

USD/CNY Outlook

Appreciation part of tightening campaign

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And the pace quickened...

US policymakers and politicians have been relatively quiet of late on USD/CNY. Little wonder, as CNY appreciation against the USD sped up to 6.6% last year. In particular the past two months saw a substantial quickening of the pace. Since China decided to shift towards a loosely defined basket peg in July 2005 the CNY appreciated a total of 12.7% against the USD. The recent spurt amidst a broad battle against domestic overheating risks only suggests there's more to come. In this brief update we discuss how CNY appreciation fits into the broader economic picture for China and include our latest USD/CNY forecasts for 2008.

External pressure: US rather content

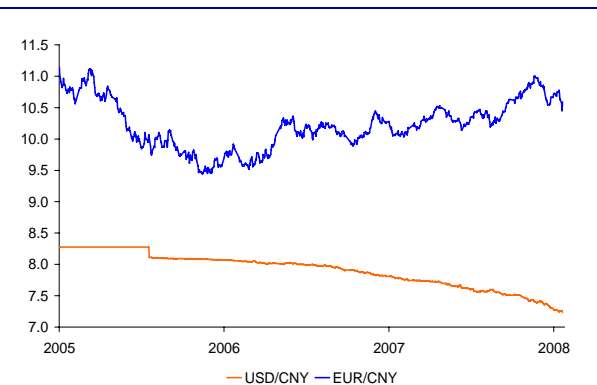
We continue to find it instructive to differentiate between internal and external pressure on China to allow further CNY appreciation. At the external front we note US pressure on China has eased somewhat, in no small part due to the increased pace of actual CNY appreciation over the past year. The US bilateral trade deficit with China remains very substantial, yet US policymakers and politicians have wisely decided there's little need to scream all the time when you get what you want. While we are in a year dominated by the US presidential elections, the debates have so far taken on a rather domestic focus, in particular where it concerns the economy. That's hardly set to change as the US economy slows down further during 1H08. Populist candidates on either side of the aisle may not be able to resist some cheap shots at China, but even they will struggle to pin the home-made housing market-led slowdown on China. US pressure on China for further CNY appreciation continues to be

present, but the real sting's out of the dialogue with the current pace China's setting.

External pressure: EU disgruntled

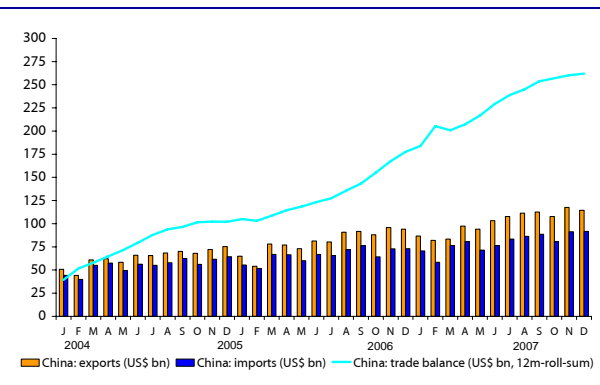
It would be reckless to overlook the European Union (EU) here. The EU's an important trading partner for China and growing increasingly disgruntled with the course of EUR/CNY. For a long time the EU opted for a dialogue behind closed doors, seemingly preferring to play good cop to the US bad cop. Yet EU policymakers and politicians have come to realize this has proven rather ineffective. The best illustration of the EU's frustration is the divergence between EUR/CNY and USD/CNY. Where the CNY appreciated 12.7% against the USD since July 2005, the CNY depreciated 7.9% against the EUR during the same period. Providing China indeed attempted for much of this period to stabilize the value of the CNY against a trade-weighted basket of currencies, it makes sense for the US triumph to equate the EU's misery. Yet we doubt this explanation will go far with EU policymakers. During a high-level EU-China meeting in December, EU policymakers and politicians noticeably changed tack and adopted a far more aggressive tone. Trade repercussions may follow in due time, in particular as China will have a hard time meeting EU demands for as long as EUR/USD remains under upwards pressure. A full discussion of EU-China trade relationships and scenarios goes beyond the scope of this brief, but suffice to say EU-China trade tensions could figure more prominently in the next 12-18 months.

