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# On the Yuan Revaluation

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**Donald Luskin**

Today **China** announced changes in its **exchange rate regime**, resulting immediately in a small **revaluation** of the **yuan** against the **dollar**. We see this as no surprise. It adheres precisely to our predictions made three months ago, when **Senators Schumer and Graham** introduced **legislation** to slap a 27.5% across-the-board **tariff** on goods entering this country from China unless China revalued. That legislation was due to be voted at the end of July, with what looked like a **veto-proof bipartisan majority** in favor. From the very beginning we identified this as an urgent yet low-probability threat, predicting that China would "find a dignified way to announce that it has unilaterally decided to make a small modification in its peg or the band around the peg...If the US would just stop humiliating China by ordering it do this, China may well find it is motivated to do it for its own selfish reasons" (see "Tsunamis! Killer Asteroids! Protectionism!" April 21, 2005). As we reported earlier this month, strong hints from Chinese authorities about revaluation and the withdrawal of the Schumer Graham bill represented a "coordinated mutual stand-down," and the end of the crisis (see "Policy Takes A Right Turn" July 5, 2005). Today's move makes it official.

We have never agreed with assertions that the yuan is dramatically undervalued relative to dollar (how could it be -- having been **pegged** to the dollar for a decade?). So all else equal we don't expect to see today's move leading to a wholesale revaluation. Consequently we don't expect to see any gigantic shocks to earnings of **US** companies that have exploited the Chinese **labor-cost arbitrage** (nor do we expect to see the revival of the **textile industry** in **South Carolina**). Also, we don't see today's move as a substantial threat to China's interest in holding US **Treasury** securities in its **central bank reserves**. Though China has announced that going forward its peg will be to a **basket of currencies**, no doubt the dollar will dominate that basket -- as the dollar dominates China's trade. But be that as it may, we don't believe that China's vast reserves are the product of its peg in the first place. After all, China has been running a peg, not a **currency board**. Rather, those reserves represent what amounts to **collateral** guaranteeing China's performance in global transactions on a scale that its immature and flawed financial sector could not otherwise support. As long as the **global economy** continues to want to exploit the China opportunity, and as long as China's internal structural weaknesses require the risks in such exploitation to be externally collateralized -- and as long as US Treasury securities remain the closest thing the world has to riskless assets -- then Chinese demand for Treasuries should stay robust. TM

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