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China Flash

Wider trading band unlikely to change RMB appreciation trend

The People's Bank of China (PBoC) announced the widening of the daily trading band last Saturday. The band of the RMB against the USD is expanded to +/- 1.0% (around the daily opening fixing rate) from +/- 0.5%, effective from today (April 16). In addition, the PBoC also raised the bid-ask spread for USD offered by the foreign exchange-designated banks to their customers from the current level of 1% to 2%. According to the PBoC's statement, the relaxation of the RMB trading band is an important effort that will "facilitate price discovery and enhance the flexibility of the RMB exchange rate." We expect that widening the RMB daily trading band will help deter "hot money" inflows because it will introduce higher volatility; however, we do not expect that it will change the RMB's long-term trend of appreciation. In this regard, we maintain our projection that the RMB will appreciate by 2- 3% by the end of this year.

- **China currently adopts a "managed float with reference to a basket of currencies,"** under which the PBoC sets a daily opening fixing rate of the RMB against the USD and then allows the spot exchange rate of RMB/USD in the interbank market to fluctuate within the daily trade band (+/-1% henceforth). The fixing rate is presumably set with reference to a basket of currencies. However, the composition of the currency basket has never been revealed.
- **Widening the daily trading band of the RMB is a long-awaited move,** given that calls for increasing the flexibility in the RMB exchange rate have been increasing steadily after China's quick recovery from the global financial crisis. Nevertheless, the PBoC has maintained the daily trade band of +/-0.5% for almost four years, after it was widened from +/-0.3% on May 21, 2007. It is noteworthy that during the entire period that the +/-0.5% trade band was in effect, the intraday high/low of RMB/USD rarely hit its upper/lower bounds (only hitting the upper bound 19 times, with the lower bound hit zero times).
- **The move was in line with the market's expectation**, as China has frequently emphasized that it will continue to improve rules concerning the RMB exchange rate under the backdrop of further financial reforms (see: RMB internationalization, the opening up of the capital account, interest rate liberalization, etc.). In our view, there are three key takeaways from the decision:
  - First, a wider band, which allows more flexibility in the RMB exchange rate, is an important step toward a fully convertible exchange rate system, without which the opening up of the capital account may lead to distortions in China's financial system.
  - Second, the recent appreciation in effective terms, coupled with other rebalancing measures such as promoting imports, has already helped to narrow the current account surplus down to around 3% of GDP this year.
  - Lastly, the US treasury just postponed its biannual currency report on trading partners (including China) until after the IMF and World Bank's Spring Meetings in late April. The timing of widening the RMB trade band, therefore, will help to alleviate political pressures from abroad.
- **The new trading band will not change our forecast for RMB appreciation.** Given the RMB's history of only hitting the upper and lower bounds of its trading band on rare occasions, this implies that the RMB level is mainly determined by the PBoC's fixing rate. We see the RMB appreciating slightly by 2-3% in 2012, as the RMB has neared its equilibrium, and its exchange rate eventually becomes more determined by a basket of currencies.

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