Impact of China’s Revaluation

How Australian importers will be affected

* What are the details of the Revaluation? The People’s Bank of China has abandoned its 10-year-old peg against the USD at a rate of around USD8.28/CNY, and now manage the currency’s value against an unpublished basket of foreign currencies. The yuan will fluctuate within a band of +/-0.3% on either side of a midpoint. The midpoint was initially established at USD8.11/CNY, a 2.1% revaluation (strengthening) from the previous peg. The central parity is established by the end of day closing price of the yuan, so potentially the yuan can fluctuate by 0.3% per day against the previous day’s USD closing level, and by 1.5% per day against the other currencies in the basket. However, in practice the yuan has fluctuated much less than this since the announcement.

* Why did they do it? Political and economic pressure had been building for some time. On the political side, governments have pressured the Chinese to liberalise their FX regime and increase its responsiveness to market forces. Economically, expectations of a future revaluation were attracting high levels of capital inflows, which were leading to excessive investment. This has brought about a “bubble” in certain economic sectors that leaves China vulnerable to deflation, which has been present at times over the last 20 years. Unlike the RBA in Australia, the PBOC does not have a monetary policy rate that it can change. The Chinese are hoping that this small revaluation and additional measures to discourage capital inflows will deflate the “bubble” and ward off deflation.

* How does the revaluation work? If the Chinese were to make this process totally transparent, then they would have published the currencies included in the basket as well as the weights, which would have allowed an analysis of how the yuan is being managed against the basket on a daily basis. However, this information has not been published (this is a similar situation to the MAS in Singapore, who also have a basket approach, but do not publish the weightings). In practice, what this means is that the markets will over time try to understand what the currencies and their weights are (eg weighted according to trade relationships) while continuing to express the yuan in its value against the US$. The PBOC appears to be defending the USD peg level (8.11) already, however markets will be left to simply observe whether they also intervene to buy or sell the other foreign currencies in the basket, if they move more than 1.5% on a daily basis.

* The practical effect. A 2.1% revaluation is small; the yuan has moved against currencies other than the US$ more than 2.1% on a daily basis in the recent past. No economic impact is expected from such a small shift, but the additional measures to reduce capital inflows may slow investment and therefore eventually slow growth from its incredible 9.5% current pace of expansion. The PBOC have said that they do not see this 2.1% revaluation as an initial step in a series of revaluations. There has been considerable market speculation as to the future path of the currency, but our expectation is for the PBOC to continue to make small adjustments. We are forecasting an end-2005 rate of USD8.03/CNY and an end-2006 rate of USD7.8/CNY, or a total revaluation of 6% by the end of 2006.

* Impact on AUD/USD. Negligible, or negative, depending on what the PBOC do in the next 12-18 months. The potential inclusion of the AUD in the PBOC currency basket has likely already been factored in by the central bank and will not result in large inflows into AUD denominated assets. There is the probability of reduced commodity demand from Australia if the economy slows further than our expectations of 9% GDP growth this year and 8.2% next year. A larger revaluation would slow growth and therefore commodity demand even further, as would a “bubble burst” as a long-term outcome of no further PBOC revaluation. Therefore, we struggle to see the positive for the AUD here. If anything, it may make our exports cheaper for Chinese firms dealing in Yuan, but marginally.

* Impact on USD imports from China. There should be limited effect on import prices, if contracts are USD denominated, rather than yuan denominated. Note, USD prices will likely have not altered with this move (unless the Chinese are passing the 2% straight through), just Yuan based prices. That should be borne by the Chinese producers (in lower margin) than by clients, especially if they wish to remain price competitive. However, that does not mean that Chinese exporters may not attempt to opportunistically raise prices to boost margins, as anecdotaly has been reported already. Whether they are able to do so or not will be a supplier based issue, rather than a pure exchange rate issue. However those Australian importers with explicit yuan based price levels may have to bear the small % price rise though. For Australian exporters who export in USD’s, their price levels will be unchanged, although if Chinese firms are Yuan based, then export prices will fall in their eyes.

* Market expectations for future revaluation. Some investment banks forecast another 10% revaluation in the next 12-18 mths. We disagree with this view as we believe it is inconsistent with the Government’s gradual approach to reform. NDF markets factor in 6% over the next 12 mths. Our forecast is for a further 1% revaluation this year, and a further 3% next year, as above.