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A L E R T

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BEIJING NOW KEEPING RMB FROM FALLING WHITE HOUSE “WALKING BACK” GEITHNER ON RMB

Key points:

- The White House has virtually retracted Geithner’s comment that China is “manipulating” the RMB, saying the Treasury would decide in April
- WH spokesman Gibbs confirmed that Geithner’s staff had simply lifted the statement from Obama’s campaign declarations (reportedly without first double-checking with the WH on whether these comments still applied)
- These days, any Chinese “manipulation” is aimed at keeping the RMB from falling rather than pushing it down; the RMB has stayed flat against the dollar for months even as most other currencies depreciated
- Beijing is downplaying the ruckus in its press coverage, despite pro forma protests
- China continues to send lots of money to the US and there are lots of reasons to expect this to continue
- Obama has no interest in creating a battle with China over this issue and our bet is that, in the end, Congress will give him the slack we expect him to ask for

Overview

Amazingly, it was all a mistake. When incoming Treasury Secretary Timothy Geithner told Congress in written answers to questions that, "President Obama -- backed by the conclusions of a broad range of economists -- believes that China is manipulating its currency", the statement was simply lifted from statements made by Obama during the election campaign. In a rush to get answers to the Senate virtually overnight (as part of a 100-page answer), it seems that neither Geithner nor his staff bothered to clear the statements with either the White House or the State Department to check if formulations made during heat of the campaign still applied. That’s the word from Chris Nelson, publisher of Washington’s “must read” *Nelson Report*.

At least part of this account is now confirmed by WH spokesman Robert Gibbs, who told a press briefing that the Geithner statement, "was restating what the president had said during the (election) campaign." As for the actual Obama policy, Gibbs said what Geithner should have said: "I think it's safe to say this administration will determine in the spring what that means." That's when the Treasury is under Congressional mandate to issue its twice-yearly report on whether any country is manipulating its currency to gain trade advantage. If the US officially labels China a "manipulator," that sets off a round of negotiations but, under present US law, no sanctions.

While Obama did make comments about the RMB other trade issues during the primary campaign, he quickly backed off from these comments once the primaries were over. He even acknowledged in a June 2008 interview with *Fortune*, when asked about his comments on NAFTA, that, "Sometimes during campaigns the rhetoric gets overheated and amplified" We were told months ago that Obama had taken the word of his advisors and backed off from making the RMB an election issue, since the US would need Beijing's cooperation during this time of global economic crisis. As a Senator, Obama voted along with most other Democrats for legislation intending to pressure the Bush White House to take a tougher stance with. However, life looks different once people move into the White House. We have little doubt that Obama, like his predecessors, will see the wisdom of using a light touch in getting China to move on the RMB issue.

Manipulation In What Direction?

The fact is, these days, Washington should be grateful for Beijing's "manipulation," since it is serving to keep the RMB from falling vis a vis the dollar, along with most other currencies, rather than pushing it down.

Take a look at *Figure 1*. From July 2005, when China changed its currency regime, the RMB rose against the dollar almost exactly the same amount as the "broad" index of currencies as measured by the Federal Reserve, i.e. the index of virtually all of the US trading partners on a trade-weighted basis. Then, beginning in April 2008, as the broad index flattened out, China let the RMB keep rising vis a vis the dollar to a level 21% above that of July 2005. Finally, beginning in mid-July, as the broad index began its sharp fall, the RMB stayed at its post-2005 high. As a result, the RMB is now 20% higher vis a vis the broad index than it was in July 2005 (see *Figure 2*). It is up 14% against the Euro and down only 3% against the rapidly appreciating yen, which is now at ¥89/\$ (see *Figure 3*).

The Chinese argue that, if not for their intervention, the RMB would be falling along with most other currencies. Although there is no public data on intervention, it conforms to sentiment among currency traders that market forces are exerting downward pressure on the RMB: 1) foreign money is fleeing China's capital markets; 2) China's exports are tanking; and 3) NDFs (non-deliverable forward currencies), which previously were priced to expect an appreciation of the RMB are now priced to expect a small depreciation of the RMB.

