



China and the US: Resolving Global Imbalances

Once again pressure is building on China to allow greater appreciation in the renminbi-US dollar exchange rate but the Chinese authorities insist that exchange rate reform must proceed in a gradual and cautious manner. Many argue that exchange rate flexibility would not only serve China's best interest, but would also contribute to an orderly resolution of global current imbalances. The Chinese authorities counter that the problem of global imbalances was mainly caused by the United States, who should take the appropriate policy actions. The standoff is reigniting concerns about protectionism and its negative repercussions on the world economy. As a measure to protect the vulnerability of U.S. trade balance, a bill to levy tariffs of 27.5% on all Chinese imports was considered to force the Chinese officials to raise the value of the currency. However, the bill was dropped as U.S officials decided to seek a more amicable solution to prod the Chinese authorities to comply with global trading rules.

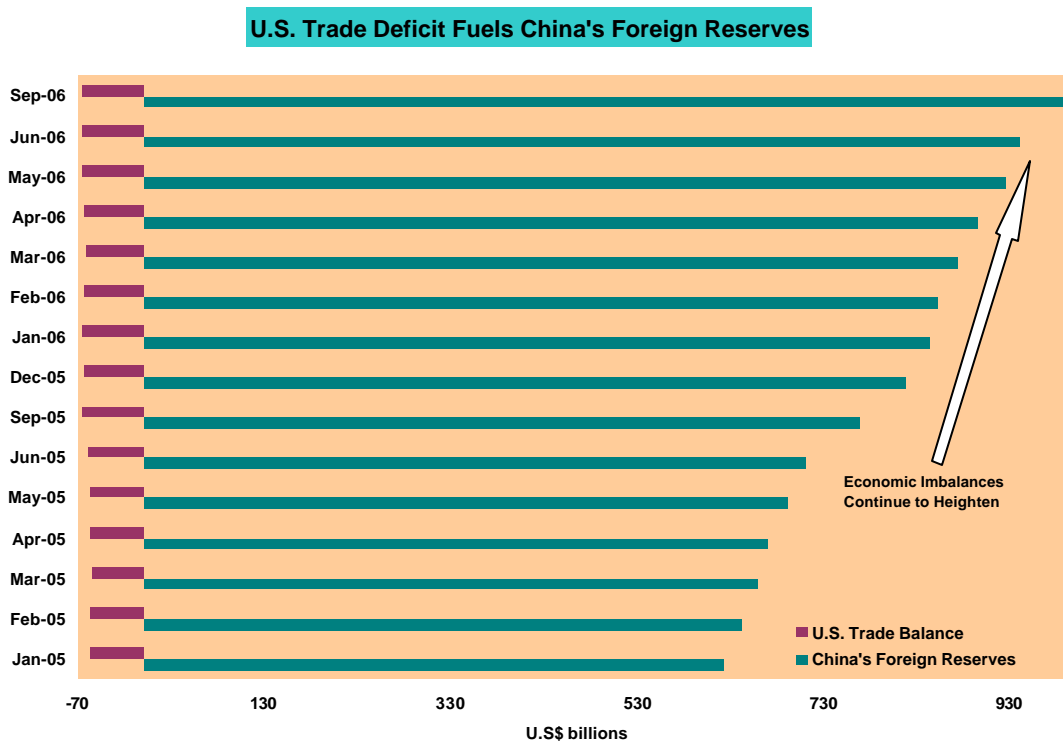
Since the initial 2.1% revaluation of the renminbi in July 2005, the renminbi-US dollar rate has appreciated by only about 1.5%. On a real effective exchange rate basis, the renminbi by May 2006 had returned to roughly its June 2005 level. Some point to this movement as evidence that the Chinese government has been intentionally disallowing the renminbi to appreciate and is not in line with most fundamental factors that determine the exchange rate's real value. In particular, China's substantial accumulation of net foreign assets and sharp rise in productivity should typically have contributed to real appreciation of the renminbi.

At the end of September 2006, China accumulated the world's largest foreign currency reserve of US\$988 billion. The People's Bank of China (PBoC) disclosed that China's reserves grew by 28.5% within the past year fueled by its trade balance surplus primarily with the United States. In fact, China built up more than US\$200 billion in 2004 and in 2005. Amidst China's extraordinary performance, the United States has unexpectedly incurred a trade deficit widening to a record US\$ 69.9 billion in August fueled by spurring domestic consumer spending. The US current account deficit has now escalated to more than 6% of GDP. Tactically, China has been purchasing US dollars and treasury securities to help finance the US current account deficit. China is currently the second largest holder of U.S. Treasuries after Japan.

Despite pleads for greater renminbi flexibility the Chinese authorities argue that even a significant appreciation is unlikely to make a meaningful dent on China's trade surplus, which expanded by US\$15.3 billion in September. The effects of a stronger renminbi would be mainly felt by exporters of low value-added goods with negative implications for rural incomes. Moreover, they are not sure the banking system can cope with significant renminbi appreciation.

In the meanwhile, the tendency to resist renminbi appreciation has created excess liquidity within the Chinese financial

market. China's money supply, M2, (the broadest measure of money supply including cash and all deposits), has been posting growth rates of 17% in recent months. Fearing inflationary pressures, the PBoC started to tighten monetary policy. Firstly, the PBoC hiked the one-year reference lending rate to the current level of 6.12%, up from 5.58% at the start of 2006. Secondly, the central bank increased the reserve requirement ratio for all commercial banks twice in 2006, depressing the ability of banks to disburse loans. And finally, the PBoC sold off treasury bills, forcing banks to buy central bank securities in an effort to curb the availability of funding.



Source: Bureau of Economic Analysis, State Administration of Foreign Exchange, People's Republic of China

Regarding the global imbalances, statistics show that in order for US trade deficit to deflate, exports must grow by about twice the rate as imports. The US dollar weakened by a marginal 2.2% against a basket of other international currencies, which may help to grind down the US trade deficit in upcoming quarters. However to reduce the US trade deficit by roughly 50% would require a more significant depreciation in the US dollar against other major currencies. In theory, a stronger renminbi coupled along with other Asian governments allowing their currencies to appreciate could provide the necessary leverage for US goods and services to become more competitive and hence stimulate US exports in international markets. But it is clear that dealing with global imbalances requires concerted action by ALL countries not only China. The US must undertake fiscal consolidation, Japan and Europe must enact structural reforms, and oil-exporters must make greater investment of the petrodollars.

FINANCIAL & ECONOMIC INDICATORS

As at 2nd November 2006

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	117.13	118.15
Euro	1.28	1.26
Jamaica	66.49	66.17
Guyana	201.4	201.40

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	57.88	60.36
Natural Gas (US\$/mmbtu)	7.32	7.91
Gold (US\$/Troy Ounce)	624.70	597.15

Eurobond Indices (Returns, % YTD as of 2- Nov- 06)

Lehman Brothers Global Aggregate Index	3.14
JP Morgan EMBI+	-0.20
CMMB Eurobond Index	2.74

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Month</u>
United States	5.25	5.25
Euro Zone	3.25	3.25
Japan	0.25	0.25
Brazil	13.75	13.75
Trinidad	8.00	8.00
Jamaica	11.95	11.95
Barbados	4.75	4.75

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	4.96	4.99
US 10-Yr Treasury	4.60	4.72
3-month UK Libor	5.20	5.18
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	13.30	13.70
TT 90-day T-Bill	6.72	6.72
Jamaica 90-day T-Bill	11.77	11.77
Barbados 90-day T-Bill	6.37	6.21

Sources: Bloomberg, CMMB Research Centre, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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