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GLOBAL MARKET COMMENT

REVALUING CHINA'S RENMINBI

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Revaluing China's Renminbi
Ominous for the United States, Panacea for Rest of World

Deafening applause and shouts of "Encore, encore!" rang through frenzied trading rooms and staid Wall Street offices as financial pundits of all ideological stripes heralded China's currency revaluation in July. With the aftershocks still reverberating through global markets, and opinions and analyses coming fast and furious, we thought it would be helpful to distill the varied commentary into several overarching themes that have emerged in the succeeding weeks.

What Happened?

The People's Bank of China (PBOC) abandoned the renminbi's (RMB) fixed peg against the US$ and adopted a managed floating rate regime set against a basket of currencies. The central bank immediately revalued the currency 2.1% to RMB8.11/US$, from its prior peg of RMB8.28. The PBOC also set a trading band of +/-0.3% of the previous day's closing rate of the US$. The trading band for other currencies will be within a "certain range" of the previous day's closing rate. Analysts expect the new exchange rate arrangement will be roughly similar to Singapore's rule-based basket regime.

In the weeks following the initial announcement, central bank officials, while not providing the precise weighting of each currency in the basket, surprised traders by indicating it *could* include the currency of any country that trades more than US$10 billion with China; this suggests the basket could include an array of currencies far wider than initially presumed. It could include not only the US$, ¥, and €, but also, potentially, the Korean won (KRW), Singapore $ (SG$), British £, Malaysian ringgit (MYR), Australian $, Canadian $, and Thai baht (THB). Official statements did not mention the HK$ or Taiwan $, perhaps for political reasons, but considering China's high degree of trade with these regions, it is reasonable to expect they will be included as well.

Does it Portend Additional Increases in the Future?

Pundits are nearly unanimous in predicting China will further revalue its currency in coming months. Indeed, Chinese officials have suggested as much by characterizing July's move as an "initial step," though they have also tried to dampen expectations by stressing the need to keep the currency stable. The forward markets currently expect the RMB to further appreciate 4.8% versus the US$ over the next 12 months, while our sense from reviewing Wall Street research is that the consensus expects the RMB to appreciate an additional 10% over next 12 months. Over the longer term, the RMB is generally expected to appreciate substantially. Bridgewater Associates, for example, expects that in order to balance inflation and economic growth, the currency must appreciate 25% to 30% against the US$ over the next three years, and 60% over the next decade.

Before July's move, many analysts believed China needed to revalue its currency by 15% to 25%. According to them, a move of this magnitude would be necessary to bring the RMB closer to fair value, lessen economic imbalances, and relieve speculative pressures within China, as well as avert protection measures in the United States.

How Will U.S. Interest Rates be Affected?

The RMB revaluation could reshape the forces that have kept U.S. interest rates so low in recent years. The specific weightings of the currency basket will determine how the attendant effects on U.S. bond yields, the greenback, inflation, and the current account deficit will play out over time. The PBOC will diversify into other currencies; the question is how much will its demand diminish for U.S. Treasuries.

A few pundits are not terribly worried that China will cease intervening heavily in foreign exchange markets. Stephen Jen, Morgan Stanley's currency strategist, for example, estimates that based on the proportion of trade and foreign direct investment, the greenback could make up about 43% of the basket. According to his schema, including "hard US$ pegs" (MYR) and "soft US$ pegs" (¥, SG$, KRW), currencies that are closely linked to the greenback could account for about 75% to 85% of the RMB's new currency basket. Clearly, China will continue to intervene heavily in the foreign exchange market to keep its currency relatively stable against the US$.

Others believe several pressures will push U.S. bond yields higher, probably considerably. First, Chinese demand for U.S. Treasuries and other US$ assets will fall substantially, they argue. Second, the weaker US$ will provide some stimulus to the U.S. economy, which could incite higher inflation and induce the Fed to raise policy interest rates. Third, faced with an increase in overall uncertainty, financial markets and buyers of long-duration assets will require higher compensation—that is, higher interest rates—for taking on added risk. Several pundits are chiefly concerned that rising import costs will fuel inflationary pressures in the United States, which in turn will boost nominal interest rates by increasing the inflation premium.

Others envisage an endgame with dire consequences. Bridgewater, for example, believes the revaluation marks the beginning of a US$ crisis. According to its analysis, the "self-destruction" of the Asian dollar-based monetary system, whereby countries had maintained a quasi-peg to the greenback in order to remain competitive relative to China, will sharply curtail their demand for US$. If Asian central banks slow their pace of buying US$s, the greenback will sell off; if they sell the US$, the consequences will be "devastating." In fact, the odds of a "US$/U.S. debt crisis" in the next 12 months have risen to about 50%, Bridgewater believes.

