



Is China a "currency manipulator"? Yes!

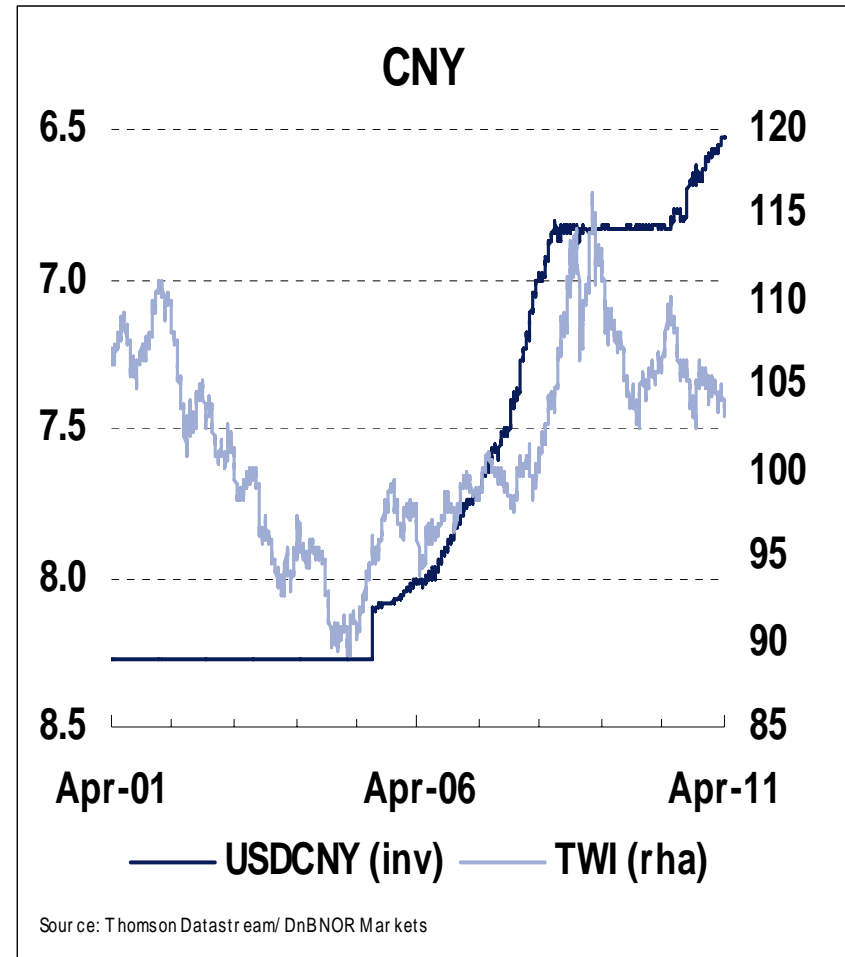
CME-meeting, 2/5/11, Chief Economist Øystein Dørum, DnB NOR Markets

V. ARESH

Overview: Fifteen years – four stages



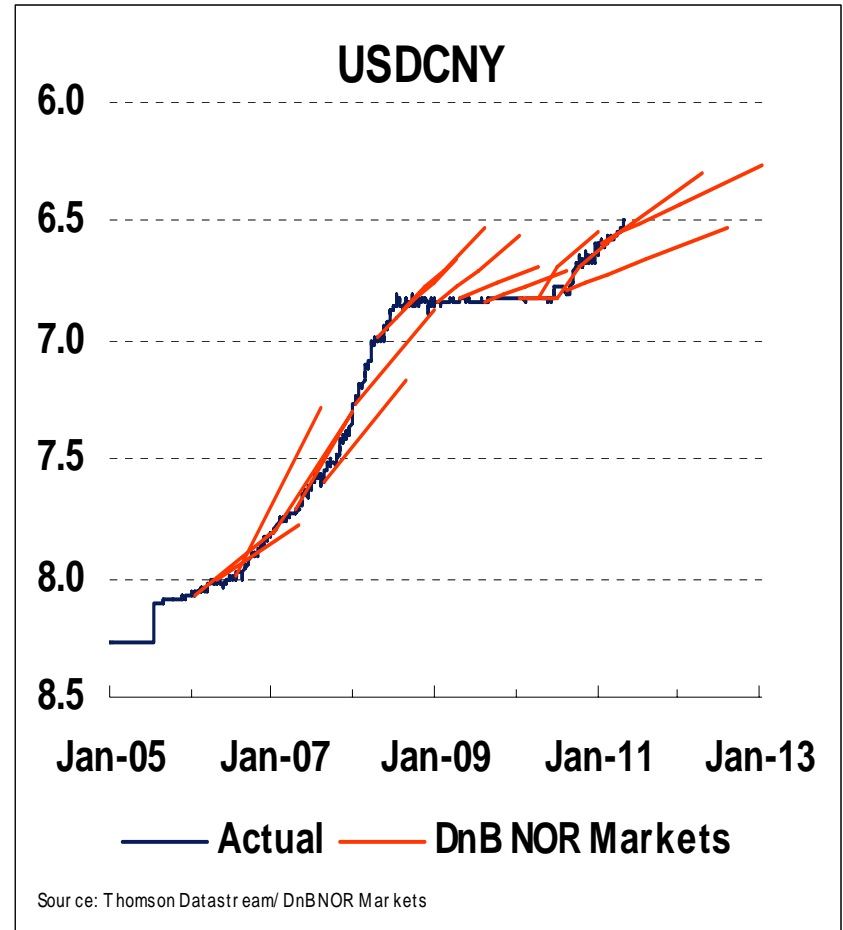
- **USD-peg** at 8,28 from Asian crisis 1997, until 21/7/2005.
- From peg to (yet unknown) **basket** and 2% revaluation vs USD, followed by gradual appreciation both vs USD and trade-weighted. Faster as the economy picked up speed.
- Mid-July 2008-July 2010: **Stable USDCNY** around 6,83 due to financial crisis and lower exports. CNY followed the USD down.
- **July 2010**: Signalling freer float after increasing pressure in China and accusation of currency manipulation.
- 4.8% appreciation vs USD thus far. But nothing trade-weighted. Will continue. Necessary for domestic stabilisation.



