

ASSESSING THE COMPOSITION OF THE CHINESE CURRENCY BASKET

An update at the end of October 2005

Early September, we used different econometric techniques to try to estimate the relative weight of the currencies included in the basket that is used as a reference for the exchange rate policy conducted by the People's Bank of China (PboC). The full paper is available on TAC's website on the 'Food for Thought' page <http://www.tac-financial.com/cp-fft.php>.

During the last weeks of October, we decided to update our quantitative exercise to check on the validity of the first estimation when using a longer period. We are obviously trying to achieve the impossible, since the Chinese policy includes the possibility of a daily adjustment of +/-0.3% of the Chinese Yuan against the USD, an "uncertainty" that makes the estimation of the weights of the different currencies technically unfeasible. However, we notice that the CNY has remained almost flat against the USD since our last estimation (CNY 8.0856 on November 4, against 8.09 early September and 8.11 when the policy change was implemented in July).

We decided therefore that it was useful to look again at our econometric exercises to check whether the addition of six weeks of daily spot rates can bring additional information.

And indeed, it does... We summarize here the major conclusion of this updating exercise:

- The explanation of the three "core" currencies" outside the USD (Euro, Yen and Korean Won) appears to be significantly weaker than in our earlier estimate, with a correlation coefficient (R^2) declining from 90% to 55%: bilateral changes of these three currencies against the USD are not sufficient anymore to explain the daily changes of the Chinese currency.
- When adding three "secondary" currencies that were initially included officially in the list indicated by the Chinese authorities, we are able to improve the correlation coefficient back to above 90%: the Singapore dollar, the Thai Baht and the Russian Ruble now appear to be "used" more significantly in the overall currency basket, and their daily fluctuations against the USD play a more important role in understanding the evolution of the CNY.
- Whatever the list of currencies identified or used in the currency basket, the weight of the dollar remains very large, between 60% and 67% of the total basket.
- Finally, we noted that the time-lag between foreign currency changes and the CNY adjustment appear to have increased from one day (which provided the best statistical results in our initial exercise) to about 5 days now, i.e. one week of working days, which now enables to significantly improve the statistical qualities of our econometric relations.

Reminder: list of currencies included in the basket as indicated by the Chinese authorities

	Symbol	Name
Main currencies	USD	U.S. Dollar
	EUR	Euro
	JPY	Japanese Yen
	KRW	Korean Won
Secondary currencies	SGD	Singapore Dollar
	MYR	Malaysian Ringgit
	AUD	Australian Dollar
	CAD	Canadian Dollar
	RUB	Russian Rouble
	THB	Thai Baht

The bottom line of our analysis is almost unchanged, i.e.:

1. The Chinese authorities are going to move very gradually in their path towards a more flexible exchange rate and towards a more significant appreciation of the CNY.
2. The most likely value for the CNY over a one-year time horizon would be close to CNY 7.5 against the USD, in the middle of a larger range of 6.85-7.99.
3. The appreciation of the Yuan is still considered by the Chinese authorities as a bargaining instrument in the current international trade debate. The likelihood of the appreciation is fundamentally dependent on successful trade negotiations between China and its main trading partners.
4. If the WTO Ministerial meeting in Hong Kong next December results in a more predictable and less risky medium-term trade environment for China, recent remarks by PboC Governor Zhou about the Chinese economy "sufficient flexibility" can be considered as serious announcement of a more rapid appreciation in the first half of next year.