How Will China's Economy be Affected?

Pundits are nearly unanimous in agreeing that the revaluation will help China's economy. On the surface, this assessment seems to run counter to economic theory, which states that the appreciation of a country's currency acts as a drag on economic growth, similar to the effects of higher interest rates. China watchers do not see events unfolding this way.

Many economists who have worried that China's economy had been slowing prior to the revaluation, are optimistic that the repegged exchange rate will revive it. In their view, the RMB's higher exchange rate should ease domestic commodity inflation because most commodities, particularly oil, are priced in US$. Lower input prices should relieve the profit margin squeeze that afflicts much of the manufacturing sector. Pundits also downplay the potential negative effect of a higher exchange rate on Chinese exporters, because most rely on imported inputs, which can now be obtained at lower cost. Moreover, diminished trade friction with the United States will also open markets. Should the RMB begin to hurt the economy, pundits argue, Beijing will quickly respond by easing fiscal policy, lowering interest rates, and/or loosening administrative controls. Conversely, economists who believe China's economy is currently running too hot expect the revalued RMB to reduce the need for a significant upward adjustment in domestic interest rates.

Over the longer term, pundits believe, the RMB's higher exchange rate should help rebalance the economy, helping to facilitate the shift from an export-dependent economy to one that relies more on domestic consumption.

There may be a couple of potential negatives about the RMB revaluation. First, it is possible that foreign investors will worry that the RMB is on the verge of a secular appreciation which could undermine China's global competitiveness. This sentiment has yet to appear, but it will be important to monitor flows of foreign direct investment in order to determine whether it develops into a major trend. Second, the bulk of China's nonperforming loans are denominated in *yuan*,[1] which the revaluation suddenly made more expensive and burdensome. Some economists worry that the revaluation will heighten the vulnerability of state-owned banks and incite capital outflow. Liberalizing capital outflows could cause many Chinese savers to switch part of their portfolio to a foreign country, in order to avoid holding money in Chinese banks if and when a financial crisis arrives.

How Will the Rest of Asia be Affected?

The RMB's regime shift will almost certainly encourage the appreciation of other Asian currencies. Indeed, July's move prompted Malaysia to abandon its fixed peg foreign exchange rate regime in favor of a managed float, "based on economic fundamentals," probably against a trade-weighted basket. Malaysia's central bank will "monitor," rather than target a trade-weighted index, which will, in principle, allow it considerable discretion, which differs from Singapore's regime.

Many China watchers downplay the likelihood that the RMB revaluation will initiate a meaningful currency realignment throughout Asia. They see higher exchange rates throughout the region as an overall positive because they will reduce the pressure to raise domestic interest rates, which will reinforce the expansion of domestic demand.

[1] The RMB is the currency used for foreign transactions, while the *yuan* is the domestic currency. The *yuan* is tightly controlled with strict capital controls and is not freely convertible.

How Will Equities be Affected?

Perhaps predictably, the revaluation was interpreted as an unambiguous positive for equities throughout the region, whether developed or emerging. Japanese equities should benefit from the reduction of risk of a hard landing for China. Hong Kong equities should benefit, because the PBOC will presumably purchase HK$, which should lower interest rates and encourage capital inflows. For Asia as a whole, the RMB revaluation has reinvigorated analysts who have been bullish on equities that will benefit from asset reflation and higher consumer purchasing power.

What's our Take?

While optimistic about the longer-term prospects of Asian economies and equities, we find ourselves unable to share in the veritable love-fest about the consequences of the RMB's revaluation. We take a more sober view, recognizing that Chinese equity investors will confront setbacks and volatility along the way. Over the shorter term, the greater threats to China's economy may be from pressures that were already in force before the revaluation occurred: narrowing profit margins among much of the industrial sector, as well as the possibility of overcapacity among certain industries which could drive down global prices. We also worry that the revaluation will at some point trigger a beggar-thy-neighbor reaction among regional currencies, though this has not occurred thus far.[2]

