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China's Revaluation Pressures, Rate Hikes & V-Shaped Recovery, How the Asian Century Begins

Increased Pressure on China to Revalue

With the dollar's recent slide, the Chinese are now under a constant barrage from American and European leaders to appreciate the yuan. We believe this supports our prediction that the Chinese are more likely to revalue than raise interest rates.

Because the yuan has been virtually pegged at about 6.83 to 6.85 per dollar since July 2008, virtually all dollar weakness against the euro since then has translated into yuan weakness against the euro. Continued dollar weakness against the euro has therefore bolstered the international chorus for yuan revaluation. The IMF's Domique Strauss-Kahn is joining in the pressure, and comments coming from Europe are striking. This week, UK journalist Ambrobse Evans-Pritchard reported that ECB board member Lorenzo Bini Smaghi said on the subject, "I think the best way [to alleviate yuan weakness] is that China starts adopting its own monetary policy and detach itself from the Fed's policy." Meanwhile, ECB Governor Guy Quadan offered, "The problem is not the exchange rate of the dollar against the euro, but rather the relationship between the dollar and certain Asian currencies, to mention one, the Chinese Yuan. I say no more." A Chinese monetary policy independent from the Fed, however, is unlikely until Beijing does more to internationalize the yuan, for example, via more currency swap deals and yuan-bond offerings.

At the same time that pressure out of Europe is growing, American unions and the U.S. paper industry are turning their protectionist aims on China while Congress and the Treasury continue to insist that the yuan is undervalued against the dollar. Because we reject the notion that interest rate increases can be used to set the yuan-dollar exchange rate, we believe that ultimately the PBOC will forced to appreciate the yuan against the dollar, which would benefit China (if done gradually) and diffuse the international pressure.

Bottom line: continued dollar weakness will likely exert more pressure on the Chinese to appreciate the yuan.

This Week's Currency Interventions

Today's Financial Times reports of extensive currency market interventions on Thursday by Asian central banks, such as **Thailand, Malaysia, Taiwan**, and **Singapore**, to stem the dollar's slide against those respective currencies. These follow the **Bank of Russia**'s recent intervention to keep the ruble from strengthening too much against the dollar. The net effect of such operations are likely to be inflationary in the short-term for each of these countries and unhelpful in the long-term as they whittle down reserves and deliver mixed signals on the inflation outlook for their given markets. Indeed, in **Taiwan**, the Taiwan dollar actually outpaced the U.S. dollar in terms of weakening against gold at the conclusion of yesterday's interventions.

But with the White House's continued neglect on the subject of the dollar, and a blasé attitude from the Fed, there will likely be more currency interventions by foreign central banks to stave off perceived 'excessive' strengthening of respective currencies against the dollar. At the least, Republicans such as Senators Chuck Grassley and John Kyl are beginning to line up behind Sarah Palin, who as a national Republican leader expressed concerns last week in Asia over the weak dollar, as well as this week on Facebook. Virtual silence over the issue by the Obama administration suggests that the Republicans may seize it, albeit weakly, as a campaign issue during the 2010 elections.

Rate Hikes on the Assumption of a V-Shaped Recovery

There is a V-shaped recovery in sight for China and perhaps most of Asia, but this may be emboldening hawkish monetary regimes – **Australia, Norway, India, South Korea** and **Taiwan** – to come out and limit their economic upside with anti-growth rate hikes. This week the **Reserve Bank of Australia** became the first of the G20 countries to raise interest rates, as it announced that the "risk of serious economic contraction" has passed and that the "board's view is that it is now prudent to begin gradually lessening the stimulus provided by monetary policy." (Note: this hawkishness is consistent with our forecast offered in our September 25 central bank study.) Governor Glenn Stevens expects a continued commodity boom to benefit asset prices, including housing. We agree with that outlook, although we disagree about raising interest rates now. As for **South Korea**'s hawkishness, it is clear the Bank of Korea is at loggerheads with the pro-growth President Lee, meaning such hawkishness could abate when BOK Governor Lee steps down in March 2010.

The Asian Century Begins With a Whisper

This weekend, foreign ministers and deputy government officials from **Japan, South Korea** and **China** will be meeting in Beijing to continue talks on the development of an East Asian Community: a Euro-style common market that may initially include visa-free travel but eventually a common currency and barrier-free trade area. It is clear that what we are witnessing is the maturing of an important regional trend – temporarily retarded by the Asian flu during the late 90s – toward a broad Asian market, free from trade barriers and the chaos from a fluctuating dollar as the preferred unit of account.

According to reports in the Singapore Business Times and the India Times, Prime Minister Yukio Hatoyama has already put his proposal for East Asian Community to Chinese president Hu Jintao and the two countries have been in negotiations since. The main sticking point between Japan and China is on the initial composition of an East Asian Community. China believes such a community should involve 13 nations China, Japan, South Korea and the ten nations of ASEAN: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. But Japanese Foreign Minister Katsuya Okada believes Australia and New Zealand and India should be included at the outset. There may be some compromise here between both views. Perhaps India, New Zealand and Australia will be given associate status to act as a weigh station to full integration. The summits involving ASEAN countries and Japan, China and South Korea, scheduled for October 23-25 in Thailand, may ultimately decide what the initial composition of an East Asian Community will look like. It is hard to imagine that Australia, New Zealand and India will not eventually be absorbed into a greater Asian union.

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