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Cracking the Code of China's New Currency Regime

Three weeks after China announced a 2.1% appreciation of the renminbi (RMB) against the US dollar to 8.11 and a regime shift to a floating foreign exchange arrangement, the People's Bank of China (PBOC) supposedly has revealed clues about the composition of the reference currency basket against which the RMB is currently managed. PBOC Governor Zhou Xiaochuan indicated last week that the currency basket is taken from China's 11 top foreign trade partners. Since the regime change, however, the RMB has moved more in concert with a US dollar-pegged regime than it would under a truly trade-weighted regime.

By and large, the central bank's announcement confirmed market expectations, with the only surprise being that neither the Hong Kong nor Taiwanese dollar were mentioned, even though both are key trading partners with mainland China. We think the Hong Kong dollar may be used as a part of the US dollar bloc because of the city's long-established currency board system. The exclusion of the Taiwanese dollar seems politically motivated, in our view.

In **Display 1** we calculate the likely weights of the RMB's currency basket, based on total export and import shares of China's 11 top trading partners. The outcome of this simple calculation (presented in column 3) should meet with a raised eyebrow, however, as it puts the US dollar weight at a little under 20%. We believe the actual US dollar weight may be much larger. For one, use of the greenback in China's foreign trade (i.e., export invoicing) is reportedly close to 80% or 90%. Moreover, with the exception of Singapore and Hong Kong dollars, the other Asian currencies in the basket—Malaysian ringgit (MYR), Korean won (KRW) and Thai baht (THB)—are in fact not fully convertible, which should limit their importance in any currency basket arrangement. By the same token, the Russian ruble is also a relatively illiquid currency in foreign exchange transactions. If we lump the Asian currencies and Russian ruble into a US dollar bloc, the estimated share of US dollars in the basket rises to 54% (column 4), more in line with our theoretical perception of the new regime.

Nominal Effective Exchange Rate…

To better compare RMB movement against probable currency baskets, we calculated a nominal effective exchange rate (NEER) consisting of China's global trade weights in one model and our own weights in another. We estimate that the RMB's NEER was on a depreciating trend from early 2003 to the end of 2004 before appreciating again early this year on the back of a firmer US dollar (**Display 2**).

If we take one step further, adding a comparison of actual RMB movement over the past three weeks of trading with the implied movements of our NEER model baskets, it would appear that the PBOC has hardly moved away from a straight US dollar peg. For instance, if the central bank had followed the currency basket weighted by Alliance Capital, the RMB would have appreciated to 8.023 against the US dollar on July 28 before depreciating to 8.129 on August 12. In reality, the spot rate has been moving more in line with a basket containing a US dollar weight of 90% than a true multiple-currency regime (**Display 3**).

…Implies the PBOC Is in No Hurry

Given these results, it is probably safe to conjecture that it will take time for China's exchange-rate policy to release its US dollar peg. We suspect that over the next year or so, policymakers will manage the exchange rate with only a loose reference to their new currency basket.

In the long run, China's learning process should also include setting a more defined framework for future monetary policy. We view this as essential because a country with a market-oriented economy can only control two of the so-called "holy trinity" of economic forces (i.e., free external capital flow, a controlled currency and an independent interest-rate policy). Given its increasingly open capital account, China may choose (as the US has) to achieve interest-rate autonomy by allowing the market to determine its currency. Alternatively, China may decide to follow Singapore's policy framework of an open capital account but without an independent interest-rate policy, in order to achieve a controlled currency regime with a built-in appreciation bias to raise the value-added of domestic production.

Whither the RMB?

At this point, the consensus expectation is that the RMB will move on a steady path of appreciation, somewhat resembling the experience of the Singapore dollar over the past four years. We agree that this is likely to be the case over the next six to 12 months, though it is uncertain whether China will adopt the Singapore model in the long run. In our opinion, to effectively control its credit and investment cycles China needs more of a self-determined interest-rate/credit policy than the purely export-driven Singaporean economy does. At any rate, these policy conflicts will eventually emerge, and policymakers will need a more formal policy target as the economy becomes increasingly market-driven.

Bottom-line, considering the PBOC's slow departure from its US dollar peg, a theoretical currency basket will provide little help in forecasting the RMB/US$ exchange rate for the near future. A NEER model, on the other hand, could help to gauge the central bank's overall currency stance, especially as China inches toward a true floating currency basket. Indeed, by gauging the potential pressure on the RMB, the NEER might help to assess the level of adjustment the central bank is willing to take.

Display 4 shows outcomes for the RMB/US$ rate under varying assumptions of the PBOC's desired NEER appreciation, using our six-month currency forecasts for euro, yen, Australian dollar, Canadian dollar, and British pound sterling in an Alliance-weighted basket. Our simulation suggests that the RMB/US$ will depreciate to 8.17 if the central bank wants to keep a flat NEER from the current level while the exchange rate would appreciate to 7.78 and 7.43 under NEER appreciations of 5% and 10%, respectively. Our central scenario, which assumes a modest 4% appreciation of the effective exchange rate in six months' time, implies a RMB/US$ rate of 7.85.