Not just another bad hair day



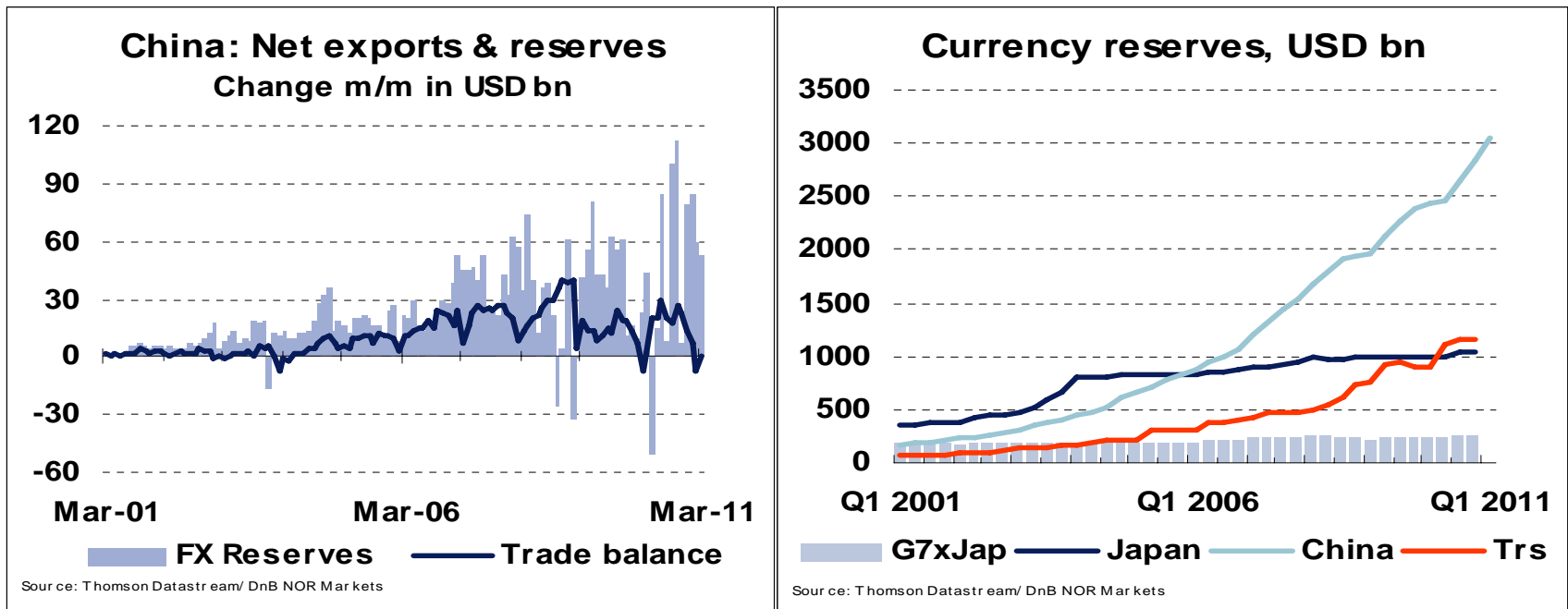
- **Jan-05:** Will introduce gradually appreciating crawling peg by mid-year.
- Began predicting USDCNY May-06
- Average deviation 12m ahead (13 obs.) 2.0%. No directional errors: Our **best currency forecasts**.
- (Only truly bad forecasts are the ones made **Aug 2008-Apr 2009**, with a belated acknowledging that economic conditions put further appreciation on hold.)
- In a sense **paradoxical**, as we should have better grasp of currencies closer to home.
- Obvious, **two-fold explanation:** This is a managed ("dirty") float, and developments reflect underlying economic conditions.