Chart 1: Painful divergence - USD/CNY and EUR/CNY



Source: CEIC Data, Rabobank International

Chart 2: Trade surplus continued to rise in 2007



Source: CEIC Data, Rabobank International

USD/CNY Outlook

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Internal pressure: Curbing overheating risks

The Chinese economy expanded at a robust rate of 11.2% year-on-year in 4Q07. That was marginally down from the 11.5% year-on-year reading in 3Q07 and possibly an early sign of the gradual impact of a broad array of past tightening measures. Regardless the Chinese economy retained strong positive momentum towards the end of last year. The real possibility of a substantial US slowdown and the negative impact that would ultimately have on China's economy should not be dismissed out of hand, but clearly Chinese policymakers cannot simply rely on a US slowdown to counter domestic overheating risks.

We continue to think China does not display clear signs of generalized overheating. In particular wage growth remains in line with nominal GDP growth, while core inflation is still very subdued. Nevertheless Chinese policymakers cannot risk being complacent. Money supply growth eased back moderately in December, but still came in at 16.7% year-on-year. Loan growth came off too, partially as a result of a step-up in year-end window guidance, but still posted a 16.1% year-on-year increase in December. What's more headline inflation's stands as high as 6.5% year-on-year in December, coming off only moderately from 6.9% in November. This elevated inflation readings remains almost exclusively the result of higher food prices in a limited amount of food categories. Core CPI runs only at around 1.5% year-on-year. In a country where divergences in income distribution are already an issue and where food makes up about 1/3 of the CPI basket, it is logical policymakers opt to focus on bringing down headline inflation, or at a very minimum curb further upside risks, in a bid to safeguard social cohesion.

One complication in controlling domestic overheating risks remains rapid FX reserve accumulation, the impact on the domestic money supply of which offers a formidable challenge to sterilize. To the extent it isn't sterilized it propels domestic money supply growth and produces real

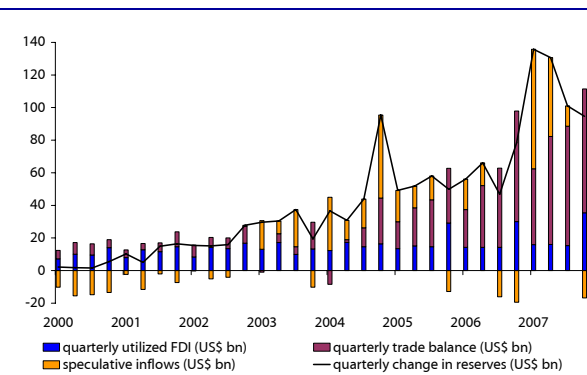
inflationary risks. Last year alone FX reserves rose US\$462 billion to a grand total of US\$1528 billion. A ballooning trade surplus of US\$262 billion for 2007 as a whole made up a substantial part of that, but steady FDI inflows and speculative flows continued to contribute as well. Hence the large trade surplus not only produces external pressure, but through the domestic economy also provides Chinese policymakers with a clear incentive to allow further CNY appreciation.

We look for a wide array of domestic tightening measures combined with a slowdown in key export markets such as the US and (to a lesser extent) the Eurozone to slow China's economic expansion down over the course of the year. We forecast 2008 GDP growth to ease back to 10% from around 11.5% last year. That's by all means still the envy of just about any other country in the world and slightly above our trend growth estimate of 9.5%, but a slowdown nevertheless. We'd caution against excessive pessimism, as contrary to popular belief China's domestic demand component is both robust and substantial. Should the net exports contribution to GDP growth evaporate entirely (a far too pessimistic assumption), domestic demand alone would most likely still come in strong enough to produce 9% annual GDP growth. Meanwhile we look for headline inflation to average 4.3% in 2008. Food price inflation was rampant in the past year and pushed headline inflation to elevated levels. We expect food price inflation to be far more moderate this year. Base year effects should then see to a material pullback in headline inflation.

Quo vadis: USD/CNY

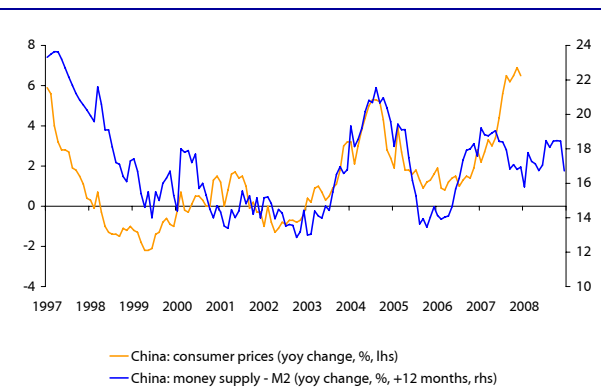
Chinese policymakers continue to fight overheating risks and inflationary pressure in the domestic economy. This is a battle fought along a long front line, in which all available instruments are currently deployed aggressively. Additional

