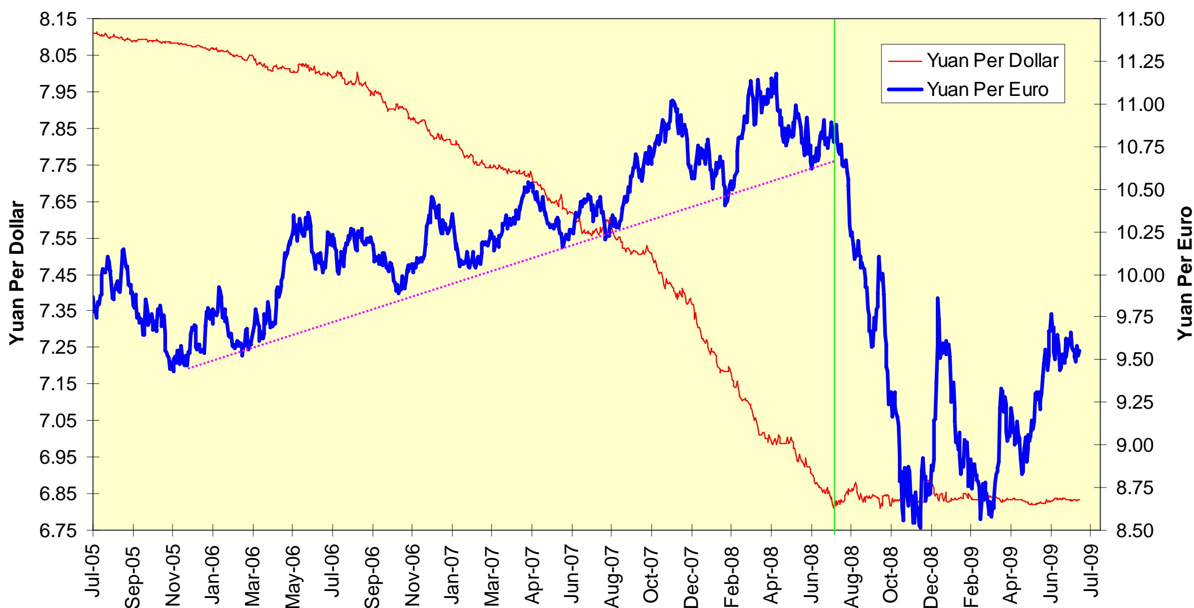
The Yuan Re-Pegging One Year Later

As I mentioned last Wednesday, the re-pegging of the yuan is one year old. As birthday cake seems inappropriate, I thought I would update a column I wrote last September just before the dam broke on the re-pegging. I noted with irony then and with even greater irony today given my comments on purported manipulation in the crude oil market this was one instance where I was prepared to toot the whistle on a closed-door deal. One Hank Paulson was involved, so I feel a little bit better about being suspicious.

Three Currencies, Two Rates, One Peg

A fellow trader said to me back in the spring of 1987 when everything in the world appeared linked to the Japanese yen, "The yen's not even a market." Naturally, my curiosity was aroused. He went on to point out the discontinuous nature of yen movements, its statistically different distribution of returns, its propensity to trend when other currencies were static and vice-versa. He was right; for the longest time during the 1980s, the yen went pretty much where the Japanese authorities decided it would go and no further. I always envisioned a wiretap of the Bank of Japan and the Ministry of Finance being as frustrating to listen to as a wiretap of a wily don: Everything would be said with a facial expression or some meaningless-sounding comment, and heaven help those who failed to understand.

Now let's look at the yuan per dollar and yuan per euro exchange rates from the July 2005 decision by China to allow a managed revaluation of the yuan. It kept getting stronger and stronger in such a linear fashion that even the most obtuse trend-followers had a chance of getting it right. Then on the Fannie Mae weekend in July 2008, marked with a green vertical line here and elsewhere, the CNY per USD rate took a hard right turn. To paraphrase my friend, markets do not do that.



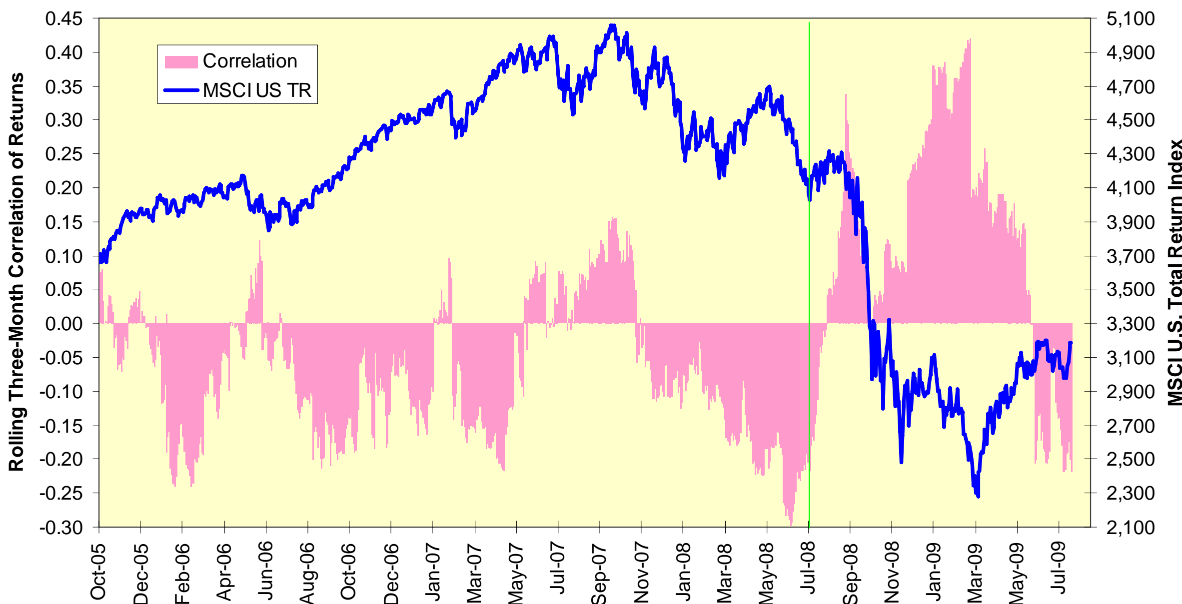
However, the CNY per EUR rate looks very much like a market. The yuan had been weakening steadily against the euro along the superimposed dotted trendline and then broke to a much stronger rate by the November 20, 2008 date of Tim Geithner's nomination to be Secretary of the Treasury and a $300 billion backstopping of Citigroup. As an aside, if I were writing this for a movie script I would change the dates away from such obvious markers just to sound more authentic. But one Tim Geithner was involved, so I feel a little bit better about being suspicious.