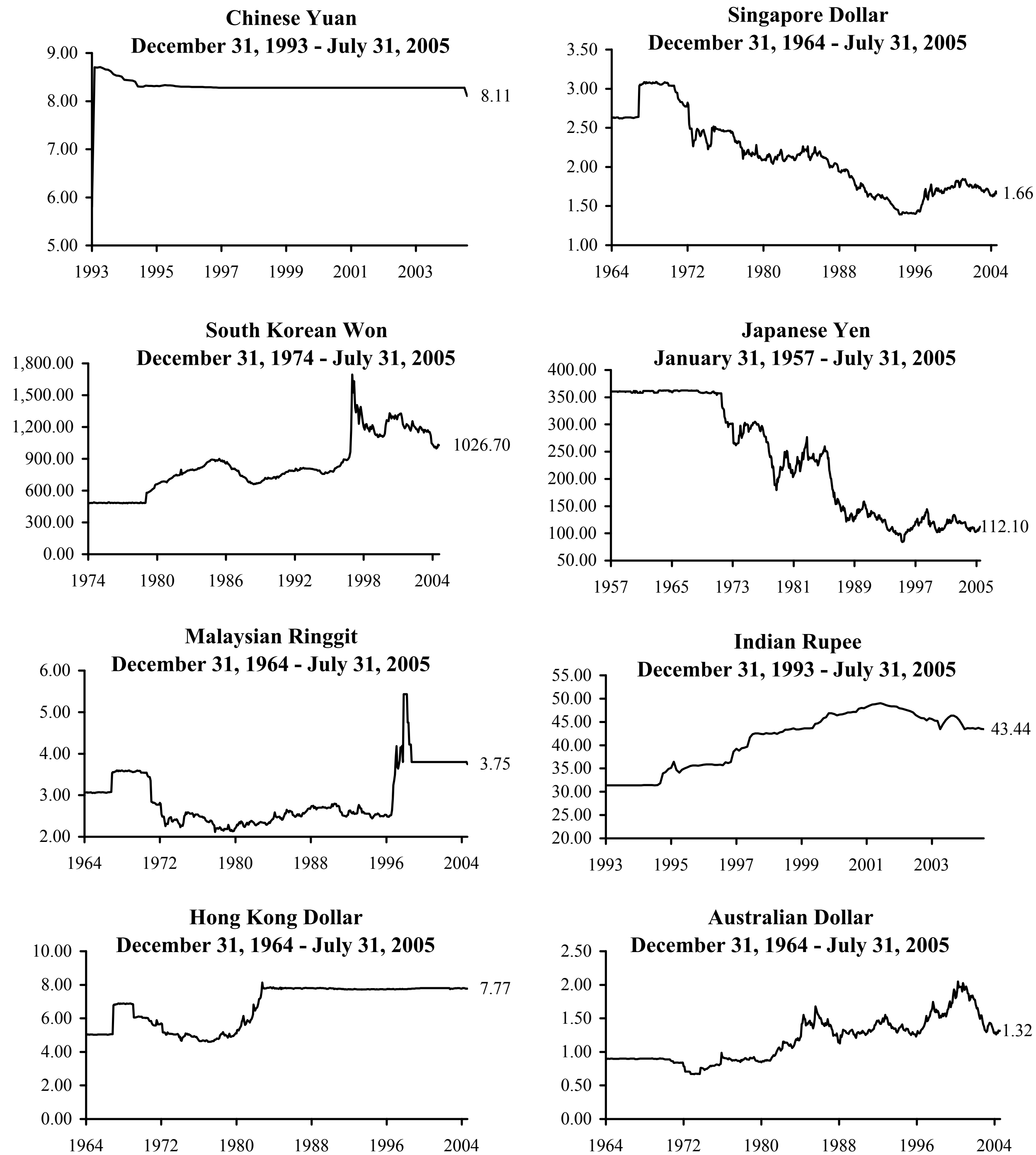
While from a secular view, the revaluation may mark the first of additional increases in the RMB and depending of financial reform, over the shorter term its appreciation is by no means inevitable. Indeed, in the early weeks following the July 21 announcement, the RMB's activity has been quite muted, appreciating to only 8.10/US$ (0.12%) by August 24.

The potential consequences for the U.S. economy are indeed worrisome, and we continue to believe the greenback is in the midst of a long-term secular decline. However, the apocalyptic scenario of an imminent US$ crisis is not our base case. Major central banks have a vested interest in keeping their exchange rate to the US$ stable, though diversifying away from the greenback and into other currencies suggests a reduction in demand for U.S. Treasuries and other US$-based assets. Even a marginal decrease in demand could pressure the US$'s exchange rate and usher in higher interest rates.

[2] While the RMB's revaluation, the Indonesian *rupiah* has depreciated 4.8% to a three-and-one-half-year low against the greenback, it had been falling prior to China's move as well.

Table A

EXCHANGE RATES OF ASIAN CURRENCIES AGAINST THE U.S. DOLLAR



Source: Thomson Datastream.