

# Market Focus – RMB exits from the peg

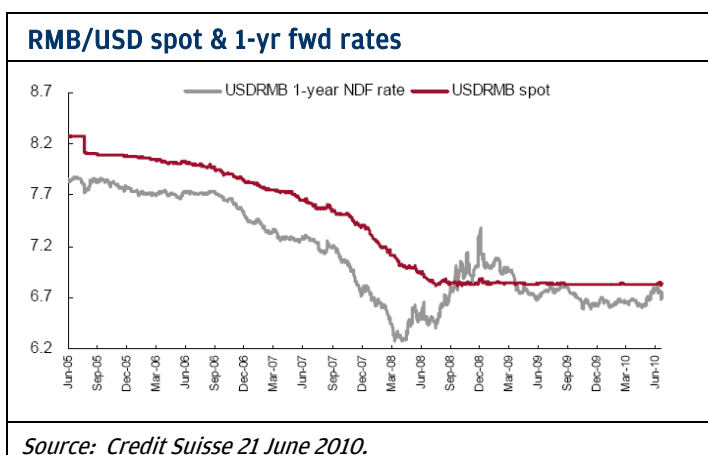
22 June 2010

## China recognises the need for greater RMB flexibility

- ◆ In our view, the announcement by the PBoC over the weekend that China is ready to move away from the RMB/USD peg after 23 months represents a shift in policy by Beijing, even if RMB appreciation in the early stage turns to be quite modest. In comparison with other global events and macro problems facing investors just now, the return of the RMB to a crawling-peg is likely to have a relatively muted economic impact.
- ◆ Unpegging the RMB has very little significance for the macro outlook for China (or, indeed, the rest of Asia) over the next 12 to 18 months. Undoubtedly, however, the RMB will continue to attract a lot of attention in the media, not least because we have reached a turning point that over the longer term could have far reaching consequences.
- ◆ Whilst the precise timing may have come as a bit of a surprise to investors, the Statement's content - implying a return to gradual appreciation for the RMB/USD rate - is something most China watchers had expected to occur around mid-year. The move was probably a 'done deal' following US Treasury Secretary Timothy Geithner's visit to Beijing in late May for the "Strategic and Economic Dialogue" bilateral meetings with Chinese leaders.
- ◆ The US came to realise that China was more likely to go ahead with (incremental) currency reforms in the absence of strong public pressure from Washington than it was under duress or threat of trade sanctions, as called for by the less economically liberal politicians in the west. The Obama Administration wisely refrained from megaphone diplomacy on the RMB and has been rewarded by a move by China in the desired direction.

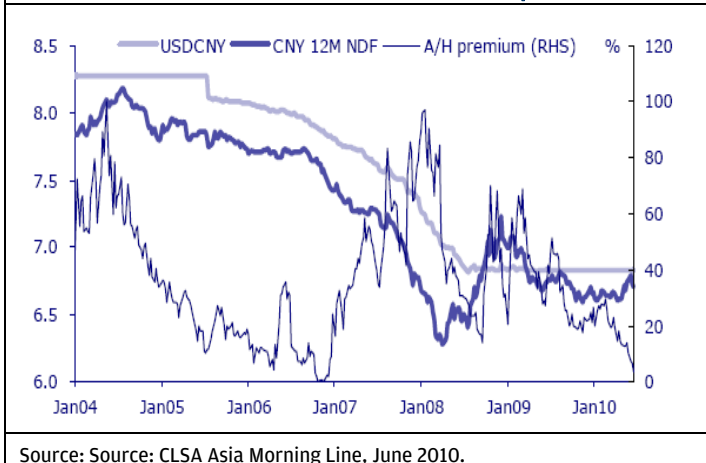
## Why make the announcement now?

- ◆ The announcement was not really a big surprise, but why now? Firstly, the move came ahead of the 26-27 June G20 summit in Toronto, and may defuse the mounting anti-China sentiment in the US Congress, at least through the November mid-term elections.
- ◆ Secondly, the Chinese economy has been recovering faster-than expected, with industrial production growth at 16.5% yoy in May and exports surprising to the upside again at 48.5% yoy so far, China has not been affected much by the Europe debt crisis.