It is hard to look at the chart above and not conclude the yuan's rate against the dollar has been through two controlled regimes while its rate against the euro has been allowed to look like a market.

Equity Market Linkages

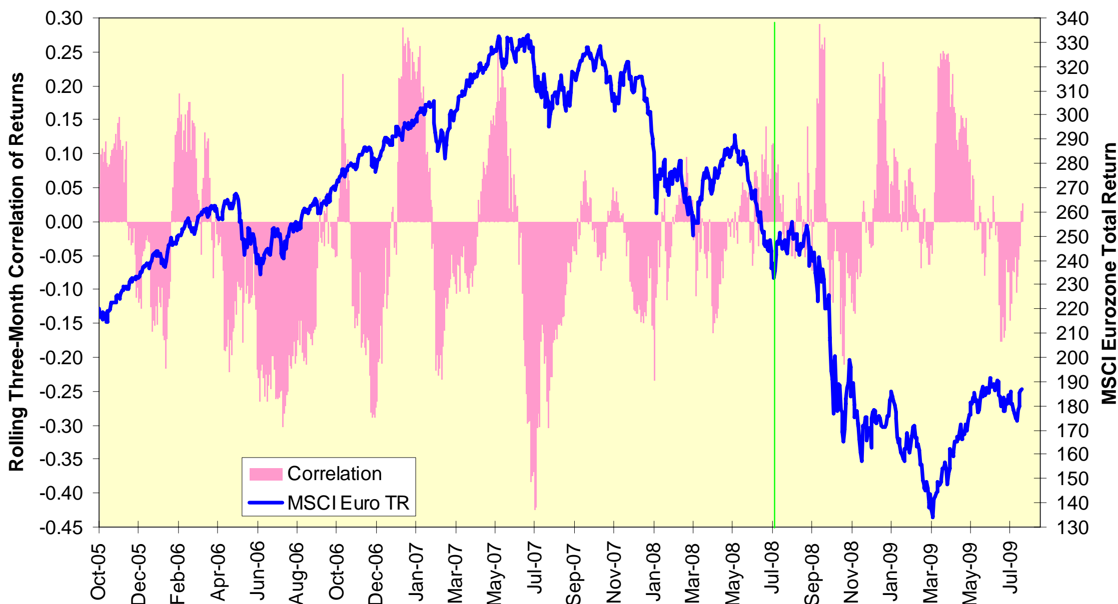
The rolling three-month correlation of returns between the yuan and U.S. equities as measured by the MSCI U.S. total return index had been negative for nearly all of the 2005-2008 period. Once the yuan was re-pegged, some very strange statistics allowed this correlation to become positive moving into the March 2009 lows. It has now become negative once again, but given the very confined range in which the yuan is being allowed to move, we probably should not attribute much causality to this relationship at present.

The Yuan And U.S. Stocks Negatively Correlated



We can reach a totally different conclusion by comparing the MSCI Eurozone total return index to the yuan per euro rate. Here the rolling three-month correlation of returns moves about erratically, which is what we should expect from a market.

The Yuan And Eurozone Stocks Are Correlated Erratically



We Have Each Other *Where?*

The mutual interdependence between the U.S. and China, remarked upon heavily prior to the onset of the credit crunch two years ago, remains an unresolved problem. We had carped incessantly at China to allow for a stronger yuan despite the implicit tax this would impose on buyers of China's exports. They acquiesced until they realized their massive dollar reserves, now over $2 trillion, were a huge liability: They had to finance our deficits and by

implication our various bailouts and schemes to maintain their export engine. Moreover, investing that amount of money is serious work, and only the U.S. can provide an outlet for their accumulated funds.

Our capital surplus has been a dangerous crutch indeed. Not only has it kept our interest rates well below where they might have been otherwise, but it has required us to maintain a current account deficit and to continue losing our manufacturing base.

Both sides would be better off ending this dual manipulation (did I just use the M-word?), allowing the yuan to revalue and working to end the massive structural imbalance across the Pacific. Failing once is one thing, but failing twice at the same thing is well-nigh inexcusable. To paraphrase Ronald Reagan from that long-ago 1987 era, “Mr. Geithner, tear down this wall!”