

# Commentary

BUFFIN PARTNERS INC.

INVESTMENT AND ACTUARIAL RESEARCH

## Global Spotlight on China

Members of the financial community who are concerned with interest rates, inflation, asset valuation, investment strategy and actuarial valuation of contingent liabilities and assets need to be aware of the influence of China on all of these factors. Since 1995, China has pegged its currency in a narrow range around 8.278 renminbi to the U.S. dollar. The question now being debated by the world's leading economists is whether the renminbi is undervalued and provides China with undue competitive advantage in the global economy. The world's leading financial authorities, including Federal Reserve Chairman Alan Greenspan, Treasury Secretary John Snow, Japanese Finance Minister Masajuro Shiokawa and European Central Bank President Wim Duisenberg, are generating international pressure on China to revalue its currency. Japanese economic adviser Haruhiko Kuroda claims that China is exporting deflation throughout the world. A former Merrill Lynch economist was recently quoted as saying "China is changing the world and will continue to change the world more than any other single factor over the next generation."

Chinese economic statistics are noteworthy. Economic reforms have produced impressive results since China was admitted to the World Trade Organization in 2001. China's State Statistical Bureau reports a 16.5% increase in industrial output from a year ago. Foreign exchange reserves amount to \$340 billion. Over the last year China has attracted \$53 billion in foreign direct investment, more than any other nation. Chinese exports have increased by 33.4% in the current year to date. A significant factor in China's economic growth is the outsourcing of manufacturing operations by multinational corporations; 65% of the increase in China's exports over the last decade is

attributable to these outsourcing activities. The U.S. trade deficit with China exceeded \$100 billion in 2002. China now has a larger trade surplus with the United States than does Japan.

Although there are increasing international calls for China to revalue the renminbi, a move is not expected in the near term. China has already rejected calls for a free float of the renminbi. Prime Minister Wen Jiabao has been quoted as saying "To keep the stable renminbi will not only benefit the stability and development of the economic and financial order in China but also the economic and financial order of surrounding countries and fundamentally the international economic and financial order." A free float of the renminbi would be a dangerous policy since it would require China to abandon controls that influence demand for the currency and undermine the stability of China's whole financial system. From the U.S. perspective, China has been beneficial in helping with financing the current account deficit and providing support for a policy of declining interest rates through investment of its trade surplus in U.S. treasury securities.

As an alternative to a free float of the renminbi, China could allow a wider band for the pegged exchange rate around the existing 8.278 level. China is very unlikely to revalue the currency, as its critics would like. China knows only too well the influence of speculators in the Asian currency crisis of the late 1990's and the destabilizing effect of large short-term money flows. A revaluation would have the effect of reducing the trade surplus and curbing the country's economic growth. Revaluation would trigger a downturn in the worldwide level of demand for goods and services, thereby risking global deflation. China's current inflation rate is only 0.3% and revaluation would certainly create a

deflationary effect. China's policymakers will focus on deflation risks before embracing any revaluation policy rather than reacting to international pressure. China will consider its own economic situation in setting policy regarding currency valuation and only when China's economy experiences significant inflationary forces, excessive monetary growth or economic overheating, might China be expected to consider a revaluation of the renminbi.

An interesting concept is the possible adoption by China of a crawling peg system of continuous valuation adjustments. It would provide China more flexibility and predictability than either a fixed peg system that is subject to occasional revaluation adjustments or a direct managed float system, and it may offer an acceptable global solution that addresses the concerns of the U.S., Japan and Europe. The three critical elements that comprise a crawling peg system are: the permitted width of the currency-trading band; the target crawl rate; and the basket of international currencies against which to make parity adjustments. A potential construct might include a 2% band on either side of the peg and a 4% annual adjustment rate for five years against a trade-weighted basket of currencies. This contrasts with the features of the present renminbi valuation system with its narrow trading bands, zero crawl rate and its 100% dollar weighting. We endorse the crawling peg concept and trust that it will gain acceptance in the corridors of power in Washington, Tokyo and Brussels.

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