

## China: RMB And The Upcoming Annual US-China Dialogue

- The RMB exchange rate is likely to come into focus at the upcoming annual strategic dialogue, as our analysis of past meetings shows varied responses from the central parity as well as onshore and offshore trading of the RMB.
- Beyond its near-term weakness, we remain positive for the RMB especially with the acceleration of RMB internationalization process.
- For 2014, despite our expectation of recovery from current levels the RMB could still see first annual decline since 2009, though we expect the currency to hover near the 6 handle by end-2015.

### RMB In Focus

The RMB will once again come into the spotlight as the annual China-US Strategic Economic Dialogue (S&ED) gets underway this week, on 9-10 July 2014 in Beijing.

US Secretary of State John Kerry and Treasury Secretary Jack Lew will lead the US delegation to the sixth annual meeting, to be joined by their Chinese co-chairs, State Councilor Yang Jiechi and Vice Premier Wang Yang.

The talks come against the backdrop of a slew of contentious issues between the two major powers, including intellectual property rights, maritime territorial claims, and China's valuation of its currency, the RMB, as well as cyber security, among other concerns.

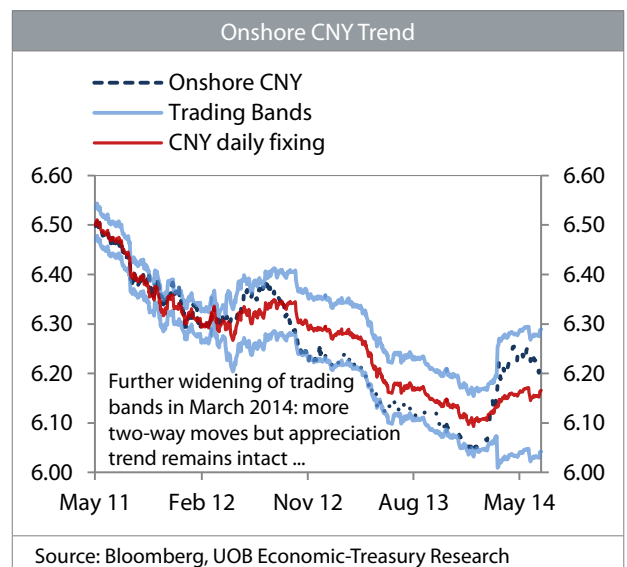
One perennial issue is the value of the RMB exchange rate. Prior to the meetings, US Treasury Secretary Jack Lew had said last Tuesday (1 July) that the RMB value was a "very big issue" for the US and that the currency needed to appreciate more. As such, there is no doubt that the foreign exchange rate will be a key topic especially after the RMB has depreciated by about 2.4% in the first half of 2014, in contrast to its almost uninterrupted appreciation trend between 2005-2013.

### How Did The RMB Perform Around The Annual Dialogue?

Here we summarize the impact of prior editions of the S&ED (and the previous version called SED) on the movements of the USD/CNY fixings, onshore and offshore values of the RMB, five days prior and five days after the event.

As shown in the table on the next page, our analysis suggests that there have been a discerning impact on the RMB during past events, especially on the daily fixing, and generally weaker spot RMB exchange rates against the USD around the these events in recent years.

For example, in 2013, the fixing has been set firmer an average of 0.2% during the 5 days prior to the event, and weakened 0.12% on average in the five days following the end of the dialogue. For the onshore and offshore spot trading however,



