One Yuan Yawn

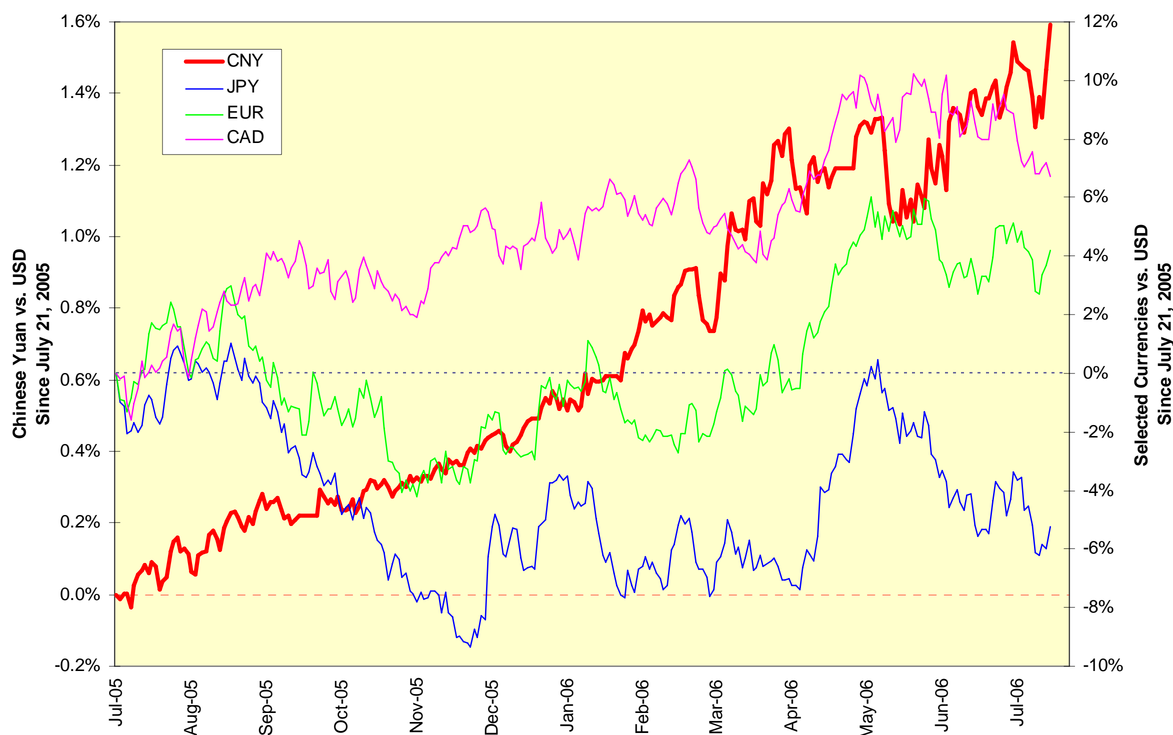
Have you ever done something just to shut someone else up? Of course you have, and that puts you in the company of the People's Bank of China (PBOC) even though you do not have Senator Charles Schumer (D., NY) yapping at your heels. It was one year ago at the end of last week that the PBOC announced in a muted and confused manner that would free the yuan (CNY) from its rigid trading band.

The news was not greeted warmly by the American bond market. Yields on ten-year Treasuries climbed from 4.158% to 4.276% on July 21, 2005. The Japanese yen (JPY) rallied sharply that day, too, climbing from 112.90 to 110.26.

The presumption in both cases was the Chinese revaluation was going to change trans-Pacific trade and financial flow patterns. The bond selloff was premised on the idea U.S. rates would have to climb to finance our trade deficit; broken clocks are right two times a day more than this claim. A secondary notion was consumer prices would rise as Chinese exports would now be priced higher in dollar terms. The JPY rally was premised on the notion the Japanese would have less reason to buy American bonds or otherwise intervene in the currency market to suppress the JPY.

Some, present company included, wondered whether a more liberalized CNY regime would result in a falling CNY as the various hot money speculators who had piled into China in anticipation of a revaluation would leave if the currency failed to appreciate immediately. That has yet to happen. If we compare the movements of major currencies against the U.S. dollar over the past year, we see how the JPY has fallen, the euro both fell and rose, in that order, and the Canadian dollar (CAD) continued its multiyear ascent against the greenback. The CNY has risen, in a near-linear manner, a whopping 1.6% over the past year. That's not a revaluation, that is a token ascent. Other major currencies have traded in a wider range in a single day.

