China announced on Saturday April 14 that it will widen the allowable band the US dollar trades against the Chinese yuan. The new band is 1% from the official fixing rather than the 0.5% that band that has been maintained since May 2007. Before that, the band was 0.3%. Although the timing of the announcement was impossible to predict, we had recognized that this was a distinct probability.

It is a ploy that would no doubt bring a smile to the faces of Sun Tzu and Machiavelli. **First, China is giving up something that it is not really using.** Specifically, the current band itself has rarely if ever been utilized, which is why some observers have scoffed at the suggestion that the band would be widened. If the Chinese officials have shied away from using the full range that the 0.5% band offers, there is no guarantee the wider band will be explored.

Second, even if the 1% band is explored, it needs to be understood within a broader context. Consider that under the Bretton Woods dollar-gold standard, which was to be an adjustable regime that instead became in practice fixed exchange rates that necessitated crisis to spur an adjustment, currencies were allowed to move in 1% bands that were regarded as "fixed". Although the media and some observers will make a big deal of China's move, operationally the crawling peg regime may lead to a slower crawl than what took place under the 0.5% band, not a faster crawl. Indeed, we continue to believe that the yuan will be largely unchanged in nominal terms this year, but stronger in real terms as higher inflation and wages erode some of China's competitiveness.

Third, Sun Tzu and Machiavelli would be able to see another political benefit from the apparent economic/financial move. It will help keep China's adversaries off balance. The pricing of the 12-month non-deliverable forward suggests that investors expect modest yuan depreciation this year. This irritates China critics who see the yuan as terribly undervalued. However, a wider band will create a fissure among the critics as it introduces another dimension to "flexibility."

Often when US and European officials talk about the need for a more flexible yuan, they mean to remove the government's hand, which they argue limits the appreciation of the yuan. It needs to be more flexible so it can appreciate. By widening the band, Chinese officials are being true to their word, and gradually reforming the currency regime in a more flexible direction.

Moreover, it is no coincidence that the move is happening on the eve of the IMF/G20 meeting. Some countries, like Japan, often make concessions after an international gathering. It demonstrates their willingness to be good neighbors and responsible members of the

international community. It demonstrates an element of flexibility and desire and ability to compromise.

China, in contrast, pursues a different strategy. Often it has made announcements or implements reforms prior to a G20/IMF meeting. In so doing, China exerts influence on the formal or informal agenda. In bureaucratic politics, the setting of an agenda is critical.

The US Treasury announced that it is delaying its next assessment of the foreign exchange market, in which it comments on the practices of other governments and can cite a country as a "manipulator" of the foreign exchange market. Although China has not been cited as a manipulator for many years, across both Republican and Democratic Administrations, ahead of the November US national elections, there is some risk. **China's decision to widen the band will steal some thunder from some of its critics in Congress.**

The argument here is that the political implications are of greater consequence than the economic implications. A wider band will likely reinforce perceptions, already discounted, that there will not be substantial appreciation of the yuan this year.

In addition, one of the characteristics of the yuan that appeals to some investor segments is its low volatility. Only time will tell the extent of the impact that a wider band will have on the CNY-dollar volatility. Implied volatility is likely to rise in the days ahead as the market players adjust to the wider band, but we don't expect a major move. There is some scope for the implied volatility to rise as it has fallen well below recent ranges. The 3-month implied volatility is about 2.3%, and both the 100- and 200-day moving averages come in around 3%. Leaving aside the Hong Kong Dollar, most of the Asian regional currencies are considerably more volatile than the Chinese yuan. Therefore, even a modest rise in the yuan's implied volatility is unlikely to substantively alter the quantitative characteristic of the yuan or force investors to change the way it trades the yuan.

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