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CHINA'S YUAN REVALUATION

China has announced that it will effectively end the peg of its currency to the U.S. dollar and instead float the yuan against a basket of currencies which would include the dollar. China has not indicated what the basket will contain and in what ratios, perhaps following the example of Singapore which has refrained from revealing the composition of its basket so as to discourage currency speculators from trading against such information. In addition, the composition of the basket can be changed at will without the need to announce such changes, as has been Singapore's practice.

Based on information available so far, the new yuan rate revalues the currency by 2.1% (to 8.11 per dollar), a very small adjustment and far less than would be needed to create a level field on trade.

The immediate consequences of the announced revaluation would cause the dollar to weaken modestly against many currencies, particularly those of Southeastern Asian countries that have tied their own currencies to the yuan. The adjustment versus the two other key global currencies, the yen and the euro, will likely cause these currencies to firm temporarily versus the dollar.

The political and economic rationale behind China's action is multifaceted.

- 1) By pegging the yuan to a basket, it allows the currency to appreciate gradually rather than precipitously, hence skirting the sudden impact of a shock.
- 2) It would help China to engineer a gentle fight against inflationary pressures and cool its overheated economy by reducing both imports and exports. Keep in mind that nearly all industrial commodities are traded (priced) in dollars.
- 3) It will allow China's central bank to act with greater flexibility in raising interest rates.
- 4) Given the small revaluation in this first step, it leaves the door open to further action without much fanfare or political pressure.
- 5) The shift to a basket policy will reduce China's purchases of dollars, resulting in a small increase in U.S. interest rates.

- 6) Politically, China's action at this time may have been intended to:
- a) tender an olive branch to the United States at a time of heightened frictions;
 - b) perhaps eliminate the threat of protectionist congressional action, notably the one currently on the docket to slap high tariffs on textile imports from China;
 - c) provide a hint of flexibility at a time when China seems eager to acquire U.S. businesses (think Unocal);
 - d) place China in a stronger position to thwart Japan's desire for a permanent seat on the reconstituted U.N. Security Council when this issue is debated in August.
 - e) give China an additional bargaining chip on the level of U.S. support for an independent Taiwan.

As to the reaction of the financial markets, both currencies and stocks, the response may be: "good, but not good enough."

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