Which One Is Not Like The Others?

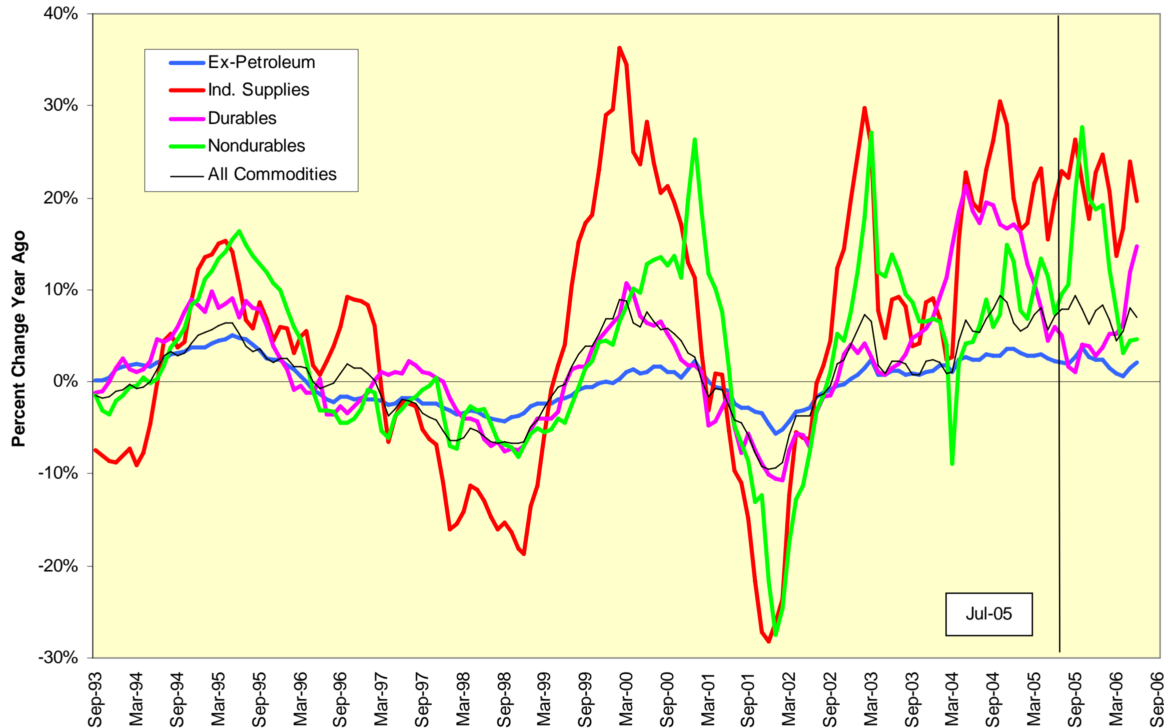


Import Prices

The concern about import prices was real. The U.S. and others effectively had been importing disinflation in the form of cheap Chinese exports. A stroll down the aisles of Wal-Mart or nearly any other retailer of significance will tell you just how important Chinese exporters have come to U.S. consumers. A similar process is underway in

manufactured goods. The record to-date for broad sector import prices reveals little CNY impact. On a year-over-year basis, the rate of price increase for durable goods has accelerated, but the rate of change for imports of nondurable goods has plunged, and import prices for industrial supplies, all goods ex-petroleum and all commodities have seen no impact at all. We can conclude Chinese exporters are doing the same thing Japanese exporters did in the 1980s, and that is absorb their modestly stronger currency in their margins.