Is China a currency manipulator? Yes



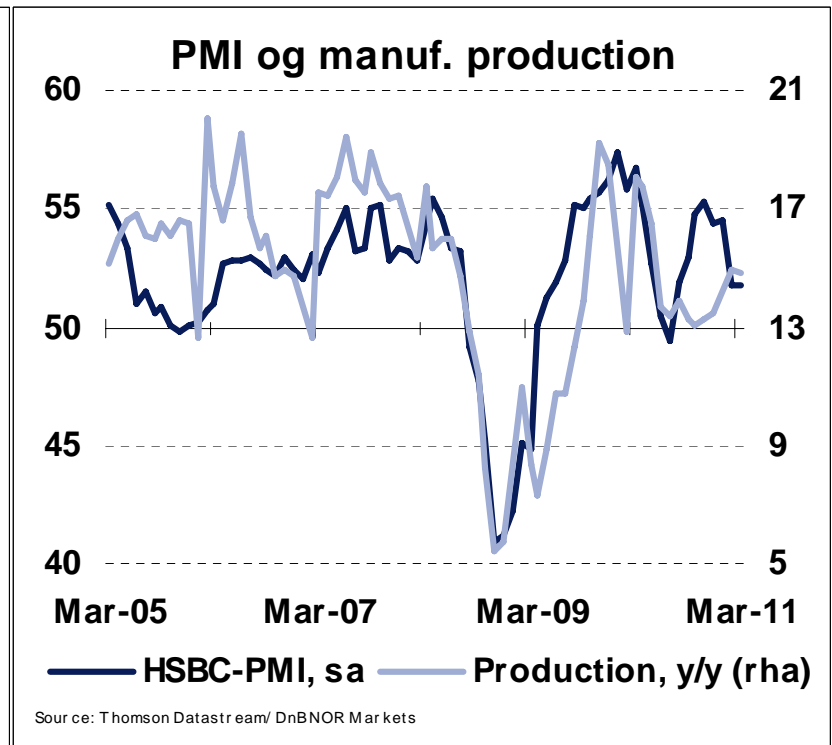
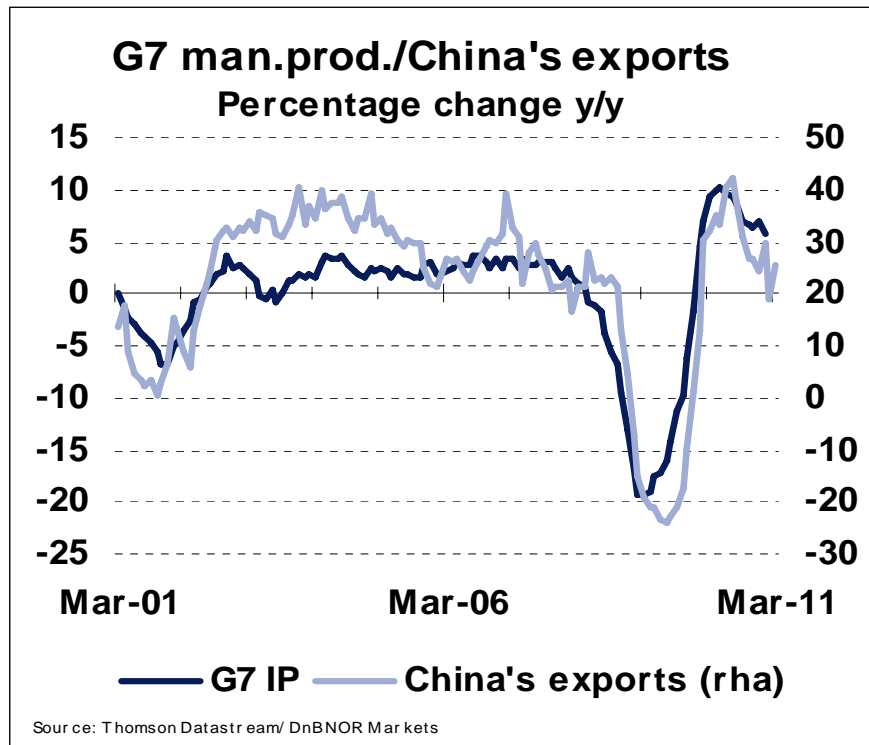
- Managed, not market-determined exchange rate. Many years with a trade surplus indicates an undervalued currency. Large capital inflow *in addition* (reserves increasing faster than the surplus) supports this view.
- China's currency reserves stood at \$3045''' by 31.3.2011, 52% of GDP & 17 times reserves in 20001Q1 (=33%/year). This is classic mercantilism. As a poor, fast-growing nation China should have imported capital.



China was hit by The Great recession



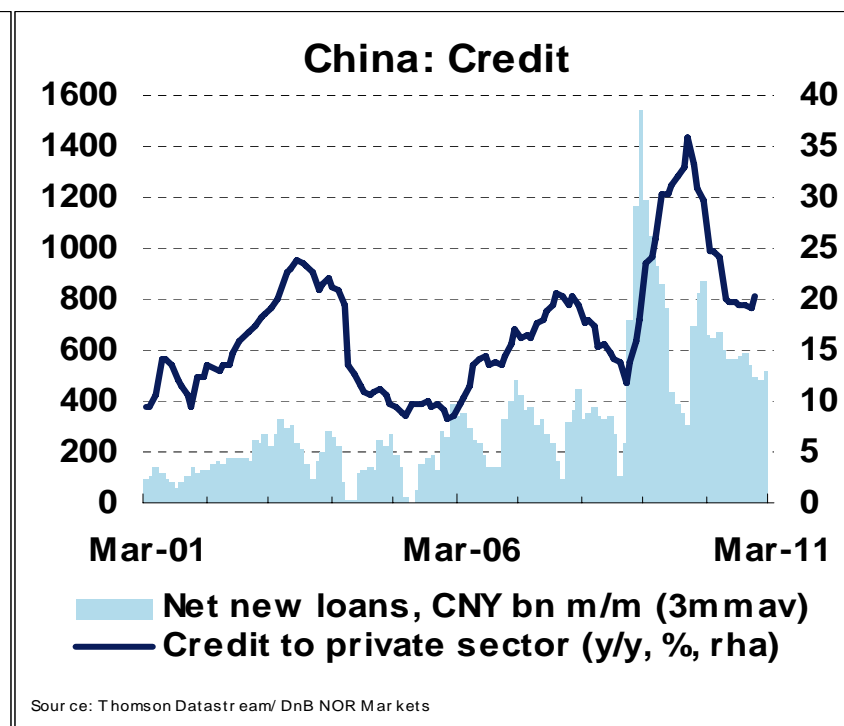
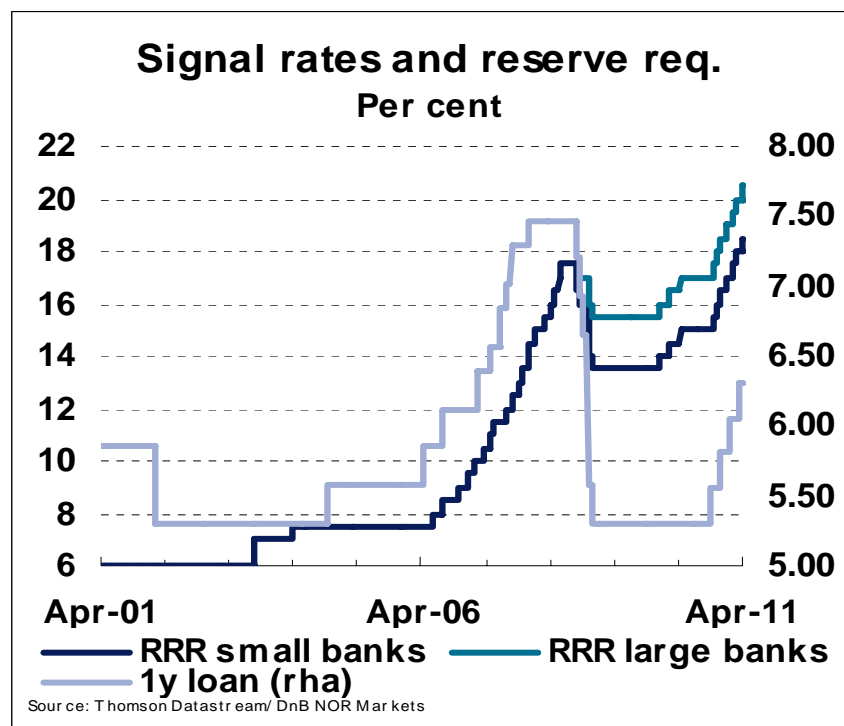
- In the Winter 2008/09 the value of exports fell at an underlying rate of over 50%. From 2008Q3 to 2009Q3 exports fell by 25%.
- HSBCs PMI index was below 50 (contraction) from August 2008 to March 2009. Production growth declined from 15-20% y/y to 5% y/y.



