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Chinese move not likely to shrink U.S. trade deficit

By Walden Siew
Bloomberg News

China yesterday ended its decade-old policy of pegging the yuan to the U.S. dollar, allowing the currency to strengthen and fluctuate against a basket of currencies.

Chinese finance officials acted in response to criticism from the U.S. and Europe that the nation enjoyed an unfair trade advantage.

Since the peg of 8.3 yuan per dollar was introduced in 1995, China's economy has tripled, exports have surged and the country surpassed the U.S. as the biggest destination of foreign direct investment.

The following are questions and answers on yesterday's shift in China's currency policy and what it means.

Q: What is a revaluation?

A: It's a change, typically an increase, in a country's fixed exchange rate.

Q: What is a trading band?

A: This refers to the range that a country's finance officials will let the currency trade in before intervening. The new yuan rate strengthens the currency by 2.1 percent to 8.11 per U.S. dollar immediately, the People's Bank of China said on its Web site. The bank said it will maintain a trading band of 0.3 percent.

Q: What countries have their currency pegged to the dollar?

A: Thirty-two countries, including Saudi Arabia, Ecuador and Hong Kong, have their currency pegged to a single currency, which principally is the U.S. dollar, according to the International Monetary Fund's 2004 annual report on exchange arrangements and exchange restrictions.

Thirty-four countries, including the U.S. and

Japan, have independently floating, market-driven exchange rates.

Q: What does this mean for U.S. trade with China?

A: "What they have said is they'll allow the yuan to move very, very slowly," said Meg Browne, a currency strategist at Brown Brothers Harriman. "The yuan will strengthen slowly over time. As for the trade deficit in the U.S., it won't have an impact. Two percent has no impact on the U.S. deficit. In the long run, we are looking at further revaluations, but those are way down the road."

Q: What is the U.S. trade deficit?

A: The U.S. trade gap narrowed to $55.3 billion in May. The imbalance in goods-and-services trade dropped 2.8 percent from $56.9 billion in April, according to the Commerce Department's latest figures.

Q: What is the U.S. trade deficit with China?

A: The deficit with China, whose currency peg to the dollar had led to threats of tariffs from Congress, widened to $15.8 billion, the third largest on record. The gap accounted for about a quarter of the entire U.S. deficit during the month.

So far this year, the deficit with China is $72.5 billion, up a third from January-May 2004. The goods deficit with China was a record $162 billion in 2004.

Q: Will China do this again?

A: "I consider today's announcement to be an intermediate step — a warm-up," said Campbell Harvey, a finance professor at Duke University's Fuqua School of Business. "The big event will come in the fall when I expect they will float the yuan. The 2 percent revaluation is no big deal because cheap Chinese imported goods will remain cheap after the revaluation."

Q: What does this mean for U.S. exports?

A: It probably has little impact on U.S. exports.

The greater impact will be on other exporters, such as China's regional Asian competitors, because they are more direct competitors with China in industries such as electronics, according to Brown Brothers Harriman.

The initial revaluation is likely too small to have a significant impact on the

China-U.S. bilateral trade surplus, according to Paresh Upadhyaya, a currency portfolio manager who is part of a group that oversees $29 billion at Putnam Investments in Boston.

As the yuan continues to appreciate, it will reduce China's surplus, Upadhyaya said. A more significant development is broad-based Asian currency appreciation that will help boost U.S. exports in the longer term, Upadhyaya said.

Q: Will U.S. consumers pay more for goods from China?

A: There may be higher prices for Chinese goods, analysts said.

"At the margin, consumers should see a slight increase because the products just got 2 percent more expensive in dollars," said Nick Bennenbroek, currency strategist at Brown Brothers Harriman.

Material from Bloomberg News reporter Erin Burnett in New York is included in this report.

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