

Will the RMB remain a tightly controlled currency?

The Chinese Yuan Renminbi (RMB) is allowed to appreciate by 0.3% per day against the US dollar, and with inflation rising sharply, the Chinese authorities may use this flexibility further, writes James Stretton

For some time, property investors in China have been faced with a rare hedging opportunity. The Chinese Yuan Renminbi (RMB) is a controlled currency which, since the revaluation in July 2005, has been allowed to appreciate by no more than 0.3% per day against the US dollar. As the chart below shows, the Chinese authorities at first allowed the RMB to appreciate only very slowly, which drew ineffective protests from the Americans.

The view in the foreign exchange market, however, was that the undervalued RMB would exacerbate China's then nascent problem of rising inflation and that the authorities would be forced to allow the RMB to appreciate more quickly.

In the case of a fully convertible currency, this view would have been expressed immediately in the spot market. However, since the RMB is a controlled currency, the probability of RMB appreciation was instead expressed in the uncontrolled, offshore non-deliverable forward (NDF) market.

The premium at which the RMB trades against sterling in the one-year NDF, for example, is 9.19%. Given that the 12-month sterling interest rate is 6.04%, this implies a 12-month CNY interest rate through the NDF of -3.15%!

This unusual situation offers investors the opportunity to borrow in sterling, invest in China and then lock into a forward £/RMB exchange rate by selling RMB against sterling in the NDF market. The extent to which the RMB trades at a premium in the NDF market can be looked at in two ways: either as the market paying the investor to hedge against a depreciation of the RMB, or as the investor effectively borrowing RMB at a negative interest rate.

The People's Bank of China has, over the last year, become increasingly concerned about China's rising inflation rate, now 8.5%, and, in particular, the rate of food inflation, now 22.1%. As anticipated by the market, this has led to an increase in the rate at which the RMB has been allowed to

appreciate. This was particularly evident last Christmas and very recently, as the graph shows.

The recent sharp appreciation in the RMB during the week beginning 19 May 2008 coincided with sharp spikes in the price of oil and, probably more significantly, rice. The Chinese authorities are particularly sensitive to food price inflation and like most commodities, rice is priced in US dollars. The recent move in the price of the benchmark Thai White Rice to above \$1,000 per tonne, combined with the move in the oil price from \$127 to \$135 in the space of a week, will doubtless have unnerved the Chinese authorities.

The People's Bank declared last year that it would use currency appreciation as one of its tools against inflationary pressures and this now looks to have been no idle threat.

The recent, more rapid appreciation of the RMB has had the effect of narrowing the difference between the spot and NDF markets but the RMB still trades at a healthy premium, allowing investors to lock into a given rate of RMB appreciation.

Of course, property investors could instead merely remain unhedged on the

basis that further RMB appreciation is inevitable. Foreign exchange markets are, however, notoriously difficult to predict and an unhedged policy is one for the very bold.

Rational response

The People's Bank's willingness to see the RMB appreciate is a rational response to a situation that is worryingly close to global inflation. It remains to be seen whether the recent action by the Federal Reserve Bank of New York in bringing rates down to 2% was appropriate or not against the difficult background of a banking crisis accompanied by a global commodity boom.

Particularly striking, however, are the similarities between the current situation and that immediately following the 1973-74 Arab oil embargo. Then, faced with a choice of controlling inflation or safeguarding growth, western governments chose a loose monetary policy to achieve the latter, with the result that inflation got out of control. It took some very bitter-tasting medicine in the 1980s to bring inflation down.

If the period following 1973-74 was difficult in the West, however, we should not forget that in the East, where there was widespread famine, it was unimaginably worse. The Chinese authorities will therefore be prepared to continue to use currency appreciation to control inflation.

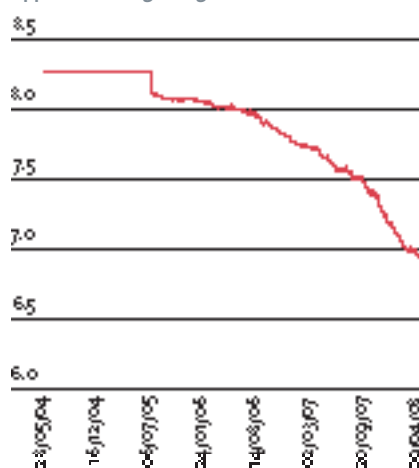
If global inflation continues to rise, the Americans, who have goaded the Chinese for years about the undervalued RMB, may be closer than they think to getting what they have wished for in the form of a very much stronger RMB.

On the other hand, if rising commodity prices lead to a global slowdown, the rate of CNY appreciation would doubtless decelerate or even go into reverse, meaning that property investors who took advantage now of the RMB NDF market would be sitting pretty.

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RMB appreciation 2004-2008

Appreciation is gaining momentum



Source: JCRA