Nature has a way to self correct?

A major topic of debate on Capital Hill over the last few years has been the value of the Chinese Yuan (Chinese currency) and its peg to the US dollar. A peg means that the Chinese government has adopted a policy to maintain the movement of their currency in unison to the US dollar. Before I explain the importance and the repercussions of this policy on US trade, let me provide some background around US-China trade.

Communist to Capitalist…

Over two decades ago the Chinese government has been transitioning from a communist to a liberal and open economy. This move has benefited the Chinese greatly from the cost competitive exports mainly to the US. China also started to export major quantities of value added products to the rest of the world and got the recognition as the workshop of the world.

…led to an export oriented economy…

Because China's growth has been fueled primarily by exports to the US, the fiscal policy makers in China adopted a policy to peg their currency to the US dollar. This currency peg has helped contain the erosion of any cost competitiveness the Chinese have commanded in case the dollar depreciates against the Yuan.

…is China manipulating its currency…

The US policy makers believe that the Chinese have an undue trade advantage as they keep their currency artificially at low levels. In other words, they accomplish this by intervening in currency markets by buying the dollar to keep it buoyed against the Yuan. Henry Paulson, the US Treasury Secretary and ex CEO of Goldman Sachs has been an instrumental liaison for the US with a major endeavor to convince the Chinese to allow the Yuan to float freely in the currency markets.

This phenomenon of currency manipulation in my view has actually helped the Chinese in maintaining an artificial cost benefit. But as they say, "Nature has a way to self correct"…lets see how.

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387

Office: 661-299-1920
Mobile: 661-312-2070
Email:manuwalia@cgamadvisor.com
www.cgamadvisor.com

… commodity prices will compel them to…

It is important to note that major commodities in the world are dollar denominated. In other words, commodities like oil have to be traded in dollars. Therefore, the value of the dollar becomes an important element in trading commodities. Many economies worldwide are growing faster relative to the US. An economy growing relatively faster than the US will naturally put pressure on the dollar relative to its own currency. With the exception of the Yen, all major currencies have appreciated against the dollar over the last few years.

…take a hard look at their policy…

Guess what!!! As the Yuan is pegged to the dollar, by default it also depreciates against major currencies along with the dollar. Also, over the last two decades, the Chinese have accumulated over $ 1 trillion in currency reserves from a combination of growing trade surplus and the Yuan peg to the dollar. The depreciation of the dollar and hence the Yuan not only will hurt the China's economy by inducing higher cost for commodities, but also hurt them with the decline in the investment returns of their trade surplus.

…and shall set the currency free…

As China becomes less dependent on the US for exports, it will be compelled to either let its currency float freely in the global currency markets or peg it to a basket of currencies instead of just the dollar. Also, an increased domestic consumption in China will force the Chinese to review inflation and hence maintain stability in their currency.

A culmination of these factors will force the Chinese to give the currency peg a hard look and make appropriate changes, no matter how gradual they are.

As I mentioned above, "Nature has a way to self correct…"

Prepared By: Manu Walia

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387

Office: 661-299-1920
Mobile: 661-312-2070
Email:manuwalia@cgamadvisor.com
www.cgamadvisor.com