Policy changed 180' (and back again)



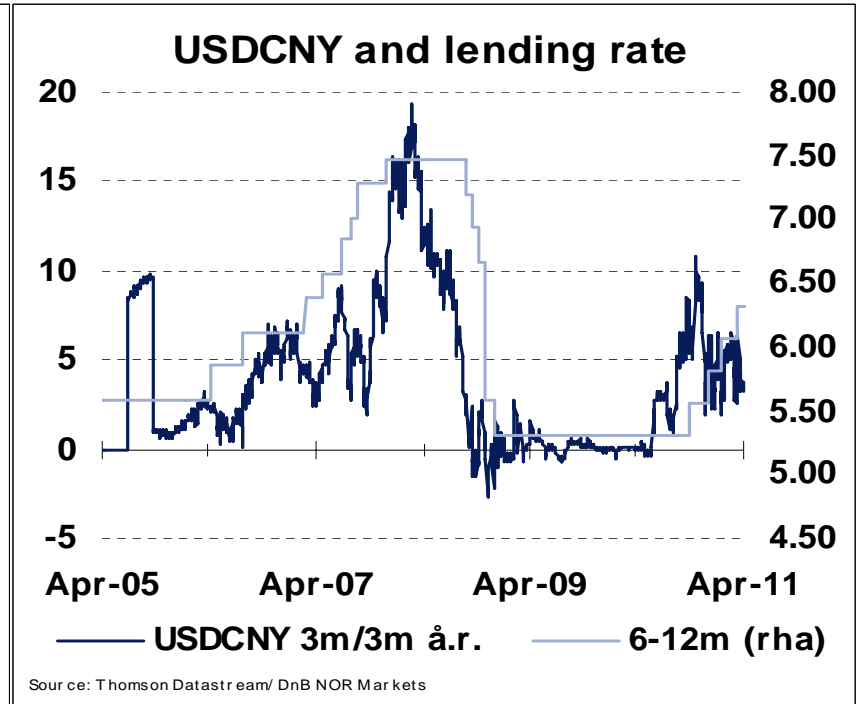
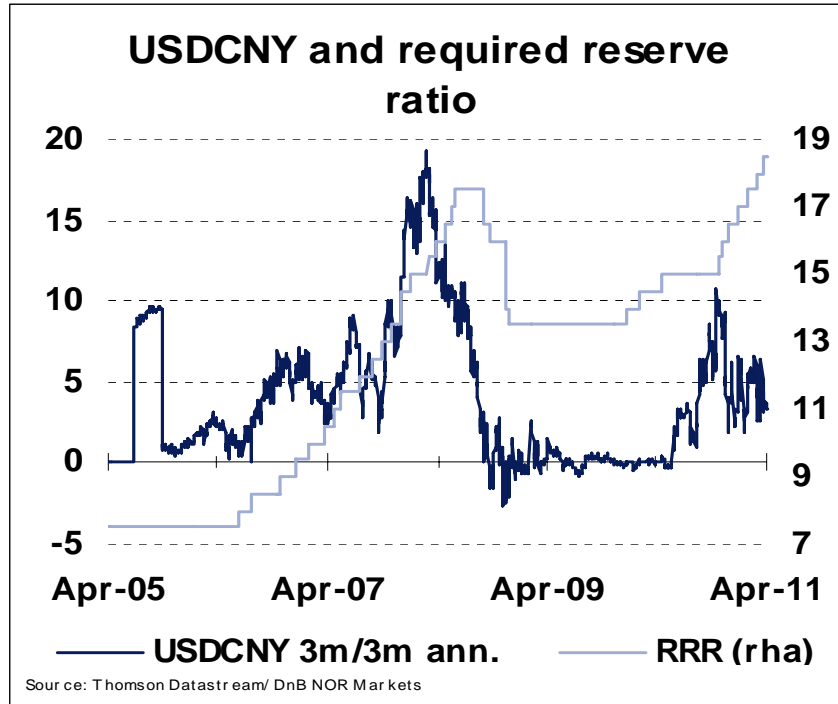
- Tighter policy from 2005 to 2007, but full turnaround in 2008, with lower reserve ratio and interest rates, and strong lending growth: CNY7,5''' in new loans 2009H1, three times 2008H1. Credit rose 33% in 2009.
- Policy tightened again in 2010. RRR raised 5 pp since last January, of which 3½ pp since mid-November.



