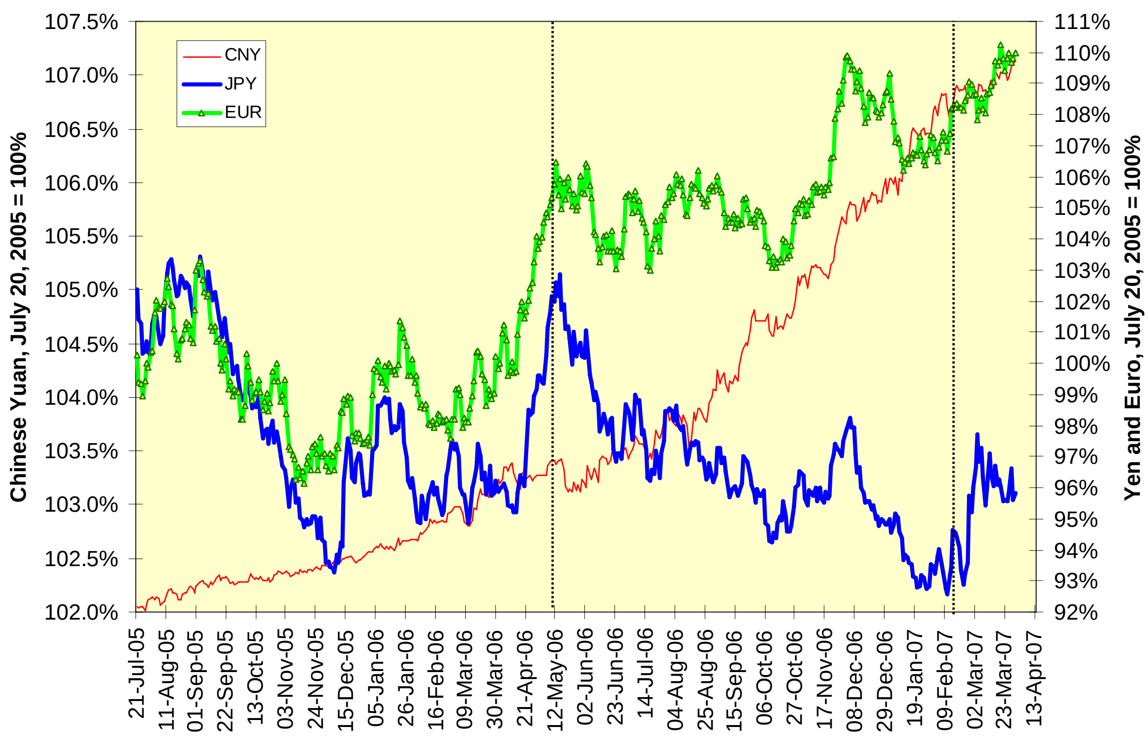
Protectionism And The Yuan

The unfortunate decision by the Bush administration to impose countervailing import duties on coated paper imports from China did not pass without comment from yours truly in a Columnist Conversation posting. But, thought I, *RealMoney* readers deserve more than an unsubstantiated rant; Lord knows we have enough of that in today's world. We need to step back and assess how the world has looked before and after China's decision to let the yuan start revaluing on July 21, 2005.

First, please note how I said "revalue" and not "float." The yuan is still a managed currency, not a freely floating one. If we index it, the yen and the euro back to July 2005, we see how both the yen and the euro rise and fall; I added vertical markers in May 2006 and February 2007 to note the two credit-tightening decisions by the Bank of Japan. The yuan has appreciated 7.1% over that period, while the euro has appreciated 10.0% and the yen has depreciated 4.2%.

Comparative Currency Strength After Yuan Peg Loosened



Is a managed currency synonymous with currency manipulation? No; let's be candid: Ever since the 1971 Smithsonian Agreement broke fixed exchange rates, all countries have used currency manipulation as an instrument of national policy. The U.S. has been one of the worst offenders in this regard, particularly during the 1985-1987 period when the dollar was devalued deliberately in hopes of reducing the American trade deficit. How did that one work?

China's trade advantages derive only in small part from the yuan. Their labor is cheaper and in many cases is thought to border on quasi-slavery. Their banks have ready access to the foreign exchange reserves of the Peoples Bank of China; think of this as the world's largest no-documentation loan. Their environmental regulations, worker safety protections and health care are non-existent by standards prevailing elsewhere in the industrial world. As China has newer plant and equipment, they enjoy the benefits of the latest technology. American class-action lawyers would be handed a blindfold and a cigarette if they tried to operate in China as they do in the U.S., and the country's abuses of global intellectual property are legion.