China's Protests of Geithner Seem Pro Forma

The Chinese seem to have limited themselves to the obligatory protests. While various officials criticized Geithner's remarks, the *People's Daily* ran a headline saying, "U.S. Treasury secretary-designate vows to deepen U.S.-China economic ties." Coverage emphasized the part of Geithner's verbal answer at the confirmation hearings that the priority was to work with China to alleviate the global financial crisis. Undoubtedly, the Chinese welcomed the part of Geithner's written answer in which he stated vis a vis the RMB that, "The question is how and when to broach the subject in order to do more good than harm."

Whenever these dust-ups occur, some people suggest that the Chinese might buy fewer Treasury bonds in retaliation, just as they inaccurately raised the same issue vis a vis Japan years ago. But such action would be against China's interests. To boycott US securities markets would just put more downward pressure on the RMB. Moreover, in this risk-averse world, the Chinese are gaining on both the flight to safety into T-bonds and the rise of the dollar. Besides, from all accounts, the Chinese are acting as "responsible" players during this global crisis, just as they did during the 1997-98 crisis in Asia. The Chinese know better than anyone how much they depend on the stability of global trade and finance. Why should they knock over the table from which they eat?

The Treasury data on long-term securities shows little, if any, letup in Chinese inflows. As of the six months ending in November (we use six-month moving averages because of the volatility of the data), China provided 20% of the net foreign purchases of long-term government and private securities. That's down from a peak of 36% in mid-2008, but it is higher than any year prior to 2008 (see *Figure 4*). Currency traders say that this underplays the inflows from China since the Chinese have moved somewhat from longer term to short-term securities and the latter are not included in the data.

What Is the Downside?

There are some potential downsides to the Geithner mistake. But at this time, it's impossible to say how serious they are.

First of all, at a time when the reputation of the Treasury Secretary is a paramount factor in his capacity to settled panicked financial markets, such a mistake hardly helps. Whether it will cause lasting damage is not clear. What we do know is that the mistake was widely publicized and criticized. The "walk back" has been less publicized.

Secondly, what will be the Congressional reaction to the WH's virtual retraction? Will Congressional hawks on the issue feel "betrayed" by Obama? Our guess is that they will give Obama the same slack that they gave Bush: if Obama argues that quiet diplomacy is better than harsh measures, they will use Congressional threats in a "bad cop, good cop" manner.

So far, we have seen no direct comment from Congress on Gibbs' "clarification." However, two of the leading hawks on the issue, Charles Schumer (D-NY) and Lindsey Graham (R-SC) commented after the Gibbs statement that they would be willing to give Obama more time on the issue. "If the countries can work out a voluntary program, that would be better than legislation, but if that doesn't work we'll have to do something, do legislation," said Graham. Graham and Schumer were authors of a 2005 bill threatening China with a 27.5% tariff on its exports to the United States unless it raised the value of its currency against the dollar (as noted above, it has since risen by 20%). They withdrew their bill when the Bush administration promised to press the issue via diplomacy.

Schumer told Reuters in an e-mailed statement he was heartened by Geithner's use of the term "manipulation"—a charge made during the Clinton years, but not by the Bush administration. "Because the administration came out of the box very quickly, we have real hope that they will do this on their own, which would be a lot easier and quicker than enacting legislation. So we will wait for them to issue their report this spring," Schumer said.

Meanwhile, Senate Finance Committee Chairman Max Baucus (D-MT), whose committee has jurisdiction over trade, told Reuters in an e-mailed statement he looked forward to working with the Obama administration to craft a "plan of action" on China's currency. "Given the precarious state of the global economy, both China and the United States must be thoughtful and prudent in how we address this issue. Failing to do so could create new economic problems that neither country can afford," he said.

Our expectation is that this year, as in the past, Congress' bite will not be as bad as its bark. While Congressional Democrats have their own constituencies, they also have no interest in making life difficult for Obama. But they will need to make themselves look tough.

