

A renminbi revaluation possible

There is pressure on emerging markets to tighten capital controls. **Stefan Hofer** argues that over time, China is likely to allow a gradual revaluation of the renminbi.

In late October, the Brazilian ministry of finance imposed a two per cent tax on new capital inflows (called the IOF), targeting external investors of local fixed-income and equities. The stated aim of this measure was to slow the appreciation of the Brazilian real, which had rallied more than 25 per cent against the US dollar since the start of the year. The move by Brazil raised the spectre of capital controls in emerging markets overall. How much of a risk are the imposition of widespread capital controls?

Emerging markets have an established track record of using capital controls in the face of unwanted capital inflows and outflows. The cost and benefit of using such measures is the subject of intense and far-ranging debate. Sticking closely to the current Brazilian example, the two per cent IOF appears relatively mild. For example, on December 19, 2006, the Bank of Thailand shocked markets by imposing a 30 per cent foreign currency holding requirement with a one-year lockup period for Thai baht transactions. This move caused Thai stocks to fall 15 per cent and the Thai baht dropped four per cent. The market's fall caused the

authorities to exempt Thai equities the next day. While a surprising move, the two per cent Brazilian tax could be discounted by investors fairly quickly.

The fact is that Brazil has been faced with large capital inflows over the past months. It follows that the BRL's appreciation is putting exporters under pressure, all else being equal. That said, given Brazil's robust economic recovery prospects and the adept local handling of the international financial crisis, these inflows and currency appreciation may simply mean that Brazil has become a victim of its own success. The question is, therefore, whether the risk of surprise and potentially disruptive policy steps are likely to derail the otherwise compelling characteristics of Brazil as an investment destination.

In short, we believe the answer is no. Given that the general election is now only one year away, investors should expect that the path to a post-Lula Brazil will be increasingly volatile. In addition to policy announcements (e.g. additional government spending) and political noise generated during the active campaign, these forces may see shorter-term



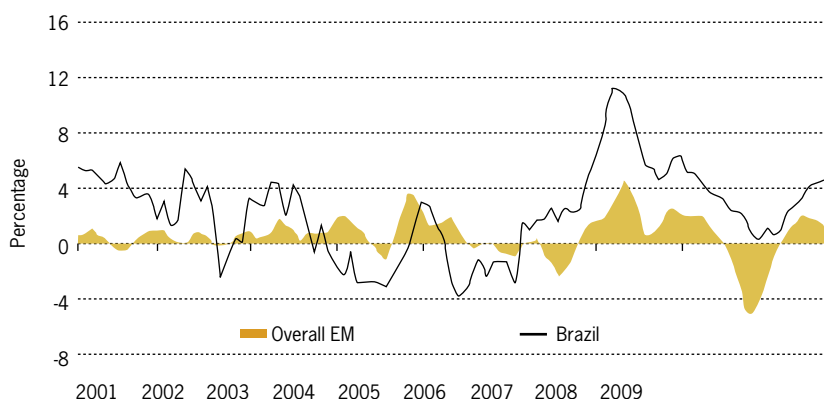
setbacks for Brazilian assets. It can be argued, however, that the dividends accrued by implementing prudent economic and debt management that has hallmarked the Lula presidency are widely appreciated in Brazil. Stronger institutions, in particular the central bank, should help Brazil weather the effects of policy and election-driven volatility.

What about the rest of the emerging markets? For the asset class overall, it seems difficult to argue that sweeping changes to the existing currency and capital account regimes are around the corner. That said, discussion in the investment community over the potential misalignment of Asian currencies, especially China, continues. In our view, China is likely to allow for a gradual revaluation of its currency over time, in part to increase the buying power of domestic consumers. This should, in turn, make China's growth less dependent on external demand. By definition, as the renminbi is a tightly-managed currency, such a move would be under the purview of the authorities. But unlike many other administrative controls, such a move would likely be welcomed by market participants.

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Brazil has been a return of capital inflows

Implied net capital flows (% GDP, 3 mma)



Source: UBS IB, Bank Julius Baer