

# FXMONITOR

## Square Pegs and Round Holes...

By Dori Levanoni

What does it mean to “peg” a currency? For example, the Chinese Yuan Renminbi is “pegged” to the US Dollar at a rate of 8.2765<sup>1</sup>.

According to the People’s Bank of China, the Objective of the Monetary Policy is:

“The objective of monetary policy is to maintain the stability of the Renminbi and thereby promote economic growth.”<sup>2</sup>

More specifically, the current objective is to maintain the stability of the Renminbi *versus the US Dollar*.<sup>3</sup> That is what it means to “peg” a currency.

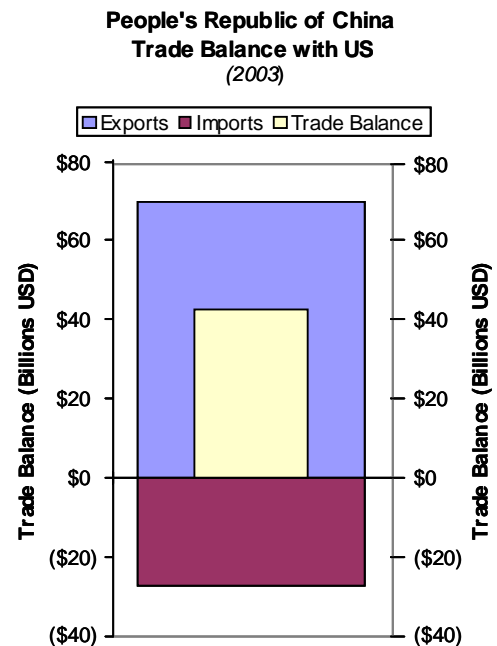
To accomplish those ends, the PBoC needs to intervene in the FX markets to offset any pressures on the Renminbi. Why? Recall that exchange rates are simply the result of trading, and so the “normal” pressures of supply and demand still hold. If there were an excess of demand for Renminbi, *ceteris parabus*, the Renminbi should appreciate. If, instead, there were an excess of supply of Renminbi, the Renminbi should depreciate.

### A Balancing Act...

The two most significant sources of supply and demand for a currency in most countries (and this should be true of China) are the result of cross-border trade in goods and services along with cross-border capital movement. China has relatively strict capital controls, hence the bulk of the “pressure” on the Renminbi is derived from trade. As the Renminbi is currently “pegged” to the US Dollar, trade with the US creates that pressure.

China has run a trade surplus with the US (which is a trade deficit from the US viewpoint) for some years, though there is some disagreement as to the scale of the trade balance.<sup>4</sup> We use the NBS China figures, as we will be looking at beyond just the China – US trade balance in this FX Monitor.

In the chart below, we’re looking at the trade balance from the Chinese viewpoint, hence we show the Trade Balance in surplus.



Source: National Bureau of Statistics of China

In 2003, China had a \$42.7 billion trade surplus with the US. That meant that there was a greater demand than supply for Renminbi, and hence the Renminbi would, under normal market conditions, appreciate. Since the PBoC wants to maintain the “peg” with the US Dollar, they had to create an offsetting supply of \$42.7 billion in Renminbi<sup>5</sup>. How they do so is to sell Renminbi and buy \$42.7 billion Dollars, which should perfectly offset the pressure on the Renminbi to appreciate.

Those \$42.7 billion in US Dollars goes into the PBoC reserves. In fact, the PBoC’s Foreign Currency reserves increased by more than \$42.7 billion in 2003<sup>6</sup>, which

we would suppose is a more accurate reflection of the size of the trade balance between China and the US.

### Fair Trade...?

A growing concern in the US has been the size of that trade balance, and that it has been exacerbated by the “undervaluation” of the Renminbi. A “cheap” Renminbi makes Chinese goods less expensive than comparable US goods for US consumers, hence the trade balance. The size of a change in the Renminbi peg to the US Dollar that would move the trade balance to neutral is quite large, *assuming the actual volume of goods and services didn’t change*.

Using the NBS China figures, it would take nearly a 38% appreciation of the Renminbi versus the US Dollar to balance exports and imports between China and the US.

A smaller change in the exchange rate may have the same effect, as US consumers may shift away from Chinese goods if prices rise much less than 38%, which would change the volume of trade between China and the US. In other words, there would be fewer exports from China to the US, and the Dollar value of those exports would shrink as well. At the same time, the volume of imports from the US to China might increase, as US goods look “cheaper” to Chinese consumers, while the Dollar value of those imports would either stay the same, or possibly increase as well.