Chart 3: Early breakdown FX reserve changes



Source: CEIC Data, Rabobank International

Chart 4: Latest inflation spike not linked to M2



Source: CEIC Data, Rabobank International

USD/CNY Outlook

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CNY appreciation is certainly one of these instruments, alongside monetary tightening through reserve ratio requirement increases and outright interest rate hikes, as well as a flurry of other measures that range from loan quotas to window guidance – a motley of market-driven incentives and old communist style central planning that has proven to work reasonably well for China in the past couple of years.

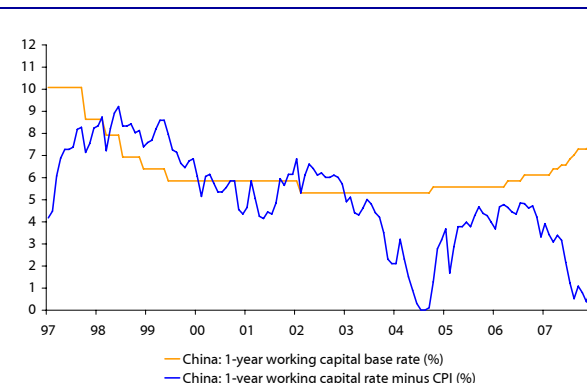
There are clear arguments in favor of aggressive CNY appreciation against the USD this year, which could warrant a USD/CNY forecast as aggressive as 6.56 by YE2008 or a total of 10% CNY appreciation against the greenback. Chinese policymakers have clearly gained a degree of comfort with CNY appreciation and no longer fear it will easily kill off exports growth. They took a cautious approach at first, but last year's gradual quickening of the pace suggests a willingness to deploy the CNY appreciation instrument more aggressively. Looking at the overheating and inflation risks out there in the domestic economy, there is a clear incentive for Chinese policymakers to actually do so.

Still, we'd caution against going overboard. Our base scenario is for USD/CNY to hit 6.79 by YE2008 or a total of 7.0% CNY appreciation against the USD. We balance the arguments in favor of a more aggressive scenario against our forecast of a moderate slowdown in China's GDP growth this year. We also expect headline inflation to come off materially over the course of the year, slowly reducing the need for an all-out battle against aforementioned risks. Moreover, we look for the USD to stage a comeback against various major currencies in 2H08, which will blunt some of the downwards pressure on USD/Asia and USD/CNY.

Summary

- Pace of CNY appreciation vis-à-vis the USD sped up materially last year (6.6%) and in particular over the past two months. Since July 2005 the CNY appreciated 12.7% against the USD.
- US pressure on China to allow further CNY appreciation vis-à-vis the USD has alleviated materially, mostly because of the rapid pace of late. When you get what you want, you don't have to cry. Encouragingly the US presidential elections have focused more on domestic issues than on China.
- EU pressure on China is something to watch closely. The CNY actually depreciated 7.9% against the EUR since July 2005. EU policymakers and politicians have recently abandoned quiet diplomacy in favor of a far more vocal approach to express their displeasure.
- External pressure aside, China's got plenty of domestic incentives to employ CNY appreciation more aggressively in its broad fight against overheating risks and in particular inflationary pressure.
- We look for USD/CNY to hit 6.79 by YE2008 or a total of 7.0% CNY appreciation against the USD. We balance the arguments in favor of a more aggressive scenario against our forecast of a moderate slowdown in China's GDP to 10.0% in 2008.

Chart 5: Despite tightening, still low real rates



Source: CEIC Data, Rabobank International

Table 1: China forecasts

	2005	2006	2007	2008	
GDP (%)	10.4	11.1	11.4	10.0	
Inflation (CPI, %) *)	1.8	1.5	4.8	4.3	
USD/CNY	8.07	7.81	7.30	6.79	
	Now	1Q08	2Q08	3Q08	4Q08
USD/CNY	7.22	7.15	7.00	6.90	6.80
1yr lending rate	7.47	7.65	7.83	7.83	7.83

*) = year-average

Source: CEIC Data, Rabobank International

USD/CNY

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