<b>The Evolution of USD/RMB with US-China Strategic and Economic Dialogue* Meetings</b>						
% of RMB gain (+) or loss (-) vs. USD**	Fixings		Onshore spot (CNY)		Offshore spot (CNH)	
	% Change before event	% Change after event	% Change before event	% Change after event	% Change before event	% Change after event
First meeting: 14-15 Dec 2006 (Beijing)	0.14	-0.05	0.12	0.12	-	-
Second meeting: 22-23 May 2007 (Washington, DC)	0.33	0.03	0.26	-0.01	-	-
Third meeting: 12-13 Dec 2007 (Beijing)	0.49	-0.17	0.30	-0.06	-	-
Fourth meeting: 17-18 Jun 2008 (Annapolis, MD)	0.25	0.12	0.26	0.13	-	-
Fifth meeting: 4-5 Dec 2008 (Beijing)	-0.10	0.01	-0.06	0.01	-	-
First S&ED: 27-28 Jul 2009 (Washington, DC)	-0.00	-0.01	-0.00	-0.01	-	-
Second S&ED: 24-25 May 2010 (Beijing)	-0.00	-0.00	-0.01	0.02	-	-
Third S&ED: 9-10 May 2011 (Washington, DC)	0.03	-0.13	-0.01	-0.14	-0.17	-0.18
Fourth S&ED: 3-4 May 2012 (Beijing)	0.23	-0.26	-0.16	-0.26	-0.03	-0.09
Fifth S&ED: 10-11 July 2013 (Washington, DC)	0.20	-0.12	-0.06	-0.08	-0.03	-0.05
*Note: The Dialogue was originally created on 20 Sep 2006 by then US Pres George W. Bush and China's President Hu Jintao, called "Strategic Economic Dialogue" to be held semiannually. Subsequently, it was changed to "Strategic and Economic Dialogue" on 1 Apr 2009 by US Pres Barack Obama and China's President Hu Jintao, to be held annually.						
** Average value of RMB 5 days prior to the first day of the Dialogue, and average value of RMB 5 days after the conclusion of the event.						
Source: Bloomberg; US Dept of Treasury; UOB Economic-Treasury Research Estimate						

the impact has been a visible weakening of the RMB before and after the event, notably since 2011.

During earlier years of the dialogue, the fixing and the onshore RMB had generally strengthened against the USD just before the annual dialogue. The effect seemed to have diluted in recent years, possibly due to China's point of view that the RMB exchange rate has largely reached "fair value".

Nevertheless, given the last two S&ED (2012 and 2013) and earlier meetings, it is possible that a similar pattern of firming and then weakening of the RMB fixing could emerge around the next meeting on 9-10 July.

### **What Did The 2013 S&ED Say On Exchange Rate?**

As a recap, in the 2013 edition of the S&ED, RMB exchange rate played a prominent role in the discussions, and with a 146-word paragraph (titled simply as "Exchange Rate Liberalization") in the post-meeting Fact Sheet released by the US Treasury Department, the second largest after the 147-word paragraph on the discussions about development of a Bilateral Investment Treaty (BIT) which was the first item in the document. The third largest section in the Fact Sheet was on the expanding opportunities for US financial service providers in China, with 136 words, in a 1540-word document. This suggests that exchange rate remains a key concern to the US side, and recent comments from US Treasury means that the topic could once again occupy the headlines.

Since the 2013 S&ED, the RMB exchange rate has gone through some shifts. First off, the upward appreciation trend has essentially been broken, resulting in a depreciation of 2.4% in the first half of 2014, the worst performing currency in Asia against the USD. Second, the daily trading band widened in March 2014, doubling to 2% from 1%. Thirdly, various officials have indicated a preference for two-way moves of the currency. Meanwhile, RMB internationalization process has accelerated significantly.

## Where To Next For The RMB?

Near term, we think that the weakness for the currency in the first half is essentially over, as the move was likely to have been engineered by the PBoC to shake off the one-way appreciation bet on the currency, which has taken root since the depeg in 2005. Beyond the near term weakness, we continue to stay positive on the RMB over the mid to long term horizon, due to the following positive drivers:

