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POLITICAL PULSE

No Protectionism Threat: Yuan To Bet?

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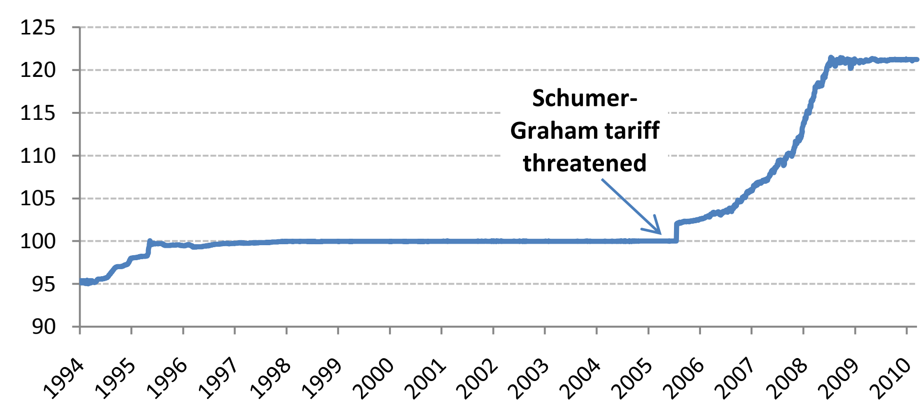
The Schumer-Graham tariff bill is back, and China will probably blink again.

Having just avoided a second Great Depression, it would seem especially unwise to repeat the policy mistakes that caused the first one. So it's worrisome to see Chuck Schumer (D-NY) introduce The Currency Exchange Rate Oversight Reform Act of 2010 in the Senate this week. It's anti-China protectionism pure and simple, aimed at forcing a revaluation of the yuan. And as if to add insult to injury, the penalties for non-compliance in this bill are structured to amend and expand The Tariff Act of 1930. Better known as the Smoot-Hawley Tariff Act, this trade-killer was enacted just when the stock market had recovered half its losses from the Great Crash of October 1929, and turned a nascent recovery into a global calamity.

Schumer introduced a similar bill in 2005 with Lindsey Graham (R-SC). At that time, Schumer claimed that "China undervalues its currency between 15 percent and 40 percent." The bill threatened that if the Treasury were to formally find China to be a currency manipulator, it would have to revalue the yuan or face a 27.5% duty -- "the midpoint range" -- on all goods exported into the United States. We predicted at the time at China would

Yuan-dollar exchange rate
Indexed to 100 on July 21, 20005



Source: Reuters, TrendMacro calculation

Update to strategic view

US DOLLAR: The revival of Schumer's trade threat against China will result in the resumption of the yuan's gradual appreciation, after what will prove to be only a temporary hold during the credit crisis.

EMERGING MARKETS MACRO, US MACRO: The resumption of yuan appreciation to head off Chuck Schumer's trade threat won't likely dent China's growth prospects. It will effectively make energy and materials cheaper for China, and inoculate it to some extent from the contagion of dollar inflation. For the US, raising the effective price of Chinese goods constitutes a form of tightening and is not helpful as the economy struggles to recover.

GOLD, COMMODITIES, OIL, US RESOURCE STOCKS: The resumption of yuan appreciation will make commodities and energy effectively cheaper for China, increasing its demand and raising dollar-denominated prices for the rest of the world.

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avoid a showdown with Schumer by undertaking a gradual yuan revaluation (see "Tsunamis! Killer Asteroids! Protectionism!" April 21, 2005), and that is exactly what happened.

The appreciation that officially began July 2005 revalued the yuan by 21.5% over three years, with the effect of China having very nearly imposed the threatened tariff on itself, a little bit at a time. It did nothing whatsoever to reduce China's exports to the US -- our trade deficit with China grew by 39% over those three years. And by lowering the effective price to China of all goods denominated in dollars, whether or not they come from the US, it no doubt contributed to the sharp run-up in energy and commodity prices in 2008.

Thus the revaluation did nothing to help the US, and much to hurt it. But it didn't hurt China's growth. Besides making dollar-denominated goods cheaper, it insulated China from some of the inflationary contagion from the Fed's too-easy too-long stance in the mid-2000's, which would have otherwise been transmitted through the yuan's peg to the dollar. China stopped appreciating the yuan in July 2008, when the global credit crisis began to unfold in earnest, and risk of contagion flipped from inflation to deflation. It has been held in a tight range around 6.8 yuan/dollar ever since.

With Schumer having initially claimed a 15% to 40% undervaluation, China must be frustrated that after the 20.8% net appreciation -- today versus its July 2005 value -- he still isn't satisfied. In introducing his latest legislation, he claims the yuan is "undervalued by 25 to 40 percent." After a substantial appreciation, how can it be more undervalued than it was to begin with? Be that as it may, like last time, we expect that China will find a dignified way to resume its gradual yuan appreciation before Schumer's bill can be enacted. We think they probably would have done so anyway, having only suspended the appreciation in the first place under the *force majeure* of the global credit crisis. For China, resumption would be a return to normalcy. And with the Fed stuck for an "extended period" in an ultra-easy policy posture, China may well view this as an apt time to again insulate itself from the contagion of dollar inflation.

We know that Treasury Secretary Tim Geithner has no interest in trying to bully China on the issue. When we asked him about it late last year (see "Geithner and the Dollar: That's Not My Job" October 15, 2009), he was candid that with China now a key funding source for US deficits, he was hardly in the position of strength enjoyed by his more bellicose predecessors in the Bush administration. Yes, in his confirmation hearings he said no less than three times, in response to written questions from senators on the Finance Committee (including Schumer), that "President Obama…believes that China is manipulating its currency." But as White House spokesman Robert Gibbs backtracked two days later, Geithner was only "restating what the president had said during the campaign, not making any determinations." Twice so far since then in the Treasury's semi-annual report to Congress, first in April and again in October, Geithner determined that China was *not* manipulating its currency. We expect him to continue to take the same course going forward, allowing

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China the face-saving diplomatic breathing room to appear to resume yuan appreciation seemingly at its own choosing.

So while Schumer's initiative raises the specter of a 1930's-style trade war, we think it's unlikely that it will lead to that. But make no mistake about it, it's protectionism and it harms global growth prospects both in its direct consequences and for the uncertainty it creates about other potential trade frictions. And China's revaluation of the yuan does constitute a form of policy tightening. For China itself, it is probably a useful and beneficial form of tightening which, if the last experience of it is any guide, will serve to contain clear and present inflation risks. It's the US and the rest of the world that is the loser. In a time of when economic recovery is tenuous to begin with, it can't help to raise the effective price of Chinese goods in world markets, or to start another bidding war for energy and commodities.

Bottom line

The revival of Schumer's trade threat against China will result in the resumption of the yuan's gradual appreciation, after what will prove to be only a temporary hold during the credit crisis. It won't likely dent China's growth prospects. It will effectively make energy and materials cheaper for China, and inoculate it to some extent from the contagion of dollar inflation. For the US, raising the effective price of Chinese goods constitutes a form of tightening and is not helpful as the economy struggles to recover. Resumed appreciation will make commodities and energy effectively cheaper for China, increasing its demand and raising dollar-denominated prices for the rest of the world.