

Chinese currency changes... more politics than economics

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US officials have for sometime complained that the Chinese exchange rate is artificially held at low levels and have, at recent times, gone as far as to name China as a currency manipulator. To be fair to the Americans, this is true - the renminbi on most valuation methods is far too cheap versus the dollar - which ultimately costs quite a lot of Americans their manufacturing jobs. So the recent announcement by the People's Bank of China (PBoC) that they are going to reform and allow more flexibility of the exchange rate may be taken as welcome news to some... or at least seen as a step in the right direction.



The Chinese will resume their official daily trading limit to plus or minus half of one percentage point to the US dollar, thus no large scale strengthening of the renminbi to the US dollar, which was imagined by some. This does allow some flexibility; two-way volatility to the US dollar. This is all very good, but one large question people must be asking themselves is: at what pace will the renminbi 'actually' appreciate in the new regime? Certainly the market currently does not think that this will be too fast. Even after the announcement, the market has only priced in around 2.5% appreciation over the next 12 months, less than there was before the sovereign solvency problems in Europe over the last few months. Speaking of which, the renminbi has appreciated at a 30% annualised rate against the European currency, simply due to the decline of the Euro against the US dollar. The Chinese will, of course, have this in mind and will surely want to resist much further appreciation. We believe that the renminbi may be allowed to appreciate at a 4% annualised rate for the rest of the year, and perhaps increase to a pace of between 4-6% per year thereafter.

So from a macro-economic standpoint, what does a modest appreciation of the currency to the US dollar mean for China? According to Deutsche Bank's Computer General Equilibrium (CGE) model, a 10% appreciation will: (i) reduce real GDP by 0.6%; (ii) increase unemployment by 0.4% and reduce real exports by 2.5%; and (iii) increase real imports by 1.0%. All of which are manageable given China's strong GDP growth, labour shortage and strong export growth (forecast 20-30% growth yoy).

Deutsche Bank's model drills even deeper. From an industrial sector view, a 10% appreciation will reduce revenue of shipping, electronic components, chemical products and computers, and reduce volume exports of apparel by around 4%. Electric machinery exports are predicted to fall by 2.2% and electronic components exports by 1.4%, however, it is predicted to boost imports of sugar by 6.7% and coal by 2.7%. There is little effect on crude oil, iron ore and non-ferrous metals.

So overall we believe the impact on the Chinese equity market is modestly positive. The airline industry is by far the most obvious beneficiary, as are manufacturers relying on cheaper imported commodities such as steel and paper. On the other hand, the currency appreciation will likely pose further downward pressure on low end and narrow margined exporters, such as the apparel and textile industries. The economic impact is therefore balanced. However, more importantly, the change in currency regime removes the considerable risk of a Sino-US trade war, improving political relations and, with that, improved overall market sentiment, albeit modest, which should be positive for risky assets such as equity.