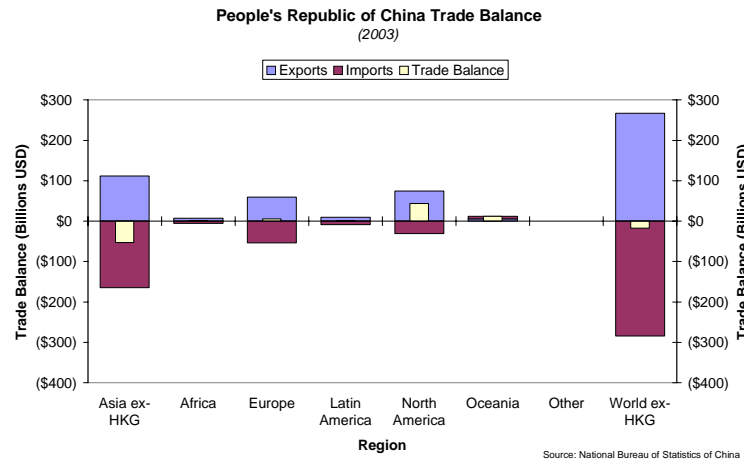
That would mean that the PBoC would still need to hang on to those enormous US Dollar reserves (because to sell them would move the Renminbi – US Dollar exchange rate, violating the peg wherever it is set), but wouldn’t need to collect any more.

### Trading Baskets...

Rather than move the Renminbi – US Dollar peg, another suggestion has been that China instead peg the Renminbi to a “trade-weighted” basket of currencies. If that were done, the PBoC would have to collect currency reserves that offset the various trade balances China has

with the World, rather than just the US.

What is China’s trade balance with the World? Below we show the overall balance, along with a breakdown by broad region.



Note that China ran a modest *deficit* with the World in 2003, largely with Asia. In that case, the PBoC would have to continue collecting US Dollar reserves and hold “short” (i.e. negative) Asian currency reserves. In other words, rather than selling Renminbi (that they print at will) to buy US Dollars, they would sell Asian currencies to buy US Dollars!

### Diversifying Baskets...

What does this all mean to the US Dollar? It means that the Chinese Renminbi will stay “cheap” versus the US Dollar unless:

1. The Renminbi is allowed to fully float, or
2. The PBoC decides to officially repeg the exchange rate, or
3. The trade balance between the US and China somehow reverses, or
4. Full capital mobility (either via FDI, M&A or explicit portfolio flows) is allowed in China to offset the trade balance, and there is strong US demand for Chinese assets via that mechanism.

Even if the renminbi exchange rate is moved (versus

the US Dollar), however, the PBoC will continue to collect US Dollar reserves until the trade balance reverses or capital flows are able to offset the trade balance.

So, much of the discussion that the choice by the various central banks (primarily Asian) to begin diversifying their reserve balances is, largely speaking, moot. Simply put, while the conditions that created those US Dollar reserves continue, those banks have essentially no latitude to sell US Dollars.

There is one way in which they can choose to diversify their holdings, though. They can choose to begin additional large-scale purchases of other foreign currencies, for the sole purpose of diversifying their US Dollar reserves. The issues related to domestic liquidity and inflation are beyond the scope of this article to cover, but it is somewhat difficult to believe that the various governments would be willing to consider such a move simply to diversify their central banks' balance sheets...

### Returns and Expectations

In February, only the US Federal Reserve changed monetary policy, raising rates by 25bp on February 2<sup>nd</sup>. The other five (or six, if you take the Danish central bank as independent of the European Central Bank) central banks left monetary policy unchanged.

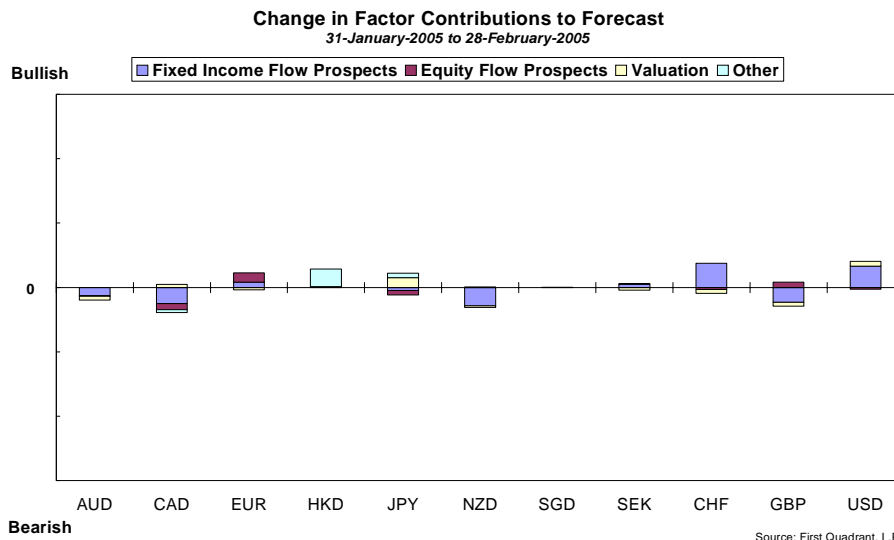
Bond yields rose in nearly all markets over the month, with the GDP-weighted world average rising by over

