

ECONOMICS: ASIAN PERSPECTIVES—AUGUST 20, 2010

RMB Volatility Sets Stage for Fresh Battles Between China and US, PBOC and Hot Money

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Our analysis of recent RMB volatility and the policy thinking behind it identifies two emerging risks linked to the currency—fresh trade friction (or worse) between the US and China, and complications for China’s monetary policy exit.

The Chinese renminbi (RMB) has weakened noticeably against the US dollar over the past week—a surprise to the market, given the conventional wisdom that China would have returned to a controlled currency appreciation policy after exiting the pseudo RMB/USD-peg regime at 8.28 on June 20. Investors wonder what lies behind this latest move by the People’s Bank of China (PBOC) and what its policy implications might be.

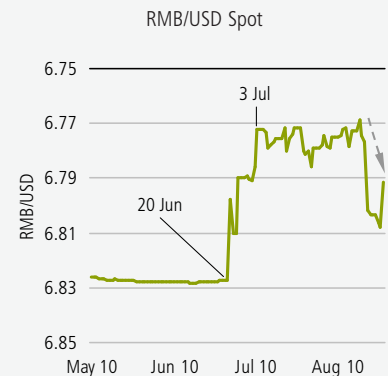
Display 1 shows that the initial pace of RMB/USD appreciation was surprisingly rapid between June 20 and July 3, amounting to a cumulative 0.8%. At that rate, the RMB would have appreciated by more than 10% against the greenback by the end of this year. China, of course, has never suggested it would commit to a straight-line appreciation, and RMB/USD remained stable at around 6.77 from July 3 until the noticeable depreciation began on August 12. The RMB rebounded again on August 18, appreciating 0.2% over the previous day.

The Need for Two-Way Currency Risk

The most plausible explanation of the volatility, in our view, is a greater willingness by the PBOC to inject more flexibility or two-way risk into the exchange rate. The motivation is likely to have been the recent release of China’s July foreign trade figures, which showed that the remarkable rebound of the external surplus since the March trough had continued. At close to US\$30 billion, the monthly trade surplus has returned to the pre-global crisis levels of early 2008 (**Displays 2–3, next page**). As the external surplus recovers, the chance of a sizeable RMB revaluation grows—as does the risk of a renewed inflow of hot money betting on such an outcome. One way to guard against this would be for the PBOC to put words into action by reintroducing greater trading volatility in the exchange rate. The battle, it seems, has started once again.

We have already flagged the risk of a marked resumption in China’s trade surplus (“China’s Next Leap Forward—Economic Rebalancing and Structural

Display 1
RMB Volatility Increases



Source: CEIC Data and AllianceBernstein estimates

Adjustments Part 2,” *Asian Perspectives*, July 9, 2010). There is no doubt that the external pressure for an RMB revaluation will increase in the coming quarter if there is no noticeable stabilization of, or decline in, China’s monthly trade surplus. The pressure will come not only from the US in the run-up to its mid-term elections but also from the next G20 summit and the second semiannual US-China Strategic and Economic Dialogue, all three of which take place in November. The perceived undervalued RMB and China’s role in contributing to global rebalancing are expected to be the hot agenda items at the two conferences. Given that Beijing announced its exit from the de facto USD peg in June, ahead of the last G20

summit, investors may wonder whether China will similarly time another significant currency move in the run-up to the November meeting.

From China's point of view, a continued gradual currency appreciation should be acceptable as long as it maintains current export strength—up 38% year on year in July. Recent economic developments have created a policy flip side to this, however, which is that the urgency for a strong RMB has faded in light of the continuous easing of China's underlying inflationary pressures. As shown in **Display 4**, both import inflation and producer prices have started to roll over a peak, while the input cost component in the country's Purchasing Managers' Index has already dropped from a high of more than 70 in April to close at the neutral 50 level in July.

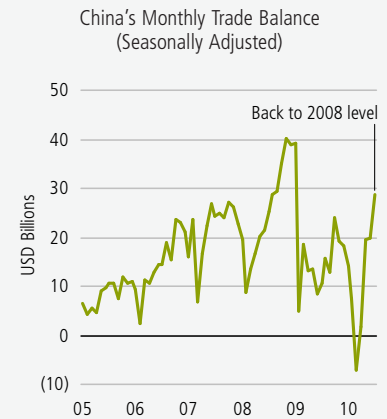
The Risks Ahead

We see risks on two fronts in respect of the RMB. First, the market expects external pressure to increase the chances of a more intense RMB appreciation before year-end. Notwithstanding the talk of an accelerated appreciation, however, the consensus

forecast for RMB/USD in the next three-to-six months is still around 6.60–6.70—a less-than-startling 2%–3% higher than current level. If this forecast accurately reflects Beijing's policy mindset, the US is hardly likely to be satisfied with such a modest appreciation, and the large expectation gap between China and the US on the currency issue will continue, once again sparking fears of trade friction if not trade war between the countries.

Second, the persistence of a sizable hot money inflow (an average US\$30 billion – US\$40 billion a month) in 2007 and early 2008 was a major headache for China's monetary management. In an uphill battle to rein in excess liquidity, the PBOC conducted severe sterilization measures, including raising banks' reserves requirement ratio by a cumulative 800 basis points within a year. If such measures are once again implemented in response to market expectations for RMB revaluation reverting to extremes, China's monetary policy exit—on which the PBOC has done a pretty good job so far—will become complicated. ■

Display 2
Trade Surplus Resumes...



Source: CEIC Data and AllianceBernstein estimates

Display 3
...as Imports Slow Relative to Exports



Source: CEIC Data and AllianceBernstein estimates

Display 4
Underlying Pressure Eases



Source: CEIC Data and AllianceBernstein estimates

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