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China's Huge Currency Reserves Pique U.S. Interest

Senators are taking the Middle Kingdom at its word that it intends to move gradually toward a more flexible exchange rate regime

Just how big can China get? For one thing, it looks as if the Middle Kingdom may now have greater foreign-currency reserves than any other country. On Mar. 28, the state-run *China Business News* reported that the mainland's reserves hit $854 billion in February, outstripping Japan's reported stockpile of $850 billion.

Although China's central bank declined to comment on the report, it's sure to push the mainland's currency policies even further into the spotlight. After all, China's swelling foreign reserves are a direct by-product of all those sneakers, DVD players, and bedroom sets that consumers worldwide -- and especially in the U.S. -- can't resist buying. One reason they look so attractive is their low price, something many in the U.S. blame on an undervalued yuan.

That served as the focus of the visit to Beijing last week by U.S. Senators Charles Schumer and Lindsey Graham. The pair is proposing a 27.5% tariff on all Chinese exports to the U.S., and has threatened to force a vote on the issue in the Senate by Mar. 31 unless Beijing starts to allow the yuan to move toward its real market value. Currently, the yuan trades at around 8.0275 bid vs. dollar.

PROMISED FLEXIBILITY. Against the backdrop of a record U.S. trade deficit -- the U.S. bought $202 billion more from China than it sold to the mainland last year -- the dollar-yuan exchange rate will be much discussed during the lead-up to Chinese President Hu Jintao's April visit to Washington. The release, also in April, of the semiannual report from the U.S. Treasury on the currency policies of trading partners will also occupy people's minds. It could potentially label China a "currency manipulator," which would lead to tariffs on Chinese goods.

China moved to a managed float last July, revaluing the dollar-yuan rate by 2.1% on abandoning a decade-long peg to the greenback. Beijing has promised to move gradually toward greater flexibility, but has allowed the yuan to appreciate only about 1.1% vs. the dollar since then, and has ruled out another one-off revaluation.

Officials insist they need more time to establish the foreign-exchange market infrastructure after they launched, in January, over-the-counter trading by 13 foreign and domestic banks designated as market makers. The central bank, the People's Bank of China (PBoC), has also begun to conductforeign-exchange swaps with major commercial banks.

GOOD COP, BAD COP. The U.S. is demanding that Beijing speed the process. Washington argues that the appreciation since last July remains insufficient. The senators were reasonably diplomatic -- Schumer emphasized that they were not looking for a timetable or specific goal, but wanted to be convinced that China is moving toward letting the currency float. And Graham indicated that they came away with a better sensitivity to China's problems, such as unemployment. Though still noncommittal, they hinted that any vote on the bill would be delayed for at least a month, until after Hu's visit.

No doubt, a good deal of posturing continues to go on. Although opposed to the protectionist tariff, President Bush presumably does not mind playing the good cop, bad cop game in an effort to wrangle some concessions from Beijing -- a stance that ironically takes on added credibility after the Dubai fiasco (you see, President Hu, I would veto the bill, but Congress would override it). Furthermore, this is just one part of a multidimensional trade negotiation with a host of other prominent issues on the agenda, including intellectual property protection.

Along with many economists who oppose protectionism, numerous business leaders have expressed concerns about the proposed tariff, emphasizing the importance of world trade to the U.S. economy. Congress must be aware of the structural problems in the savings-short U.S. economy -- and how a tariff might derail what has been a fairly healthy economic expansion financed with foreign capital.

MORE MOVEMENT. Though it is difficult to foresee how the politics will play out in this election year, we at **Action Economics** remain hopeful that cooler heads will prevail, taking the Chinese at their word that they fully intend to move gradually toward a more flexible exchange-rate regime, including efforts to phase out convertibility restrictions on the capital account over the next five years.

China is proceeding at its own pace in permitting more movement in response to market forces. The PBoC has pursued foreign-exchange intervention to limit yuan appreciation in the face of a widening current account surplus and continued strong capital inflows, reflected in the buildup in international reserves. The increase by $34.8 billion during the first two months of 2006 was in line with the annual increases of $209 billion for 2005 and $207 billion in 2004 (exceeding the accumulation by Japan, which hasn't intervened in currency markets for the past two years).

Upon abandoning the formal peg to the dollar last year, Beijing indicated that it would reference movement in the yuan against an unspecified basket of currencies. When measured against these currencies weighted by their share of total Chinese trade, the yuan has trended sideways for much of this year, hardly the sort of appreciation that would put a dent in its balance-of-payments surplus. This compares with the appreciation by approximately 8.5% during 2005, over half of which came on the back of the strong performance by the dollar, which also appreciated vs. the Chinese basket of currencies.

RECENT VOLATILITY. Throughout the period, the yuan index is seen moving in tandem with the dollar index (the green curve, which roughly parallels the dollar index compiled by the Atlanta Fed). This reflects how, except for the revaluation last July, the dollar-yuan exchange rate has been fairly steady day-to-day. This includes the constraint of the daily limit set by Beijing of plus or minus 0.3% in fluctuations in dollar-yuan, compared to the previous closing exchange rate announced daily by the PBoC.

The dollar-yuan has exhibited a bit more volatility during the past four weeks, a period when the dollar has been on a roller coaster vs. major currencies. Although some of the bigger daily gains in the yuan had market watchers wondering whether Beijing was relaxing its grip a bit to appease the U.S. Senators, on closer inspection it appeared that some of these bigger moves had come on days of big swings in the dollar in worldwide markets -- when Beijing might have tolerated more movement in dollar-yuan to limit the swing vs. the overall basket.

Our projection would be for Chinese officials to tolerate continued gradual appreciation of approximately 5% over the course of 2006, after finishing with 2.6% appreciation vs. the dollar during 2005. This is hardly as dramatic as the 50%-plus appreciation of the Japanese yen after the 1985 Plaza Accord. There is no need to widen the daily trading band -- by simply allowing the full 0.3% per trading day, the yuan could appreciate by around 20% during a single quarter. Beijing appears content to continue the current policy of gradual currency appreciation.

POSSIBLE COMPROMISE. U.S. policymakers must recognize that China does not respond well to threats. At the end of the day, Beijing's speed of currency adjustment will depend upon what risks officials see from continuation of the current trajectory, and perceived benefits from stepping out of the way a bit more.

For example, would it be prudent to reduce exposure to international reserves so concentrated in dollar assets? Can potential difficulties in sterilization of foreign-exchange intervention compromise the PBoC's ability to conduct independent monetary policy? There are also benefits from currency appreciation in lowering import prices.

Conditions are favorable for pursuing greater flexibility given that the Chinese economy remains quite strong. The consensus outlook is for annual GDP growth to continue near 9% in 2006 after 9.9% in 2005, presumably able to withstand the disruptive impact of a strengthening currency. Maybe Beijing will proceed at a pace sufficient to satisfy the U.S. Congress.

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