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ECONOMIC TALKING POINTS

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China's Announcement to Unshackle the RMB: Much Ado About Nothing?

Once again, China has shown how well it has mastered the art of timing. Whether it involves changing the value of the RMB or announcing reforms to protect foreign intellectual property rights, China has repeated its strategy of waiting until the last minute to defuse controversial issues.

Its pledge over the weekend to allow the RMB to rise in value was essentially a tactical move to mollify foreign leaders before the G-20 meeting and to preempt U.S. lawmakers from tacking on duties to Chinese imports. They may have succeeded in the short term with the former, but it is unlikely they satisfied Senate leaders who may still move forward with a bill to penalize China.

The problem is that China has not been forthcoming on how much it will permit its currency to rise against the dollar. Their June 19th announcement was agonizingly short on details, stating only it will allow a "gradual" managed floating exchange rate.

However, the RMB's value is already up 15% against the Euro over the last four months. With European growth markedly slowing, one has to wonder just how far Chinese policymakers are prepared to see their currency appreciate. Remember, China is also trying to cool down its own economy to prevent both an outbreak of domestic inflation and a violent collapse in real estate prices.

That's why we believe there's going to be a large gap between what the US hopes to see in terms of the RMB's appreciation --- and the far more limited measures Chinese policymakers have in mind. The firm peg between the dollar and the RMB may be over, but what comes next could well disappoint US exporters and policymakers. Our forecast is for the RMB to rise about 3% - 5% against the dollar over the next 12 months.

Such an increase will have no palpable impact on the US economy nor materially change trade flows in the world. Let's remember that between 2005 and 2008, the RMB rose 21% versus the dollar and even that was not enough to make a dent in the U.S. trade deficit with China. America's deficit did decline in 2009, but that should be attributed to the severe U.S. recession and the consequent decline in demand for imports, not the rise in China's currency.

We still view the RMB to be about 40% overvalued, which means Chinese exporters continue to have a huge edge over its competitors in international markets. Given the uncertainties surrounding Europe, China's biggest customer, and the global economic fallout in the event of a sovereign debt default on the Continent, China's top priority will be to prevent a severe economic decline of its own, and that means protecting its front line of defense ---which is its exports.

In summary, the weekend announcement is the most significant change in China's currency policy since it unpegged the RMB in 2005. But we do not believe the upcoming rise in value will be enough to satisfy anyone. It certainly will not be enough to bring about a re-balancing of global capital. China still has too many restrictions on money flows entering and leaving the country. It still heavily subsidizes the price of resources. State-run banks continue to play a huge role in the lending market. China's central bank still operates under a command economy structure and thus has no independence to speak of.

So while global investors and certain political leaders have initially reacted positively to the shift in currency policy, we expect many of them will shortly switch their tune and utter the lament in Peggy Lee's hit song: *"Is that all there is?"*

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