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Display 1: Cracking the Code of the New RMB Regime

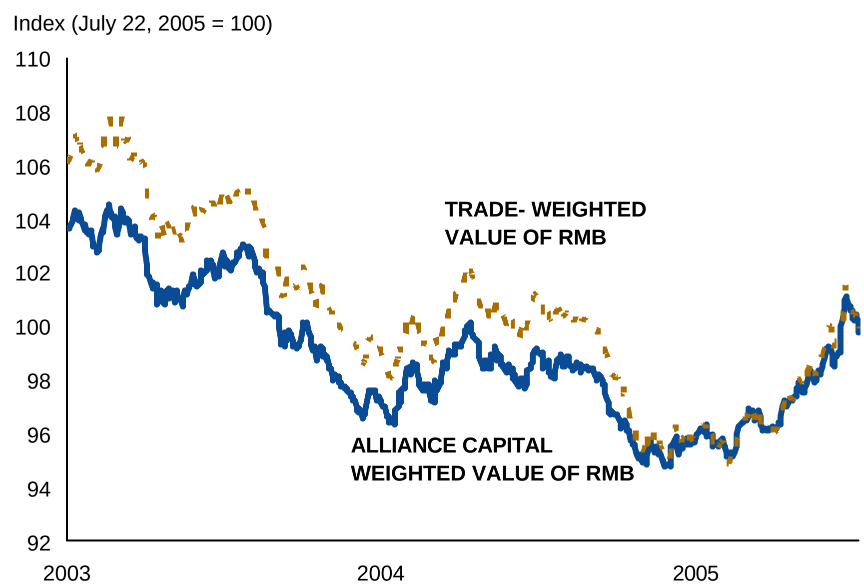
Trade-Weighted vs. Alliance-Weighted RMB Currency Basket

China's 11 Top Trading Partners	Currency	PBOC Implied Trade-Weighted Share*	Alliance Capital Weighted Share Assumptions
EU	EUR	20.5%	20.5%
US	US$	19.6	53.9**
Japan	PY	19.0	19.0
Hong Kong	HK$	12.4	US$ share
Korea	**KRW**	**11.0**	**US$ share**
Singapore	SG$	3.2	US$ share
Malaysia	**MYR**	**3.0**	**US$ share**
Russia	**RUB**	**2.6**	**US$ share**
Australia	AU$	2.5	2.5
United Kingdom	GBP	2.3	2.3
Thailand	**THB**	**2.1**	**US$ share**
Canada	CA$	1.8	1.8
		100.0%	100.0%

Note: Currencies in bold are not fully convertible.
**Average trade weights of first-half 2005 and full-year 2004*
***Sum of US$, HK$, KRW, SGD, MYR, RUB and THB*
Source: CEIC Data and Alliance Capital Fixed Income Calculations. August 16, 2005

Display 2: Assessing the RMB Trend Using Sample Currency Baskets

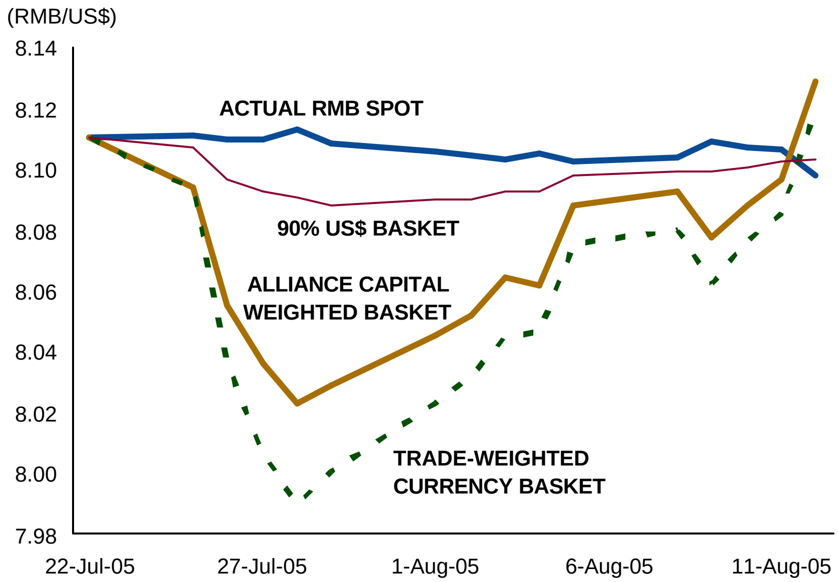
RMB Nominal Effective Exchange Rates (NEERs)



Weights consist of China's 11 top trading partners.
Source: CEIC Data, Bloomberg and Alliance Capital Fixed Income calculations. August 16, 2005

Display 3: RMB Still Acts Like a US Dollar-Pegged Currency

Actual RMB Spot vs. Implied Movements of Sample Baskets



Weights consist of China's 11 top trading partners.

Source: CEIC Data, Bloomberg and Alliance Capital Fixed Income calculations. August 16, 2005

Display 4: Using a NEER Model to Guage the Central Bank's Currency Stance

Exchange Rates Under Different Appreciation Scenarios for the Nominal Effective Exchange Rate

			Central Scenario		
NEER Appreciation	**0.00%**	**2.00%**	**4.00%**	**5.00%**	**10.00%**
RMB/US$	8.17	8.01	7.85	7.78%	7.43

Source: CEIC Data, Bloomberg and Alliance Capital Fixed Income Calculations and Forecasts. August 16, 2005

Alliance Exchange-Rate Forecast Assumptions (vs. US Dollar)

	Aug 22, 2005	6-Month Forecast
EUR	1.25	1.20
JPY	109.64	110.00
CA$	1.20	1.15
AU$	0.77	0.76
GBP	1.81	1.76