- China's fundamentals are sound despite concerns about shadow banking, property market, and constant worries about an economic hard landing, given the availability of fiscal and monetary policy tools to contain any potentially severe fallout. Recent selective/targeted loosening measures from PBoC show that the authorities are likely to be aware of the risks of a severe downturn.
- As China continues to develop, it requires a strong currency to keep costs of imports of strategic commodities and materials at reasonable levels.
- External political pressures, such as the upcoming S&ED and the US Treasury's "Semiannual Report on International Economic and Exchange Rate Policies" will keep key currencies such as the RMB within view.
- The ongoing internationalization of the RMB will be a key factor keeping the value of the currency supported especially over the longer term. For the RMB to be accepted as a store of value outside of China, it is important for the currency to at least maintain its value, if not appreciation. And the push for RMB internationalization has been gathering speed. Since the kickoff of offshore RMB use in HK in 2010, the spate of announcements in the first half of this year suggests that the Xi Jinping government is indeed serious about liberalizing the financial system.

Last Friday (4 July), PBoC announced the Bank of Communications was appointed to be the RMB clearing bank in Seoul. This is the third city in three weeks to have a lender appointed to settle offshore RMB transactions, opening up the front in Northeast Asia. China Construction Bank was selected for London on 18 June, and Bank of China was chosen for Frankfurt the following day. Now China has offshore RMB centers spanning the European to East Asian time zones, broadening the scope and attractiveness of the currency in international trade and investment.

In addition, South Korea was also granted a RMB80 billion quota under the Renminbi Qualified Foreign Institutional Investor (RQFII) program, in addition to the quotas totaling RMB480 billion previously awarded to Hong Kong, Singapore, London and Paris.

On the downside though, the experience of the first half of 2014 shows that the RMB is also subjected to periodic weakness as the market plays a more prominent role in exchange rate determination. This is especially so when market reacts to domestic concerns such as China's shadow banking, local government debt and the likes.

The widened trading band of USD/CNY in early March (doubling to 2% from 1% from the daily fixings) means more volatility and two-way moves are in store for the currency.

While the PBoC was believed to be a key factor in the RMB weakness earlier this year, the currency could also be responding to the economic weakness at that time that saw headline GDP growth in 1Q14 dipping to 7.4%y/y, the weakest since 3Q2012, and headline PMI figures at the lowest since July 2013.

## RMB: Short Term Volatility But Positive Over The Mid To Long Term

Taking into account of the above, we remain positive on the RMB over the mid-to-long term horizon. While the worst of the depreciation for the RMB should be over, the currency could still see some downward pressure and greater volatility near term, with economic data showing signs of stabilization recently and economic and financial market restructuring and reform continue.

We reiterate our end-2014 forecast of 6.15/USD (which we had adjusted down from 6.05/USD in our latest Quarterly Global Outlook dated 25 June 2014), as we expect the unit to recover from current levels of around 6.20/USD with improvements of broader domestic environment and policymakers react to risks of sharp economic deteriorations. Nevertheless, this still represents a 1.5 % fall from 6.05/USD at end-2013, marking the first annual depreciation since 2009 in the aftermath of the global financial crisis. Beyond that, we expect the currency to rise at a more moderate pace of 1-3% annually on average in future years, compared to an annualized appreciation of 3.8% from 2005-2013.

FX	07 Jul 14	3Q-14	4Q-14	2015	2016
USD/CNY	6.204	6.19	6.15	6.03	5.85

Source: Bloomberg, UOB Economic-Treasury Research Estimates

### **Quick Facts: Strategic and Economic Dialogue (S&ED) and Strategic Economic Dialogue (SED)**

US President Obama and China President Hu Jintao established the China-US Strategic and Economic Dialogue (S&ED) in April 2009 as an annual bilateral forum for advancing a positive, cooperative, and comprehensive relationship between the United States and China, through a wide range of joint projects and initiatives and expanded avenues for addressing common regional and global challenges such as Iran, North Korea, Sudan-South Sudan, and climate change. The first S&ED session took place on 27-28 July 2009 in Washington, DC.

The S&ED actually followed from the path of the previous semiannual Strategic Economic Dialogue (SED), established by US President George W. Bush and China President Hu Jintao in September 2006, to examine long-term strategic issues, as well as provide coordination among the specialized continuing dialogues. The first SED session took place in December 2006 in China.

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