The exchange rate is part of the game



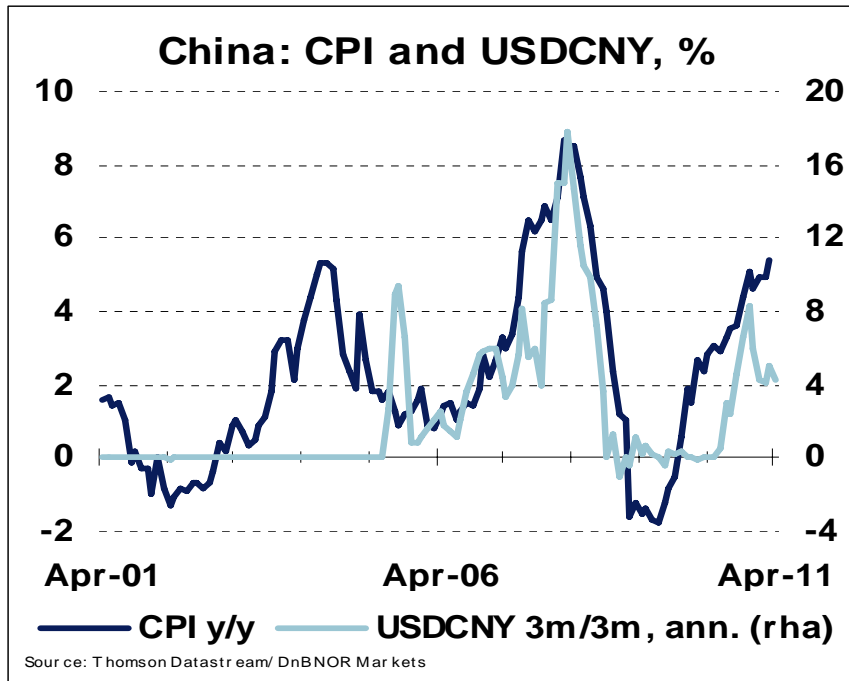
- A weak transmission mechanism due to large liquidity surplus in the banks reduce the effect of interest rates for stabilisation purposes.
- A stronger yuan weakens competitiveness, dampens imported inflation and should also counter "speculative" inflow and therefore domestic liquidity and credit growth.



Also in containing inflation



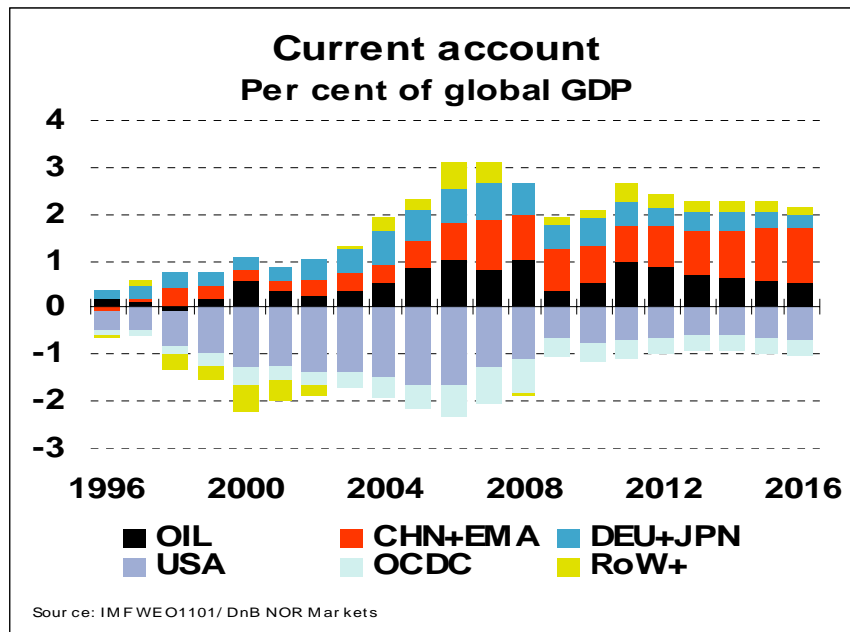
- Inflation currently 5.4% - the most important reason behind the ongoing tightening of monetary and credit policy. Inflation likely to moderate going forward, not warranting similar appreciation as seen in 2007. Also, global growth apparently less robust.
- China still enjoys healthy growth, with GDP up 9.7% in 2011Q1, and April PMI at 52.



