BBVA Research

China

Economic Watch

China Signals Currency Flexibility

June 21, 2010

Economics Analysis

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Summary

- **The People's Bank of China (PBOC) has announced a change to its currency framework to allow greater flexibility based on a currency basket. The PBOC emphasized a gradual approach, and has ruled out any one-step revaluation.**

- **Though long anticipated in view of China's large BOP surplus, the announcement came as a welcome surprise to markets, which had been discounting an early currency move in view of the uncertain global outlook. Although the opening fixing was unchanged, the RMB appreciated to close at 6.80 per USD (+0.4%).**

- **Important details are still lacking, including the composition of the basket and timing of further moves. Pending this, we are maintaining our outlook of an appreciation of 4-5% against the USD by end-year. The eventual magnitude, which could well be less than our baseline, will depend on the authorities' assessment of the strength of the global economy, and evolution of currency cross rates.**

Announcement

- **The People's Bank of China (PBoC) announced over the weekend that it will proceed with reform of its currency framework to enhance RMB flexibility.** The announcement comes after almost two years of a de facto peg of the RMB to the USD, in effect since July 2008. A move to greater flexibility has long been sought by China's key trading partners, especially in the U.S., where protectionist sentiment has been building in Congress.

- **In its statement, the PBOC emphasized that it will make reference to a basket of China's main trading partners in setting the future course of the RMB.** This should in principle allow for greater two-way flexibility against the USD, although it is widely expected to result in appreciation given China's large BOP surplus.

- **Importantly, the PBOC clarified it will allow only gradual appreciation, rather than any step appreciation.**

Market Reaction

- **The move has come as a welcome surprise to the market, which until very recently had been discounting the likelihood of an early appreciation** given China's apparent reluctance and uncertainties to the global outlook (see Chart 1 on forward rates). Politics may have been a factor, with the announcement coming ahead of the G20 meeting in Toronto scheduled for June 26-27.

- **Today's opening fixing rate for the RMB was unchanged from the previous close.** However, during the day the spot rate moved toward the appreciated end of the +/-0.5% trading band, to close at 6.80, an appreciation of 0.4%.

- **Regional currency and stock markets soared on news of the announcement.** The Chinese stock market closed up by about 2.9%; the KRW, MYR, IDR, and AUD have seen the largest currency gains. The rally in currencies may well fade, given that any near-term RMB appreciation is likely to be modest.

Assessment and Outlook

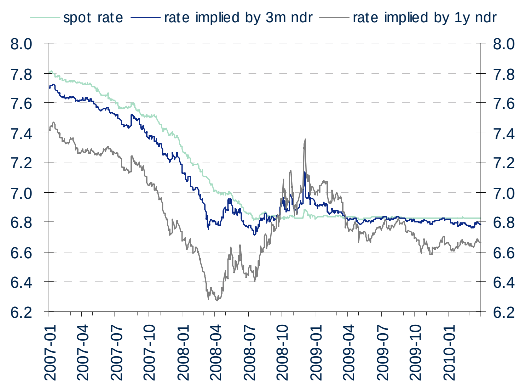
- **In some ways, the authorities' announcement is less clear in terms of the outlook for the exchange rate than the change adopted in July 2005**, when China implemented a "managed float with reference to a basket of currencies. In particular, the composition of the basket has not been announced nor, as was the case last time, have the weights or slope been disclosed. The timing of any formal changes also remains unclear.

- **The lack of clarity means that the authorities have room to move the exchange rate at the pace they consider appropriate**, and even in the direction they like, although we do not expect outright depreciation against the USD.

- **Under the announced framework, and given the conflicting forces that could affect the RMB – on the one hand, concerns about overheating and inflation would suggest that appreciation would be helpful, while spillovers from Europe would call for caution – we are maintaining our projection of 4-5% appreciation against the USD by end-year, until further clarification.** Markets appear to be generally anticipating some 2-3% appreciation over the coming year.

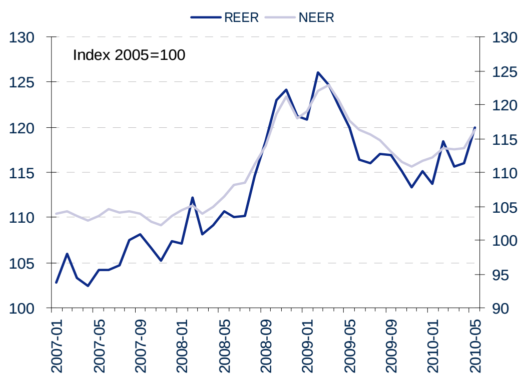
- **Among the factors influencing the magnitude of appreciation will be the authorities' assessment of the strength of the global outlook and cross-currency moves, especially of the USD-EUR**. Indeed, the recent depreciation of the EUR has resulted in some appreciation of China's effective exchange rate, by about 2.7% this year (Chart 2). Any further weakness of the EUR would likely mean less appreciation against the USD.

Chart 1
RMB Spot and NDF Rates



Source: CEIC

Chart 2
RMB Effective Exchange Rate



Source: CEIC and BIS

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