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China Loosens Currency Peg

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In a surprise announcement on Saturday, the People's Bank of China (PBOC) announced it would break the 23-month fixed peg in the yuan, allowing for more flexibility in the currency. China's fixed exchange rate has been a long-standing complaint of its trading partners, giving China a significant competitive advantage, keeping its product prices low in the U.S. Canada has been regrettably affected by this policy, as China's share of U.S. imports has risen substantially to nearly 20%, replacing Canada as America's number-one trading partner. Canada's share has fallen to less than 15% of U.S. imports.

Clearly, this announcement was timed to appease global leaders as we move towards the Toronto G20 meetings next weekend. This is a welcome development and will forestall protectionist fervor in the U.S. While the details and time frame of the change are unknown, it is likely that the yuan will appreciate gradually against the U.S. dollar at least in the near-term. Over the next year, the yuan will likely rise sufficiently to mute the commodity price effects resulting from its ongoing successful domestic policies and a global economic recovery.

This is good for the U.S. economy, making American products cheaper in China and thereby improving its trade balance, and ultimately creating jobs in the U.S. The same may be said for Canada's economy as well. By allowing a gradual appreciation of the yuan, China will be sharing more of its growth with the rest of the world. This is not a panacea, however, as surplus-saving China must take additional action to stimulate private consumption.

The yuan's appreciation will not only lower import costs, but also boost consumer purchasing power. It will also help to dampen Chinese inflation, which hit a 19-month high of 3.1% in May, above the government's full-year target of 3%. Fortunately, inflation in the U.S. is quite low, leaving some to fear deflation. The price of Chinese products will rise as the appreciation takes place. The Bank of Canada hiked rates recently in response to an uptick in inflation. Today's announcement might increase the odds of further near-term rate hikes unless the Canadian dollar appreciates faster than the yuan. This is possible given the positive effect on commodity prices this action might have.

Wage rates in China were already rising in response to some well-publicized labour strikes at foreign manufacturing companies. This alone would help boost production in other countries, as high-transportation costs had already shifted some manufacturing back to

the U.S. Profit margins are already so thin in some Chinese factories, especially in the textile industry, that some companies might not survive the adjustments.

The Chinese authorities obviously have greater confidence in the strength of their own economy. In their statement, the PBOC said, "The global economy is gradually recovering. The recovery and upturn of the Chinese economy has become more solid with the enhanced economic stability. It is desirable to proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility." It added, "The exchange rate floating bands will remain the same as previously announced in the interbank foreign exchange market." The move by China is likely to underpin a strengthening of the non-Japan Asia currency complex.

According to Bloomberg News, "China has ended its crisis-mode exchange-rate policy as the economy recovers strongly and inflationary pressure continues to build," Li Daokui, an adviser on the People's Bank of China's policy board, said in an interview. "The yuan's future trend depends on the euro's movement, and the trends of other major currencies."

Beijing allowed the yuan to appreciate by roughly 20% from July 2005 until July 2008. They stopped in the summer of 2008 when the financial crisis escalated sharply in the wake of the March rescue-takeover of Bear Stearns. The global credit crisis exploded with the September bankruptcy of Lehman Brothers, the largest in American history and the subsequent bailout of AIG. Soon thereafter the TARP was created as a emergency response to what could have been a collapse in the global financial system. The recession in the U.S. had begun earlier, in December 2007, but by July of the following year, it was evident that the economy was deteriorating very rapidly and the U.S. dollar had fallen sharply. China pegged its currency to the U.S. dollar as the Canadian dollar, the euro and other of the world's currencies appreciated sharply. Recently, the U.S. dollar strengthened as the sovereign debt crisis, ignited by Greece, caused a safe-haven rush into U.S. Treasuries and gold.

I would expect the initial reaction to the PBOC announcement to be negative for the Treasury market, likely unwinding the rally in Treasuries we've seen in recent weeks. Although China will undoubtedly continue to buy U.S. Treasury securities and other U.S.-dollar-denominated financial assets, the fear will be that the volumes could decline considerably. China owned \$900 billion of U.S. Treasuries as of April, the largest foreign holdings. The rise in Treasury yields should be relatively muted given the recent loss of momentum in the U.S. economy, but the initial knee-jerk reaction could be big.

This should be positive for U.S. and Canadian stock markets as exporters benefit. The initial reaction was a decline in the U.S. trade-weighted dollar. Commensurate with this was a modest rise today in the Canadian dollar, the Mexican peso, the Brazilian real, the

Aussie dollar and the New Zealand dollar. The euro and the British pound barely moved, edging down slightly. Oil prices have moved up a bit and so has gold in U.S. dollar terms.

June 20, 9:00 pm Update – Chinese Markets Open

As expected, as Chinese markets open at 9:00 PM EDT, there has been an initial surge in commodities and U.S. stock index futures and a fall in the U.S. dollar. This is initially good news for the Canadian dollar and the TSX. We are very early in the process, and the PBOC is likely to move quite gradually, however, the bottom line is that this is good for the Canadian and U.S. economies, the Canadian dollar, commodity prices and the Canadian and U.S. stock markets. It is bad news for the U.S. Treasury market in initial movements.

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