A big, unsustainable paradox



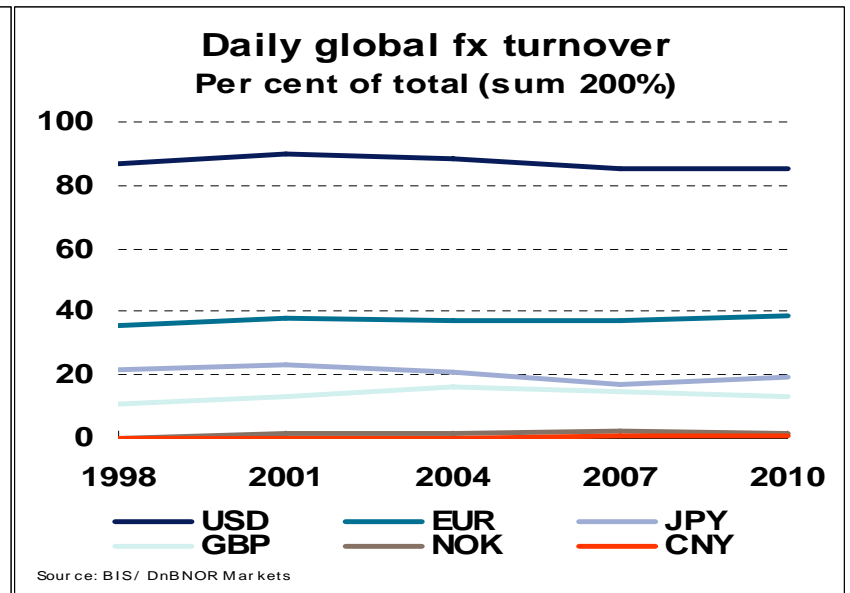
- According to US Treasury data (TICS), China increased its net purchases of US treasuries during the financial crisis. Currently holds \$1154", equal to **39% of its reserves**. ('Nominee' accounts in addition, but holdings could in principle also include private holdings.) **The paradox?** Poor and fast-growing China finances rich and slower-growing USA.
- The biggest debtor and the biggest creditor, tied together. China can not stop buying, as a large USD decline would also affect competitiveness.



A huge economy with a small currency



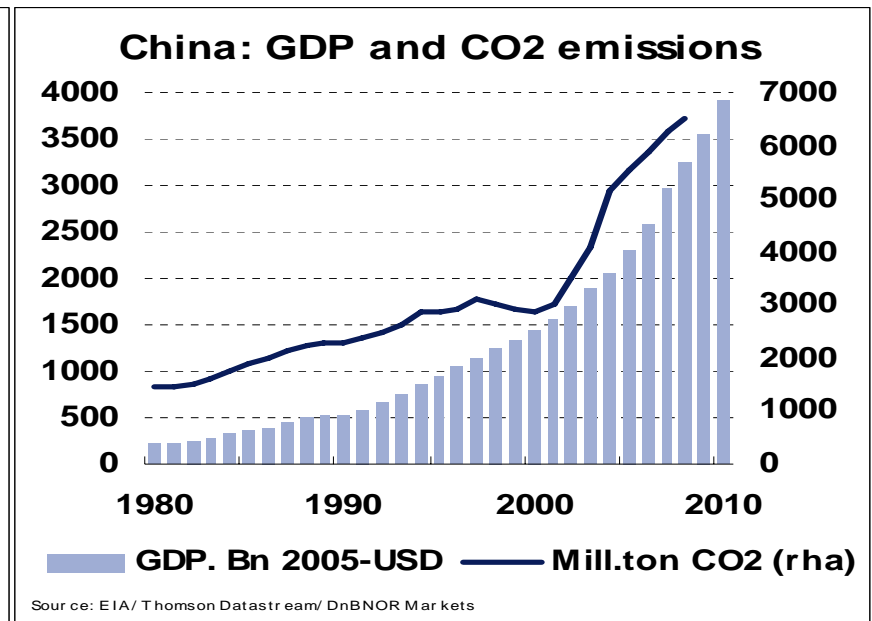
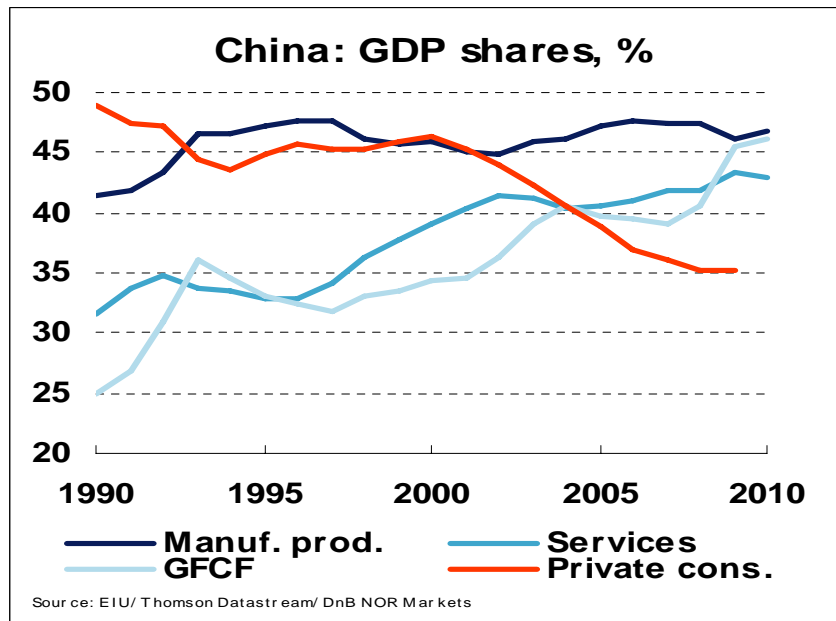
- China has now acquired the position as the world's second largest economy and importer, and the largest exporter and capital exporter.
- But its currency has marginal significance. According to BIS' latest Triennial Central Bank Survey (daily turnover, April 2010), the CNY was involved in 0.9% of all fx transactions, less than the NOK's 1.3%.
- This will change. History shows that economic strength and currency significance goes hand in hand, although with considerable lags. Although US relative importance is declining, the USD is still the world's currency.



