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After Renminbi Revaluation, What's Next?

Policymaking in China has taken a giant leap forward. On Thursday, China announced a one-off 2.1% appreciation of the renminbi (RMB) against the US dollar to RMB8.11 versus US$1.00, and also a regime shift to a managed float system with reference to a basket of currencies. While the modest adjustment certainly will not satisfy the US administration, it is China's best effort so far to accommodate world economic development.

The extent of the initial currency appreciation and shift to a currency basket arrangement were in line with our forecast, but the timing was a few months earlier than we had anticipated. In hindsight, policymakers must have viewed recent US dollar strength to be the most appropriate time to make the currency move.

The daily trading band of the new regime has not changed, at +/– 0.3%. We expect the band will widen over time, probably not exceeding 2% to 3% during the next few years, as the ultimate objective of currency flexibility is to reinstall a higher degree of monetary flexibility with a gradually opening capital account.

Certainly, the immediate market response to the RMB adjustment is only the first step in long-term appreciation of the currency. We see risk of accelerated speculative inflows in the near term in anticipation of further upward adjustments. In practice, the central bank can make use of its narrow trading band (which allows a maximum of 0.3% appreciation per day) to manage the currency appreciation at its own steady pace. When the bank did this back in the period from 1994 through 1996, the RMB ended up 4.5% stronger against the US dollar.

Having said that, potential RMB appreciation probably will never satisfy the financial markets, at most appreciating by another 5% against the US dollar in the next 12 months. Yet abandoning the peg to the US dollar should increase China's power to fend off foreign demand for a bolder, one-step currency revaluation. With a working-age population of 65 million joining the labor force over the next ten years, probably the last thing Beijing wants to see is a strong RMB, which would sabotage the country's labor-intensive manufacturing production. Moreover, higher currency-induced imports of foreign agricultural products would send a shock to its agricultural sector (China's rural populace makes up 60% of the entire population).

The composition of the currency basket will not be published, and we suspect the structure is less complicated than that of the Singapore dollar—without the extra element of "third country competitiveness" to determine overall currency competitiveness. Our guess is that the basket is approximately 40% US dollar, 20% euro, 15% yen and 5% to 10% Hong Kong dollar with the remaining 15% to 20% being some combination of Korean won, Australian dollar and British pound sterling. Consequently, it is largely a US dollar-centric basket, but a sharp fall in the euro or yen against the US dollar would cause a weaker RMB against the US dollar (assuming no central bank intervention).

Implications for Forex Intervention and Reserves Management

Importantly, we do not believe the regime shift will necessarily create US dollar weakness. At the margin, there certainly will be less US dollar buying as the central bank can now intervene through other key foreign currencies in the basket. But we should not overstate the odds of a marked decline of foreign exchange intervention by China just because the RMB is now allowed to float.

Moreover, we think the general perception of a strong link between the composition of China's international reserves and the structure of the RMB currency basket may be misplaced. After all, in Singapore, the country's foreign exchange reserves remain denominated in US dollars although it has used a basket of currencies regime for years. And

China will not need to sell down its existing holdings of US dollar assets in the reserves portfolio, but can merely purchase fewer US dollar assets in every new accumulation of reserves. We reckon China has been doing just this over the past two years, with US Treasury purchases accounting for only 30% to 40% of net reserves accumulation. In fact, we believe that the share of US dollar assets in China's total reserves portfolio has dropped to around 50% to 60% (in contrast to 80%-plus five years ago) with respective shares of euro and yen at around 20% and 15%. As such, China's currency regime shift per se may only have a marginal impact on US Treasuries.

Currency Outlook

We do expect the move to trigger further appreciation of Asia's strong current-account currencies, however. The announcement by the Malaysian central bank to change to a floating exchange rate (also with reference to a currency basket) immediately followed yesterday's RMB adjustment and will certainly reinforce the upward pressure on most Asian currencies.

We continue to favor the Malaysian ringgit, Korean won, Taiwanese dollar and Singapore dollar in the next three to six months (**Display**).

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Display: Asia Currency Forecasts

Six-Month Projections

Currency	Spot Rate (July 22, 2005)	6-Month Forecast	Projected Gain / Loss (Annualized)	6-Month Forward Rate
RMB/US$	8.110	7.850	6.6%	7.82
KRW/US$	1,035.000	990.000	9.1%	1,014.90
TWD/US$	31.940	30.500	9.4%	31.09
SGD/US$	1.651	1.630	2.6%	1.64
MYR/US$	3.800	3.600	11.1%	3.75
THB/US$	41.270	39.500	9.0%	41.30
PHP/US$	55.720	57.000	(4.5)%	56.42
IDR/US$	9,775.000	9,700.000	1.5%	9,786.00

Source: Bloomberg and Alliance Capital Fixed Income forecasts; July 22, 2005