15bp. Only New Zealand yields remained unchanged, while Australian yields rose by 18bp. Cash yields rose in most markets as well, with the GDP-weighted world average rising by just under 10bp. EMU and Swedish cash yields, however, fell by 2bp over the month. US cash yields did rise 28bp, having fully priced in the Fed's action up to two weeks before the announcement.

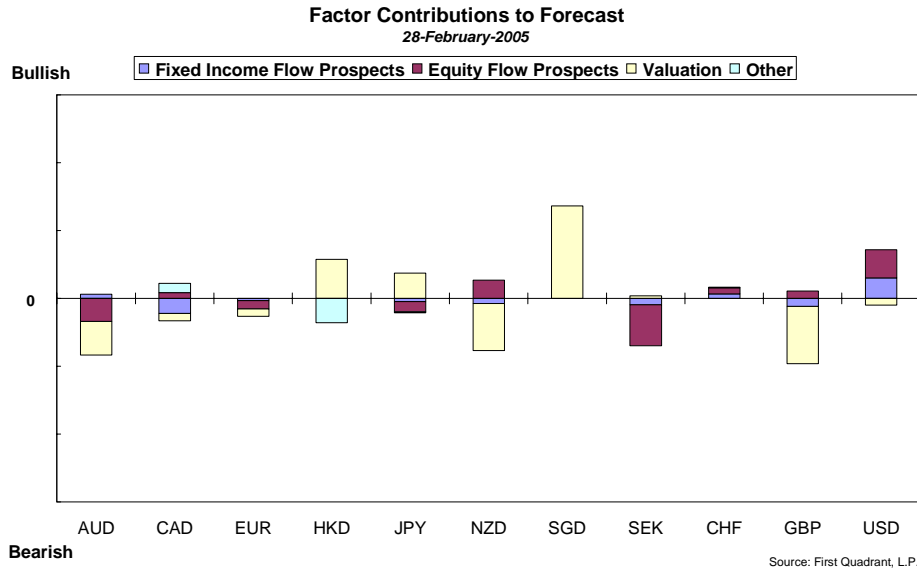
Equity markets were generally down over the month, with the GDP-weighted world average down around 0.50%. However, there was greater dispersion between markets, with the best performing market (Danish equities) outperforming the worst performing market (New Zealand equities) by over 8%!

The US Dollar declined in February, falling by nearly 1.5% versus the average developed market currency. It was not the worst performing currency in February, as the Japanese Yen fell by nearly 2.25% over the month versus the same basket. The best performing currency was the Swiss Franc, which rose by just over 1.1%.

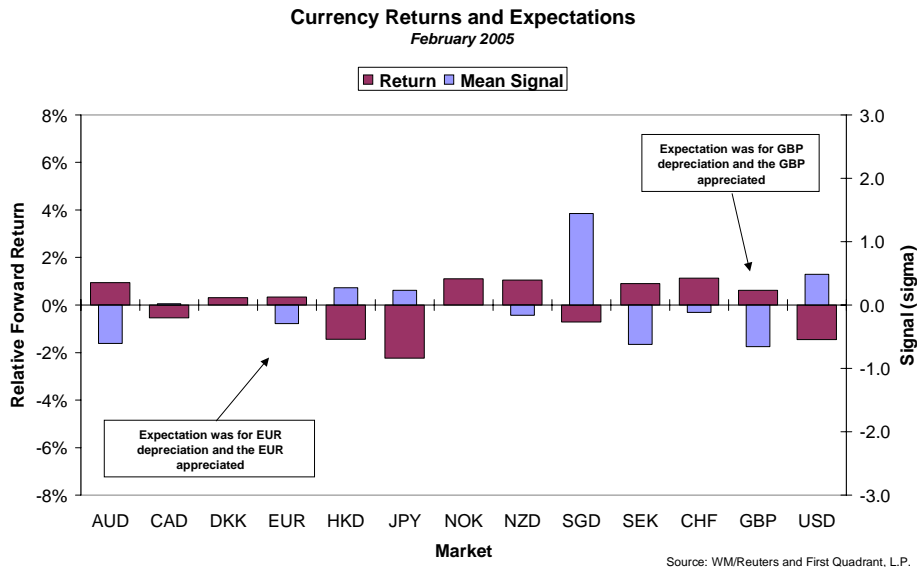
Those relative changes to bond yields drove most of the changes to our forecasts over the month, with the Canadian and New Zealand Dollars and British Pound becoming less attractive, and the Swiss Franc and US Dollar becoming more attractive. As a reminder, rising relative bond yields is viewed by the models as a source of positive future fixed income flows.