China at crossroads



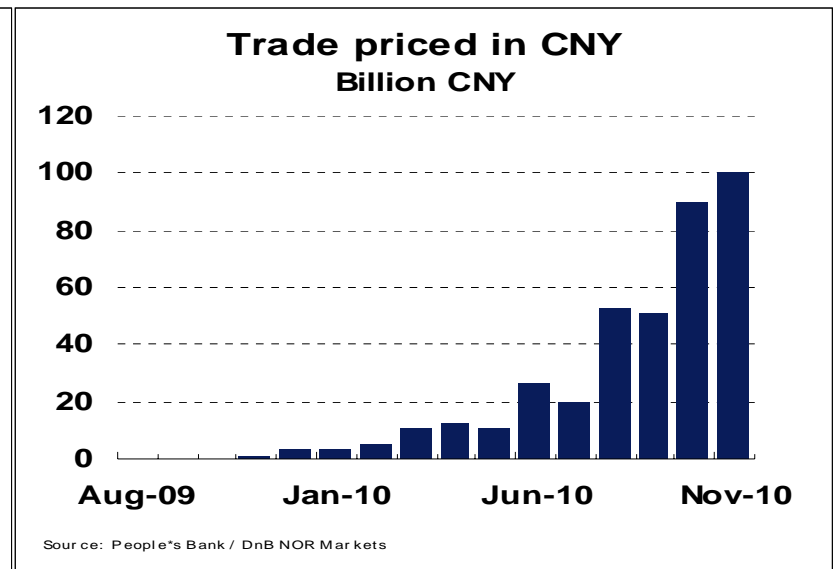
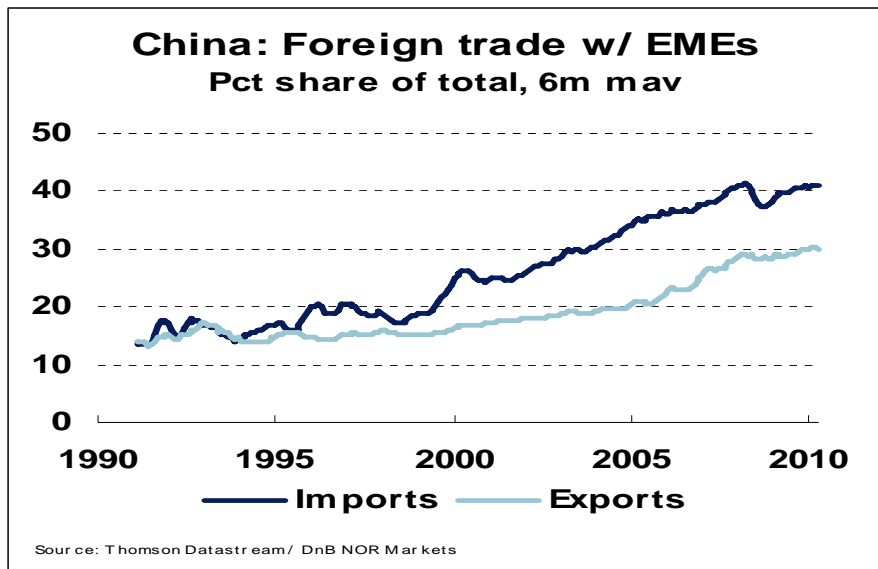
- **Five year plan 2011-15** (announced 29/10/10) with overriding aim of stable and "relatively fast" growth, but also to "accelerate" rebalancing.
- Growth should lean more on consumption and services, and less on investments, exports and manufacturing. Energy intensity and emissions to be reduced. (10% GDP-growth and 6% emissions growth since 1980.)
- How? Better welfare. Higher SOE dividends. Technology.
- Export industry and stable exchange rate will be less important.



Gradual liberalisation



- Last year importers and exporters were allowed to price imports and (gradually) exports in CNY. Strong increase during the course of the year, but payments for imports dominate. Probably largest potential in **trade with EMEs**, which are increasing their share of Chinese exports.
- Large outflows reflected in build-up of *offshore* HK market, creating a "shadow" CNY market (CNH), due to restrictions on mainland inflows.
- Big companies, e.g. McDonald's & Caterpillar, have borrowed in CNH.
- As a surplus country, trade should not cause large CNY reserves abroad.



...but still a long way to go



Hu Jintao:

- *"[The] international currency system is the product of the past"*
- **But:** *"[...making the yuan] an international currency will be a fairly long process"*

