The USD/CNY Adjustment – Is It Complete?

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June 2009
Substantial REER Appreciation

USD/CNY vs Renminbi REER

G7 Calls for Effective Exchange Rate Adjustment

USD/CNY (Left)
BIS Real Broad Effective Exchange Rate Index, Average - China, Peoples Rep of (Right)
Investment Surge to Limit Real GDP Drop

- The worst export performance on record
- Strongest pick-up since 2004
Fiscal Stimulus Already Impacting Growth

- Government financed investment surges
- Favourable government debt position
China Exports - US Share Reduced

- EU as export destination surpasses US
- Export growth to the US has lagged since peg abandoned

Bank of Tokyo-Mitsubishi UFJ
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

Bank of Tokyo-Mitsubishi UFJ
China demand for US assets persists

➢ 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

<table>
<thead>
<tr>
<th>Date</th>
<th>Countries</th>
<th>Amount (Billion RMB)</th>
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</thead>
<tbody>
<tr>
<td>Mar-09</td>
<td>Argentina</td>
<td>70</td>
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<tr>
<td>Mar-09</td>
<td>Indonesia</td>
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<td>Mar-09</td>
<td>Belarus</td>
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<tr>
<td>Feb-09</td>
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<td>Jan-09</td>
<td>Hong Kong</td>
<td>200</td>
</tr>
<tr>
<td>Dec-08</td>
<td>South Korea</td>
<td>180</td>
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<tr>
<td>Total</td>
<td></td>
<td>650</td>
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</tbody>
</table>

- 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

- Gross Capital Formation % GDP
- Household Consumption % GDP
- Net Exports % GDP
- Government Consumption % GDP

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
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