*China's currency appreciation at the margin is likely to squeeze profits / margins at exporters, though the low share of domestic value-added implies a relatively low elasticity. Nevertheless, with Mainland unit labour costs no longer falling, we think Chinese exporters may this time try to be more aggressive in passing on higher costs to their customers overseas....*

## Renminbi/US dollar FX rate & A/H share premium



*Banks and insurance as proxies for RMB assets should gain, as will importers of resources, basic materials & industrial components. Airlines, airports, and other tourism-related sectors should also gain, as will Chinese companies with high foreign-denominated debt such as IPPs. The biggest potential negative impact will be to the earnings growth of export-driven processing industries and manufacturing companies.*

## What will be the impact on the economy and markets?

- ◆ The move may help improve market sentiment (which is clearly starting to recover from the May collapse). A gradual RMB appreciation will only have a modest impact on China's economy in the short to medium term, in our view. Coupled with rising wages, a stronger RMB should improve household incomes and at the margin accelerate the rebalancing of China's economic structure from an investment-driven growth model to an increasingly consumption-driven model.
- ◆ While deciding to allow greater RMB flexibility going forward, the PBoC Statement makes it clear that one should not expect any dramatic changes to the currency regime in the near-term. Thus, the RMB's daily floating bands will remain the same as before.
- ◆ The PBoC also stressed that with China's external trade having moved closer to balance (the current account surplus as a per cent of GDP, has been declining since the beginning of 2010), there is no basis for a large-scale step revaluation at this point. The PBoC announcement is likely to be seen by markets as positive.
- ◆ On one level it is a vote of confidence by the authorities in a sustained recovery for the Chinese economy. On another level, the PBoC Statement can be seen as more a gesture of goodwill towards America.
- ◆ The macroeconomic objectives set out in the final paragraph of the Statement\* will require, in our view, more than just a gradual appreciation in the RMB for their fulfillment.
- ◆ Turning to the market's reaction, the MSCI China Index over the past week or so has edged upwards along with the global markets, helped by improved risk appetite. It is likely to continue to gradually improve post the PBoC Statement on the RMB. What about our reaction? Will Saturday's policy announcement affect our China portfolios?
- ◆ The short answer is 'No.' A slightly more flexible currency regime coupled with a gradual rise in RMB vs the USD has long been subsumed within our China macro scenarios. Thus the announcement has no major implications for our China investment strategy.
- ◆ We continue to see good value and an improving risk/reward ratio for both banking and property stocks, expecting both to rally sharply once the concerns over "policy tightening" attenuate on signs of falling property prices and slower but stable macro growth.

\* "further enable the market to play a fundamental role in resource allocation, promote a more balanced BOP account, maintain the RMB exchange rate basically stable at an adaptive and equilibrium level, and achieve the macroeconomic and financial stability in China"

**Conclusions:** The PBoC announcement that the Renminbi exchange rate will exit from its peg against the US dollar and return to the pre-crisis approach of gradual appreciation, benchmarked against an undisclosed "basket" of currencies should not have come as a big surprise.

1. The announcement by the Chinese Government allowing the Renminbi to trade with greater flexibility in future will be welcomed by international investors as another small step in the China's open-door policy reforms.
2. The most likely result is that the RMB will be allowed to appreciate against the US dollar, but at a slow pace that will not satisfy China's critics, including those in Congress. It should, however, remove the RMB as a bone of contention between the US and Chinese governments, at least for the remainder of this year.
3. A move by the RMB will also allow scope for other Asian currencies, like the Singapore dollar, Malaysian ringgit and Korean won, to appreciate moderately against the USD and the Euro in coming months.
4. In the near term, positive sentiment about the Chinese currency announcement should reinforce the momentum of the current relief rally in the Asian stock markets. This has already seen the MSCI Far East (ex Japan) Index pick up by nearly 10% to 413.5 (Friday close) from its 2010-low of 394 reached on 25 May. Over roughly the same period, the Hang Seng Index has risen by 7% from a 2010-low of 18,972 on 27th May to 20,287 last Friday, while the H-Share Index of HK-listed China plays by 8% over a similar period.