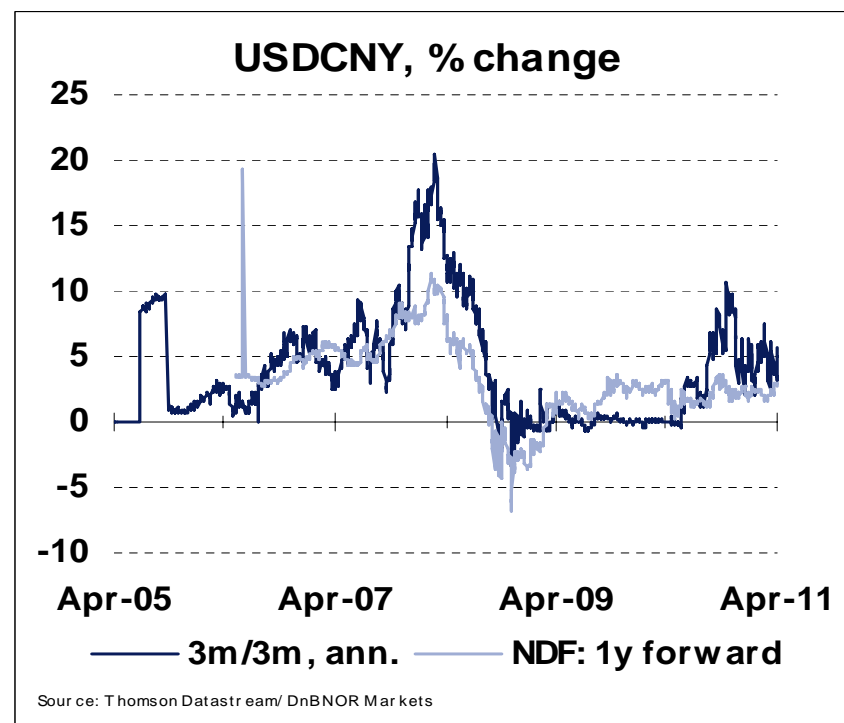
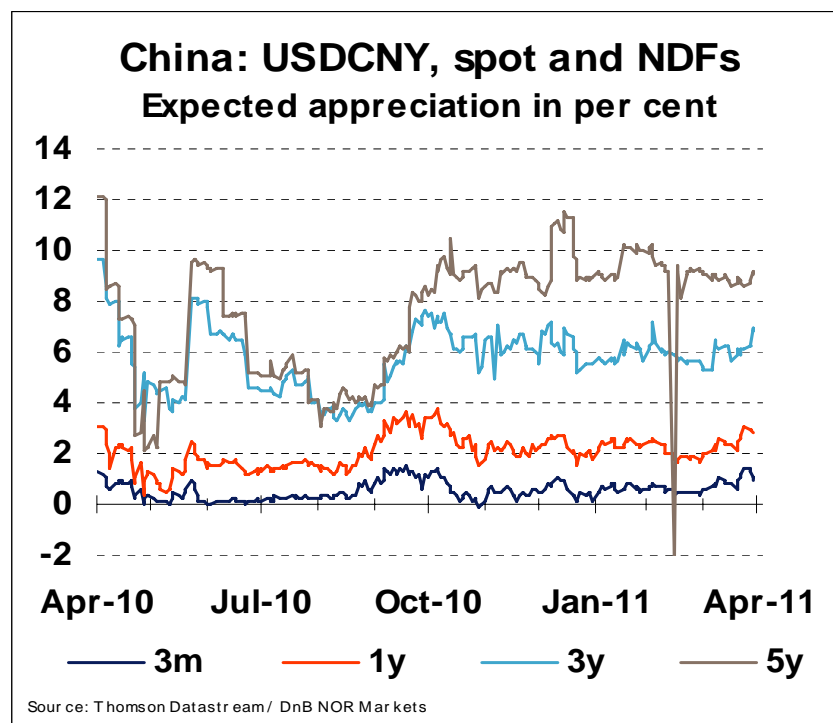
DnB NOR Markets:

- Currently expecting 2-3% appreciation vs USD over the next 12 months (but also a 10% USD trade-weighted appreciation).
- No major liberalisation over the course of the next three years.
- But there's no doubt about the direction: Stronger, more flexible.

Markets expect further appreciation



- Non-deliverable forwards (NDF's) are currently indicating an appreciation of 3%, 7% and 9%, one, three and five years ahead, respectively.
- Like economists, markets expectations are adaptive, cf. relationship between actual, annualised change and expected forward change. (But late 2008 markets were pricing in a depreciation of CNY vs. the USD.)



Disclaimer



Denne rapporten må anses som markedsføringsmateriale med mindre den er utarbeidet i henhold til krav for investeringsanalyse, jf Forskrift til verdipapirhandelloven 2007/06/29 nr 876. Denne rapport er utarbeidet av DnB NOR Markets som er en divisjon i DnB NOR Bank ASA. Rapporten baserer seg på kilder som vurderes som pålitelige, men DnB NOR Markets garanterer ikke at informasjonen er presis eller fullstendig. Uttalelsene i rapporten reflekterer DnB NOR Markets' oppfatning på det tidspunkt rapporten ble utarbeidet, og DnB NOR Markets forbeholder seg retten til å endre oppfatning uten varsel. Rapporten skal ikke oppfattes som et tilbud eller anbefaling om kjøp eller salg av finansielle instrumenter eller deltagelse i noen investeringsstrategi. DnB NOR Markets påtar seg intet ansvar for verken direkte eller indirekte tap eller utgifter som skyldes forståelsen av og/eller bruken av denne rapport. Regler om konfidensialitet og andre interne regler begrenser utvekslingen av informasjon mellom ulike enheter i DnB NOR Markets/DnB NOR konsernet, hvilket innebærer at ansatte i DnB NOR Markets som har utarbeidet rapporten er forhindret fra å bruke og være kjent med tilgjengelig informasjon i DnB NOR Markets, og andre selskaper i DnB NOR konsernet, og som kan være relevant for mottakerens avgjørelser. Informasjon om DnB NOR Markets Alminnelige forretningsvilkår er tilgjengelig på vår hjemmeside www.dnbnor.no/markets. Denne rapport er kun ment å være til bruk for våre klienter, ikke for offentlig publikasjon. DnB NOR Markets, en divisjon i DnB NOR Bank ASA - organisasjonsnummer 984 851 006 i Foretaksregisteret, er medlem av Norges Fondsmeglerforbund og underlagt tilsyn av Finanstilsynet i Norge, Singapore, og i begrenset utstrekning i Storbritannia. Ytterligere informasjon om DnB NOR Markets og DnB NOR Bank ASA finnes på www.dnbnor.no.