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OPINION

Yuan float a move towards new currency zone



By Jude Wanniski

Sunday 31 July 2005, 7:25 Makka Time, 4:25 GMT

To those of us who have followed the mysterious world of floating currencies and exchange rates since President Nixon cut the dollar loose from its gold anchor in 1971, the Bush administration's pressure on China to break the yuan's 11-year link to the dollar is one of the most interesting political issues of the year.

After several months of increasingly shrill complaints from members of Congress about the flood of cheap imports from China and the US trade deficit, China has now taken a major step to complete control over the yuan (renminbi or RMB).

Where it had no control of its national currency during the years it totally accepted the Federal Reserve's management of the dollar through the link, at 8.28 to the dollar, it has

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now broken free.

China's first step was to appreciate the yuan to 8.11 to the dollar; but that from now on will move in one direction or another depending upon its relationship to a basket of currencies of its major trading partners.

This tiny 2.1% appreciation against the dollar will actually benefit the Chinese economy, because the dollar is now in inflationary terrain, the price of gold being at \$425 oz when it should be under \$400.

The move thus removes that much inflationary pressure from the yuan and reduces the cost of capital for all yuan transaction, foreign and domestic. It will not harm the US economy in the least, only benefit China.

It is obvious from the shape of the new regime that the People's Bank of China has borrowed an idea from Singapore's central bank, which also manages its currency against an unspecified basket of other currencies - a mystery formula that permits it the greatest freedom in seeking the best "money" for domestic and export purposes.

Mystery basket

In a real sense, where American politicians have been accusing China of "manipulating" its currency by rigidly fixing it to the dollar, China can now really "manipulate" behind the curtain of its own mystery basket. In the 27 July *Wall Street Journal*, the deputy director of the Shanghai Stock Exchange, Fang Xinghai, put it this way:

"China could have implemented the new currency regime without any initial revaluation. But the decision to accompany it with a small revaluation

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was a clever move that **dollar.** responds to both China's growing external surpluses and American demands for an appreciation in value of the yuan.

Since the new basket arrangement aims to keep China's nominal effective exchange rate relatively constant, it's quite impossible for the yuan to appreciate against the dollar by the much larger amount that many US politicians have demanded, unless the dollar declines dramatically relative to other major currencies.

Because the other major central bankers at least keep an eye on the price of gold, for signs of incipient inflations or deflations, it would be "quite impossible" as Fang suggests, for the dollar to decline dramatically against other major currencies unless the dollar/gold price shot up, above \$450 oz, heading toward \$500.

Optimum currency area

This has been exactly the advice China has been getting from Canadian economist Robert Mundell, who spends much of his time in Beijing and has listed a dozen reasons why China should resist a "significant" revaluation of the RMB that have been well-publicized in the Chinese press.

Because Mundell got his 1999 Nobel Prize in economics for work he did on "optimum currency areas" that led to the creation of the euro, his arguments carry great weight with the People's Bank of China. The fact he is Canadian also helps with the government, which is aware of the American advice to Moscow in 1989, the "shock therapy" that led to the great inflation of the rouble and the break-up of the Soviet federation.

The idea of an "optimum currency area" or "zone" is that neighbouring countries or those that engage in significant trade with each other

benefit enormously from using a common currency-which is the effect when China gives the RMB a value it keeps identical to the dollar. Several other Asian countries have monetary policies that keep their currencies in line with the dollar and, ipso facto the RMB, becoming part of this broad trading zone.

Malaysia, for one, immediately joined China in revaluing its currency by 2.1%. In that sense, Malaysia clearly signalled that it was joining an RMB zone, moving away from a dollar zone.

RMB zone

An RMB zone? Yes. Unless the United States ends its own dollar manipulations, which show up in the serious fluctuations in the dollar/gold price, the Asian economies will almost certainly move toward a Chinese currency umbrella, providing a superior "money" that will end the dollar's dominance in Asia.

Money, remember, is not only a medium of exchange to facilitate trade. It is, even more importantly, a unit of account that enables domestic and international producers to draw contracts over time. The superior money is one that holds its value in real terms over the lives of contracts short and long. When a currency fluctuates against gold over time, the costs of doing business increase as interest rates must climb to cover the risk.

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In the United States, my own work shows that between 1945 and 1971, when the dollar was fixed to gold at \$35 oz under the 1944 Bretton Woods arrangement, the real economy in the US grew by 4% per year. From 1971 when the dollar was floated to 2004, real growth of the

US economy has managed only a pitiful 0.3% per year.

New Bretton Woods

Unless these inefficiencies are removed with a new "Bretton Woods arrangement," as Mundell calls it, Beijing, at some point, may decide that the costs of importing inflations and possibly new deflations outweigh the benefits of its imprecise currency zone. The intermediate step it has now taken moves it toward a fixed yuan/gold price. You might easily imagine the implications of this development.

China's economy is not yet big enough or secure enough to take on an international banking role, but at current growth rates relative to the US, it could rival the US economy in several years. With a convertible currency in the near future, it could take the next step toward fixing the yuan/gold price instead of importing its monetary policy from one or several other nations.

It would be natural for Japan to break away from its currency zone with the US and join China's, as its trade with China continues to exceed its trade with the US.

Malaysia's Mohammed Mahathir had dreamt of pulling Islamic nations out of their dependence on the dollar by joining in a fixed rate system among them, behind a gold dinar. As his success has been limited, it may be that China will get there first. Not this year or even next, but sooner than later.

Jude Wanniski is a former associate editor of The Wall Street Journal, expert on supply-side economics and founder of Polyconomics, which helps to interpret the impact of political events on financial markets.

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