Has China Re-pegged The Yuan?

When those awful stories about thousands of dead hogs floating in the Shanghai River started to hit the wires last week, I thought to myself, "Well at least they float freely; that is more than I can say about the yuan."

The world's major currencies have been on a bit of a roller-coaster ride since Japan decided the way to enrich its citizens was to create inflation at home and reduced purchasing power for imported goods. Consider the following high-low ranges for selected currencies since November 14, 2012:

- Euro: 0 – 7.1% for a 7.1% range;
- Canadian dollar: -5.0 - 2.1%; for a 7.1% range;
- British pound: -5.8 – 2.8%; for an 8.6% range;
- Australian dollar: 0.3 – 2.1%; for a 1.8% range;
- Japanese yen: -20 – 0% for a 20% range; and
- Chinese yuan: -0.4 - .2% for a 0.6% range

The yuan itself belongs in the Rock and Roll Hall of Fame compared to the range of the Shanghai interbank offered market's forward rate ratio between six and nine months ($FRR_{6,9}$) over this period. This is the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is. Its range since November has been 1.0721 to 1.0753. The USD $FRR_{6,9}$ has ranged from 1.4894 to 1.5293 over the same period.

We can get similar evidence of flat-lining from the implied volatility of three-month yuan forwards; that range has been 1.345% to 1.975%. The euro's volatility range over the same period has been 7.095% to 9.375%. I should add the yuan's implied volatility has been on the order of one order of magnitude lower than those of other major currencies since 2006; the demand for price insurance against a currency whose movements are controlled so tightly is justifiably absent.

All Interests Are Served

Everyone is free to believe in Santa Claus, the Tooth Fairy, governments acting in the interest of the mythical Little Guy or things happening by happenstance in the currency market. I choose otherwise. The facts fit the conclusion a grand currency deal took place last November. Japan wanted to weaken the yen, and China gave the nod in return for the U.S. acquiescing to a cessation of the yuan's revaluation. Everyone wanted to see the euro firm, and lo and behold many of the freshly printed yen went into European fixed-income markets. Everyone could be pleased with their handiwork.

In addition, China has regarded Japan's decision to allow the yen to firm in the 1980s as their first step on the road to their two Lost Decades. They would be more than willing to help finance the portion of the U.S. deficit not going straight onto the Federal Reserve's balance sheet to achieve this aim. The U.S. in turn welcomed a cheaper yuan to offset the dent in consumer income resulting from the cessation of the 2% FICA tax holiday; ask our friends at Wal-Mart whether their customers felt that pay cut in the light of rising inflation.

At the end of all this, the 40-year era following the collapse of the Bretton Woods fixed exchange-rate system between 1971 and 1973, an era inaptly named the floating exchange-rate era, has come to a close not with a bang but with a whimper. We are living in its replacement, an ad hoc patchwork of closed-door arrangements defying the first of Woodrow Wilson's Fourteen Points, paraphrased as open covenants openly arrived at, "…after which there shall be no private international understandings of any kind…"

This is what happens when the world's primary issuer of reserve currency also is the world's largest debtor and when the world's largest creditor will not allow its currency to be fully convertible. All of these little side deals will work, if we define "work" as producing nominal financial market gains, until the minute they fail in a catastrophic accident.