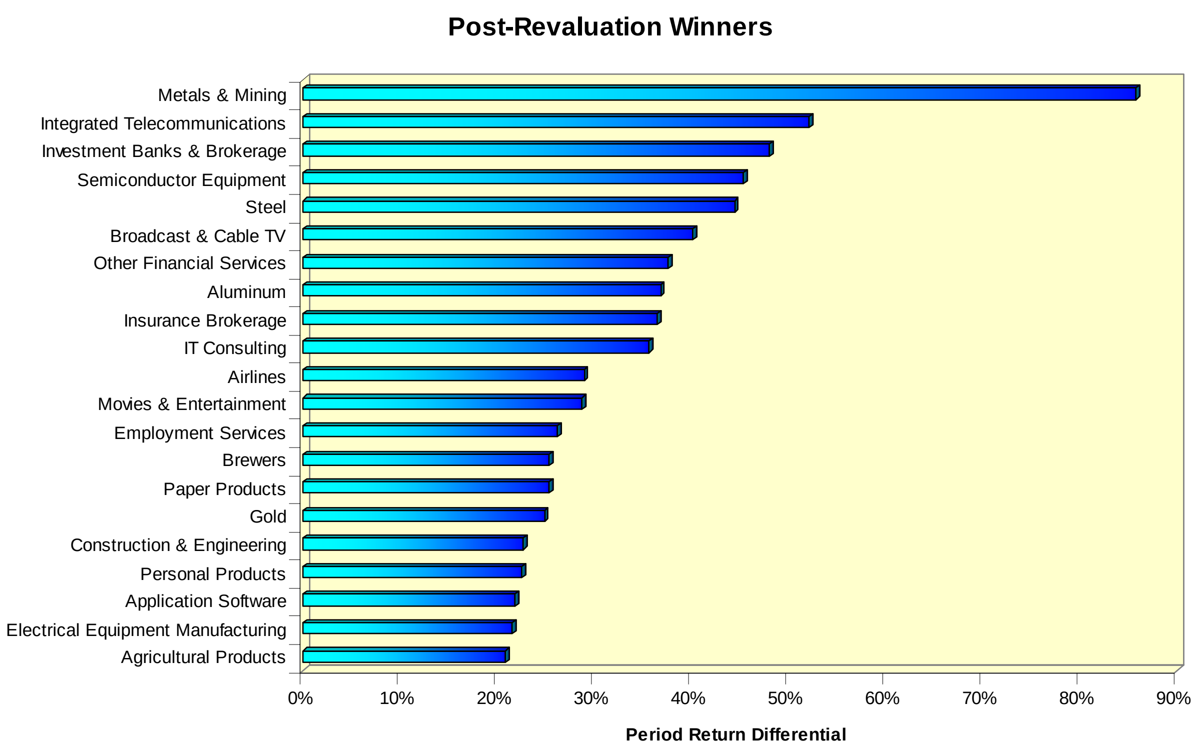
And we are worried about the yuan giving them an advantage? Get serious; a 5 or 10 percent revaluation would not even scratch the paint on their trade advantage. It would, however, represent a direct tax on the American buyer of those goods with absolutely no assurance it would result in a restoration of American competitiveness for the reason enumerated above. Moreover, the probability of their government and ours being able to manage the manipulation effectively is near zero. That 1985-1987 episode mentioned above was agreed to by the major central banks of the day; it led directly to interest rate manipulation and to the 1987 stock market crash. You can manage an exchange rate or you can manage interest rates, but you cannot manage both simultaneously.

Oh, before I forget: Who was the alleged miscreant in the 1980s? Why, it was Japan. They were going to take over the world, regarded business as war, spouted something called Theory Z, had a corporatist society, and they did calisthenics in the morning and sang the company song. That was before they entered their Lost Decade, now in its seventeenth year.

