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Economic Focus -- From Action Economics
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China's Washington Gambit

Hu Jintao will try to smooth over differences on his U.S. trip, but Beijing will continue to set its own pace for currency flexibility

Chinese President Hu Jintao's meeting with President George W. Bush in Washington on Apr. 20 will spotlight the relationship between two nations' currencies. Hu isn't expected to deviate from Beijing's often-repeated intention to move toward gradually increasing currency flexibility, but without another revaluation of the 2.1% magnitude announced last July. U.S. legislators and industry groups have stepped up political pressure for greater appreciation as a way to narrow the record $202 billion bilateral trade gap posted in 2005.

President Hu might be able to unveil a few sweeteners to soothe a restive Washington, including gestures toward intellectual-property protection, but the focus will be on the U.S. contention that China is deliberately depressing the yuan's value in order to make the country's exports cheaper.

Markets appear to accept that Beijing means what it says when it insists that further yuan flexibility will be carried out gradually. One-year non-deliverable forward (NDF) currency futures contracts imply a roughly 4% appreciation in the yuan to around 7.7 per dollar in 12 months.

MORE MOVEMENT. Upon abandoning the formal peg to the greenback last year, Beijing indicated it would reference movement in the yuan against an unspecified basket of currencies. When measured against a basket of 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 much of dent in the country's balance of payments surplus.

This compares with the fairly substantial appreciation by approximately 8.5% during 2005. Over half of this came on the back of the strong performance by the dollar, which also appreciated vs. the Chinese basket of currencies.

China is proceeding at its own pace in permitting more movement in response to market forces. Continued intervention in foreign-exchange markets by the People's Bank of China (PBoC) to limit the yuan's appreciation translated into accumulation of an additional $56.2 billion in Beijing's foreign reserves during the first quarter, showing no let-up from the pace that saw annual increases of $209 billion in 2005 and $207 billion in 2004.

RELAXING CONTROL. China's forex hoard has reached $875.1 billion, surpassing Japan with the world's largest stockpile of international reserves, and a major factor supporting U.S. Treasuries. This milestone can only heighten pressure on Beijing to permit more appreciation in its exchange rate, both in complaints from trading partners, as well as straining China's own capacity for monetary control.

Chinese policymakers insist they need more time to establish the country's forex market infrastructure, after launching over-the-counter trading by 13 foreign and domestic banks designated as market makers in January. The PBoC has also begun to conduct forex swaps with major commercial banks.

In another step in China's gradual move towards a market-driven exchange rate, which President Hu will be able to point to in Washington this week, Beijing last Friday announced it was relaxing capital controls, making it much easier for individuals and companies to buy foreign currency for financial investment abroad (raising the ceiling for individuals to $20,000 a year, from $8,000). Ironically, by creating additional demand for the dollar, this reform could actually ease market pressure for yuan appreciation generated by the Chinese trade surplus and investment inflows, and reduce the amount of official intervention to limit the yuan's appreciation vs. the U.S. currency.

CONGRESSIONAL ACTIONS. China risks becoming the focus of political attention through the U.S. Congressional elections in November, making it difficult for a politically-weakened Bush Administration to resist protectionist pressures. U.S. Senators Charles Schumer (D-N.Y.) and Lindsey Graham (R-S.C.) were reasonably diplomatic on their fact-finding visit to Beijing in March. They had threatened to proceed to a vote by Mar. 31 on their proposed 27.5% tariff on Chinese exports to the U.S. unless satisfied that Beijing was moving to allow greater appreciation toward market value in the yuan, but vote on the bill was delayed at least until after the visit by President Hu.

Before the end of April, the U.S. Treasury is scheduled to release its semiannual report on the currency policies of trading partners, where it could be obliged to label China a "currency manipulator," formal grounds for U.S. tariff imposition. That step could potentially activate a number of bills that are in the pipeline on Capitol Hill which would impose more restrictions on trade with China.

In a similar vein, a bill prepared for introduction by Senators Chuck Grassley (R-Iowa) and Max Baucus (D-Mont.) would increase pressure to officially chastise China for its currency policies. Under the proposed new rules, no intent would be required. Instead of using the term "currency manipulator," the Treasury would be asked to seek out "currency misalignments" and threaten specific sanctions, though far less Draconian than a 27.5% tariff. It remains difficult to foresee how the politics will play out.

STILL GROWING. Though the currency issue will top the agenda during Hu's visit, Washington can't easily push China beyond its comfort zone. One risk for the in pursuing a harder line is aggravating their second-biggest creditor, after Japan. China's ownership of U.S. government debt in January grew to $262.6 billion, or 12% of all foreign-owned Treasuries, up from $61.5 billion, or 6.1%, five years ago. At the end of the day, the speed of Chinese currency adjustment will depend upon what risks they see from continuing the current trajectory, and what benefits from stepping out of the way a bit more.

Conditions are favorable for pursuing greater currency flexibility, since the Chinese economy remains very strong and would presumably be able to withstand any potential drag from a strengthening yuan. China's gross domestic product release, due Thursday, reportedly will show first-quarter growth of 10.2%, year-over-year, up from 9.9% in the fourth quarter.

So far, there's little evidence of any let-up in the country's recent record of robust annual growth. Data through March suggest that the annual 2006 trade surplus should continue near the record $102 billion reported for last year. There are also benefits from currency appreciation in lowering import prices in the face of soaring global commodity prices.

In the end, recognition of their mutual dependency, both economic and political, may well keep both China and the U.S. from allowing differences over the exchange rate to poison their relationship -- one that's rapidly evolving into the most important in the world.