

China Loosens Currency Peg

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On Saturday, June 19th, the People’s Bank of China (PBoC) surprisingly announced it would break the yuan’s 23-month fixed peg against the U.S. dollar, 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 United States. 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 #1 import destination, although Canada is still America’s largest export market (Chart 1). Canada’s share has fallen to less than 15% of U.S. imports.

Clearly, Beijing knew that this announcement would limit the debate on Chinese trading practices at the Toronto G-20 meeting. This is a welcome development and may forestall U.S. protectionist fervor but only temporarily as the details and time frame of the change are unknown. In a follow-up statement on Sunday, the PBoC did provide further clarity, stating that a one-time revaluation was “not in China’s interest”. This suggests that the pace of appreciation might be more gradual than during 2005 to 2008.

Beijing allowed the yuan to appreciate by roughly 20% from July 2005 until July 2008 (Chart 2). 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, and the subsequent bailout of AIG. Soon, thereafter, Congress created the TARP as an emergency response to what could have been a collapse in the global financial system. The U.S. recession 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 caused a safe-haven rush into U.S. Treasuries and gold.

The ongoing appreciation of the yuan will facilitate the necessary global adjustments that are beneficial 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. Similarly, it will benefit Canada’s net export position. By allowing the yuan to

CHART 1
SHARE OF US IMPORTS: SHIFTING TIDES
United States (% of total)

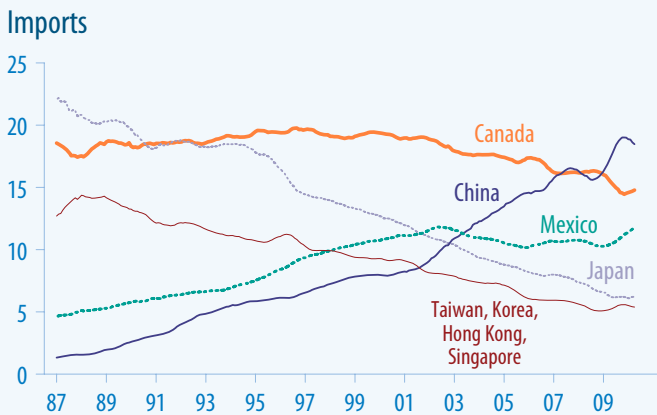


CHART 2
IMPACT FROM THE 2005 APPRECIATION
2005 (% chng from July 15, 2005)

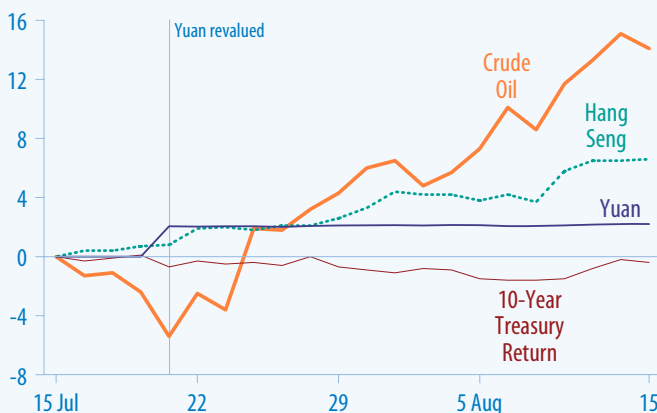
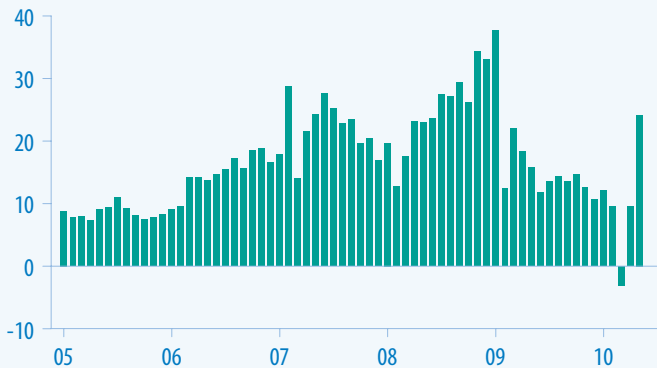
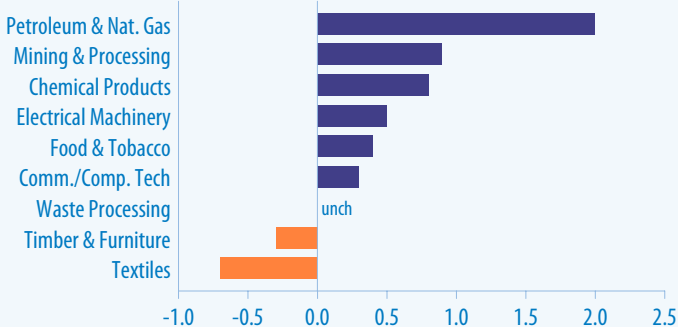


CHART 3
CHINA'S TRADE SURPLUS TO NARROW

China (US\$ blns)

Trade Balance


CHART 4
**CHINA'S INDUSTRIES...
WINNERS AND LOSERS OF A HIGHER YUAN**

 Estimated Change in Profits of Selected Chinese Industries
if the CNY Rises 5% vs USD (percent)


Source: Wall Street Journal

gradually appreciate, China will be sharing more of its growth with the rest of the world, allowing its trade surplus to narrow (Chart 3). This is not a panacea, however, as surplus-saving China must take additional action to stimulate private consumption.

The yuan's appreciation lowers import costs, boosting consumer purchasing power. It will also help dampen Chinese inflation, which hit a 19-month high of 3.1% in May, above the government's full-year target of 3%. The price of Chinese products in foreign markets will rise as the appreciation takes place. Fortunately, inflation in the U.S. is quite low, leaving some to fear deflation. The Bank of Canada has started to hike rates with an eye on longer-term inflation trends. China's announcement might increase the odds of further near-term rate hikes in Canada unless the Canadian dollar appreciates faster than the yuan, which 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 shift production to other countries, as high-transportation costs had already pushed some manufacturing back to the U.S. Profit margins are already so thin in some Chinese factories, especially in the textile and timber, and furniture industries, that some companies might not survive the adjustments (Chart 4).

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.

The initial reaction to the PBoC announcement was negative for Treasuries. However, selling pressure eased quickly as markets realized that China will undoubtedly continue to buy U.S. Treasury securities and other U.S.-dollar-denominated financial assets. Even so, there is still fear that the volumes could decline considerably. China owned \$900 billion of U.S. Treasuries as of April, the largest foreign holdings. This should be positive for U.S. and Canadian stock markets as exporters benefit.

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