determined yields gradually taking precedence**

➤ **USD/CNY spot FX turnover rising sharply?**



The Internationalisation of the RMB

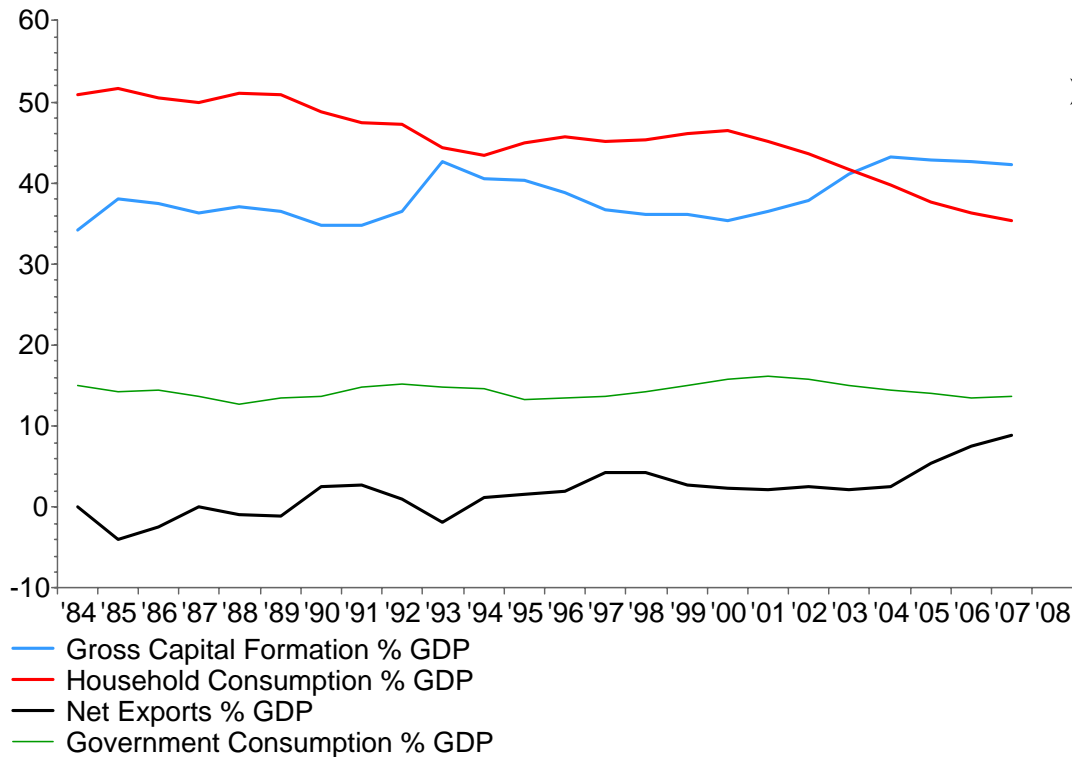
Recent Swap Agreements Announced by PBOC

Date	Countries	Amount (Billion RMB)
Mar-09	Argentina	70
Mar-09	Indonesia	100
Mar-09	Belarus	20
Feb-09	Malaysia	80
Jan-09	Hong Kong	200
Dec-08	South Korea	180
Total		650

- **China State Council approves Shanghai Development by 2020**
- **PBOC capital account regulations relaxed - 27th May**
- **A further expansion of currency swap lines expected**
- **RMB trading zone in greater China – Hong Kong and Taiwan**
- **Increased RMB settlement use in Shanghai & Pearl River Delta**
- **RMB bond issuance authorization granted outside of China**

Changes in GDP Structure Will Be Gradual

China Real GDP - Compositions



➤ **Short-term Measures to Boost Consumption**

- **Consumer Subsidies**
- **Increased Consumer Access to Credit**

➤ **Long-term Measures to Boost Consumption**

- **Social Security Reform**
- **Rural Income Growth**



International Politics Also Crucial

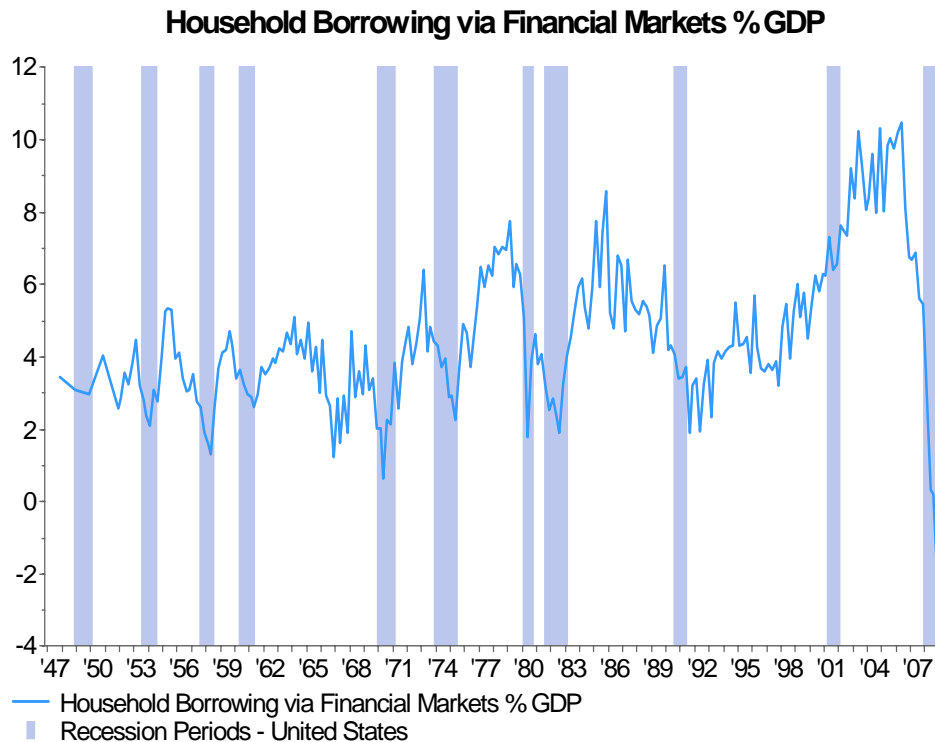
- **New Approach to Dealing with China by the Obama Administration?**
 - **Geithner visit in June underlined new phase in relationship**
 - **Now more mutually beneficial to strengthen relationship – New “Frenemies”**

- **Financial Crisis has reduced tensions in regard to USD/CNY movements**
 - **Banking sector recovery, financial market regulation the new focus of US Congress**

- **But EU could be the origin of next bout of international pressure**
 - **No CNY adjustment versus EUR since July 2005 unpegging**



US Dollar To Recover in 2010



- **Current optimism unlikely to persist**
- **Inflation concerns and dollar selling will ebb**
- **US financial markets will remain no. 1 destination helped by continued demand from China**



Conclusion

□ Little further USD/CNY adjustment over the remainder of 2009 and 2010

- **USD/CNY 6-month forecast 6.8000**
- **USD/CNY 12-month forecast 6.7500**

□ But this equates to renewed CNY appreciation on an effective basis

- **Further 5.0-8.0% effective appreciation from later this year**
- **EUR/CNY return toward 2008 lows in 2010**



This report is intended only for information purposes and shall not be construed as solicitation to take any action. In taking any action, each reader is requested to act on the basis of his or her own judgment. This report is based on information believed to be reliable, but we do not guarantee its accuracy. The contents of the report may be revised without advance notice. Also, this report is a literary work protected by the copyright act. No part of this report may be reproduced in any form without express statement of its source.