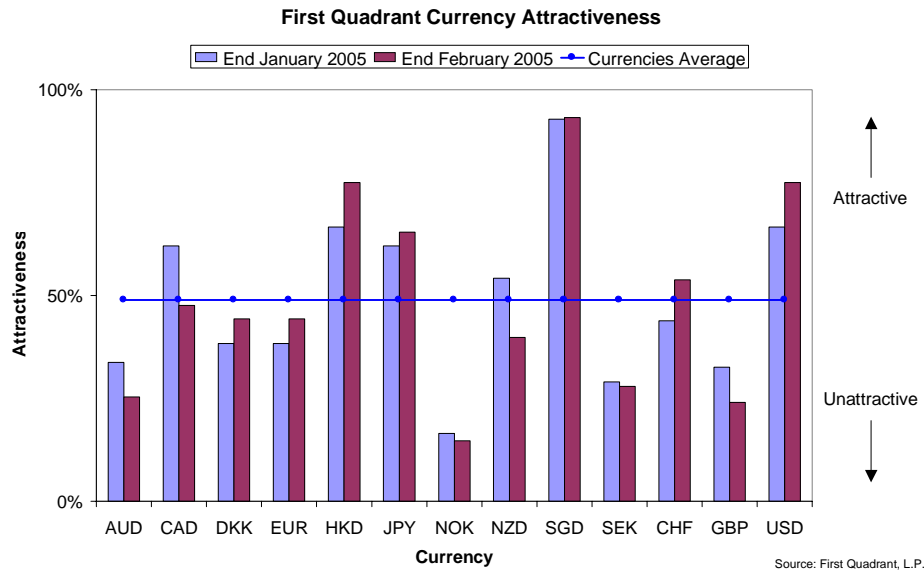
Most of those changes to the prospective fixed income flows offset previous positions, resulting in relatively little impact on our positions at the end of the month, other than a bullish contributor to our bullish US Dollar forecast, and a bearish contributor to our neutral Canadian Dollar forecast. Valuation is beginning to play a modestly stronger role in our forecasts, while prospective equity flows are retaining the impact.



February was generally a difficult month for our models, with most currencies moving opposite to our signals. A bullish forecast for the Japanese Yen had the most difficulty in February, though other currencies' forecasts had difficulty as well.



We have seen fairly significant shifts to our forecasts for a variety of currencies, becoming more bearish on both the Australian Dollar and British Pound, neutralizing our bullish Canadian Dollar position, moving from a modest bull to a modest bear for the New Zealand Dollar, moving from the bearish side of neutral to the bullish side for the Swiss Franc, and reducing our bearish view on the Euro. We've also become noticeably more bullish US Dollar, and slightly more bullish Japanese Yen.



*(Endnotes)*

- <sup>1</sup> Specifically, at the exchange rate of approximately 8.2765 Renminbi per US Dollar. It does vary slightly (in the last decimal, generally), but otherwise it is quite stable on a daily basis.
- <sup>2</sup> From the PBoC's website, <http://www.pbc.gov.cn/english/huobizhengce/objective.asp>, on 28-Feb-2005.
- <sup>3</sup> That is, of course, our opinion. We suspect that most would agree with us (at least currently).
- <sup>4</sup> The 2003 deficit from NBS China was \$42.7 billion, while the US Census Bureau reports it as \$124 billion. There are reasons why both figures may be somewhat incorrect. See Lum, Thomas and Nanto, Dick, "China's Trade with the United States and the World", CRS Report for Congress RL31403, November 19, 2004 update, pp CRS-6.
- <sup>5</sup> Which was equal to 353.5 billion Renminbi at the pegged exchange rate.
- <sup>6</sup> According to the State Administration of Foreign Exchange, currency reserves grew from \$286.407 billion to \$403.251 billion over 2003, an increase of just over \$116.8 billion.

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