Yuan Revaluation And Import Prices



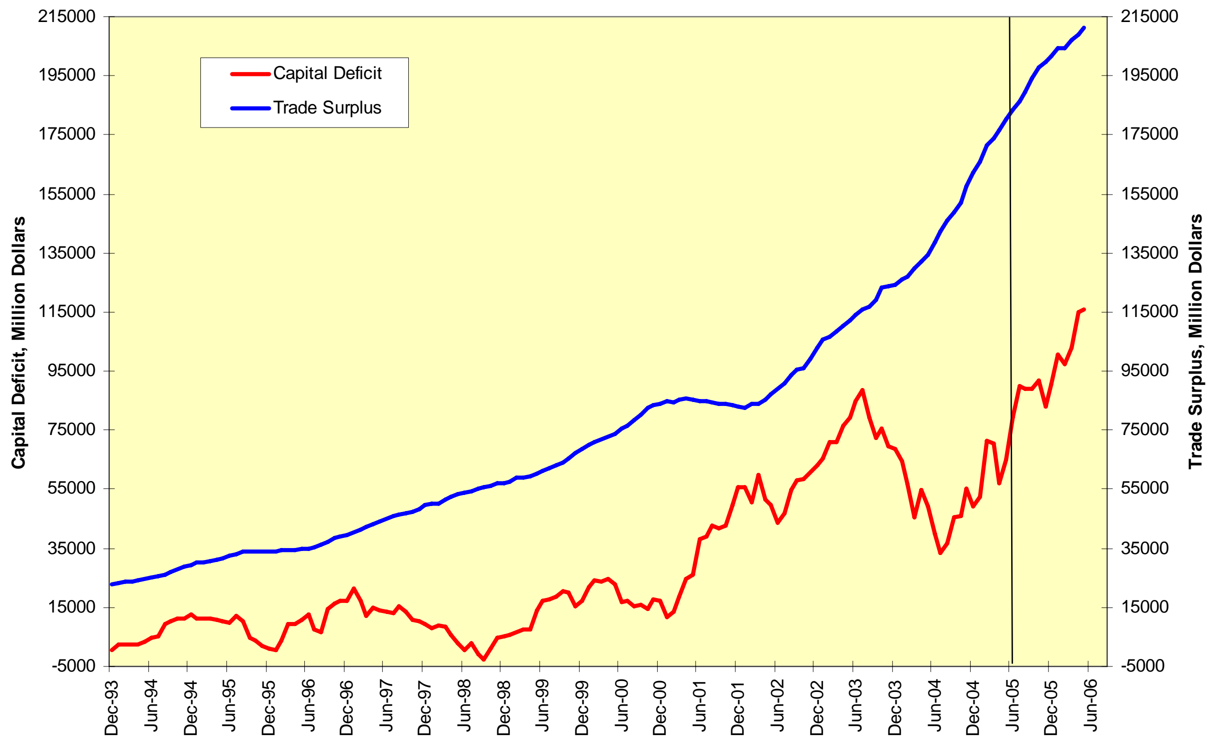
Capital Flows

Each and every month the Treasury Department (motto: When the boss calls, get his name) releases a report on international capital statistics. And each and every month various semi-educated commentators troll through the entrails to pronounce whether foreign investors are buying enough American securities to finance our current account deficit. That's so cute. This is an accounting identity; over any length of time the American capital surplus must equal its current account deficit. If not, our current account deficit would have to shrink to the vast detriment of foreign exporters.

Mind you, dollars pumped out into the global economy to pay for imports do not need to reclaim American securities that month, nor do they have to be repatriated from the exporting country. China's trade surplus today may get swapped into yen to pay for Japanese exports to China, which may get swapped into Australian dollars to pay for coal, which three months later might end up in Eurodollar deposits on the books of an American bank branch in the Caribbean.

Comparing China's capital deficit with the U.S. to its current account surplus with the U.S. is an inexact science. They will match only by accident. What is important is someone, somewhere and sometime claims U.S. assets with those dollars. Moreover, the trends of the two series are of interest. Between July 2005 and May 2006, the last data point available, the twelve-month rolling sum of China's trade deficit with the U.S. grew by 25.4% while its current account surplus grew by 12.5%.

If anything, Chinese investors found U.S. securities more, not less, attractive after the decision to revaluate the CNY was made. But don't worry: The forever-wrong worrywarts will sniff that the rest of the world will cease financing their best customer at the next available opportunity.



Yes, long-term interest rates in the U.S. increased by 18.8% over year-ago levels. Was this due to the 1.6% firming of the CNY over the past year or to numerous other factors? Let's be bold and say the CNY had little to do with the upturn in U.S. interest rates over this period.

The PBOC has given no indication it is about to change its policy of allowing a gradual revaluation. And being the central bank of an authoritarian state, they have only one master, and Chuck Schumer is not on that list. The CNY's ascent will continue to be a yawner, and for that the world can be grateful. The Federal Reserve, European Central Bank and the Bank of Japan all have had their problems managing both interest rates and their respective money supplies. China has given us one less reason to worry.