Winners And Losers

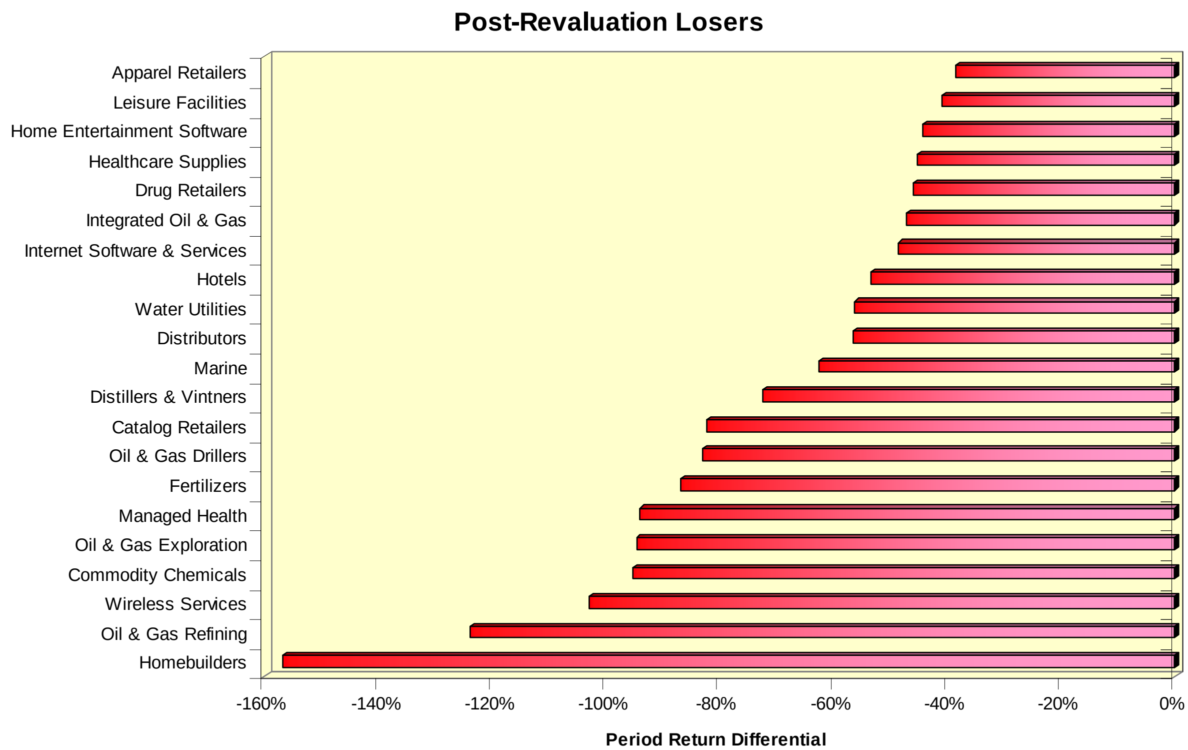
Now let's assess the yuan's 7.1% appreciation since July 2005 on an industry-by-industry basis? The S&P 1500 Supercomposite (SPR), which presently has 129 active industry groups, will serve as the data set. We will compare industry returns on two equivalent periods of time, November 3, 2003 to July 20, 2005, and from July 21, 2005 to March 30, 2007. The total returns for the SPR over those two periods were 21.785% and 19.965%, respectively.

The chart of industries whose period total return differential was 20% or higher after the yuan revaluation began is presented below. Study the list carefully while asking yourself the question, "Which of these industries benefited from a stronger yuan?"



Was it Metals & Mining, which benefited from China's growth, to be sure, but also from industry consolidation and mergers? Other commodity-related winners include Steel, Aluminum, Gold, Paper Products and Agricultural Products. The rest of the list is dominated by technology-related and intellectual value-added business; the latter category includes Investment Banks, Insurance Brokerage, IT Consulting and Employment Services. If there is a plausible case any of these industries benefited from a stronger yuan, I am incapable of making it.

If we look now at a same-sized list of groups whose total returns fell by 39% or more over the period, we find it is dominated by the oil-related groups, by an odd assortment of specialized retailers and a number of healthcare-related industries.



Once again, study this list and ask yourself who therein was hurt by a stronger yuan. The only plausible answer would be the various retailers who might rely on Chinese suppliers, but in the absence of more detailed information, we really cannot come to a definite conclusion.

The only conclusion we can come to is engaging in protectionism is playing with fire. Our current bilateral trade deficit/capital surplus with China now exceeds $20 billion a month with regularity. Those imports by definition are arriving because someone prefers them to goods and services produced domestically for any number of reasons, price included. Until and unless we know a higher goal can be served by raising the price of these imports arbitrarily, let's not impose a deadweight tax on them.