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Figure 1: RMB Remains Stable Even As Rest of World Declines Vis a Vis Dollar

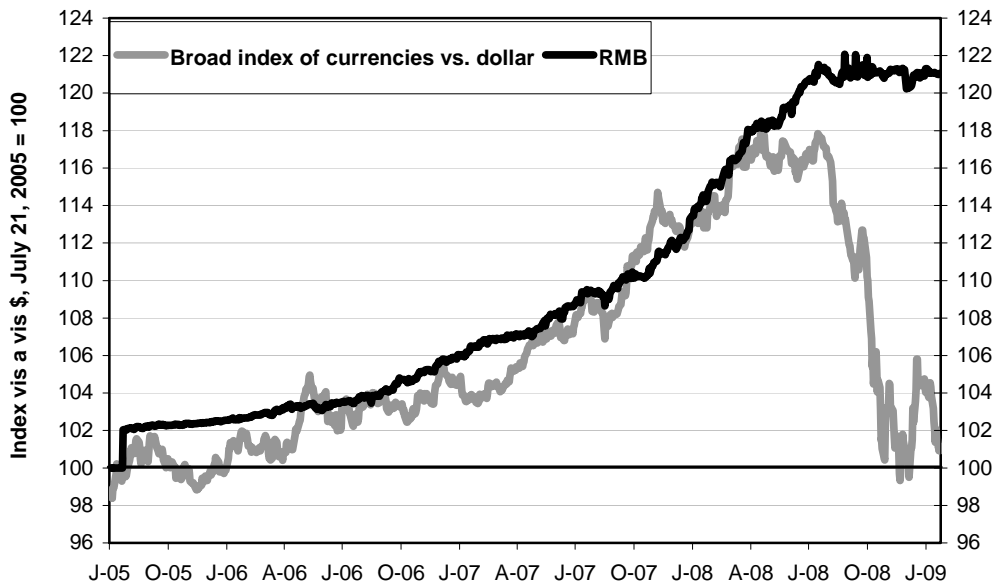


Figure 2: RMB 20% Higher Than Broad Index Vis a Vis \$ Compared to July 2005

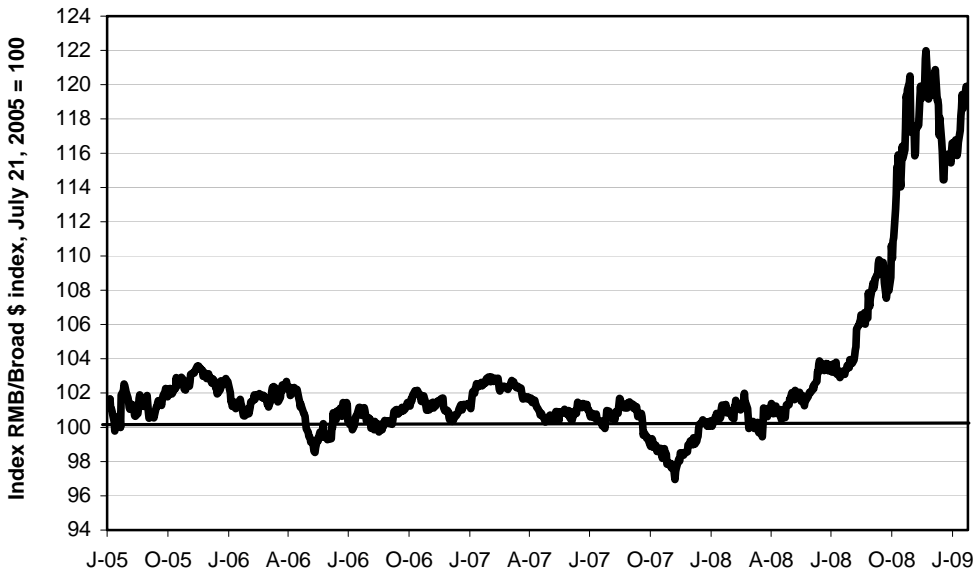


Figure 3: RMB Up Against Euro; Down A Bit Against Yen

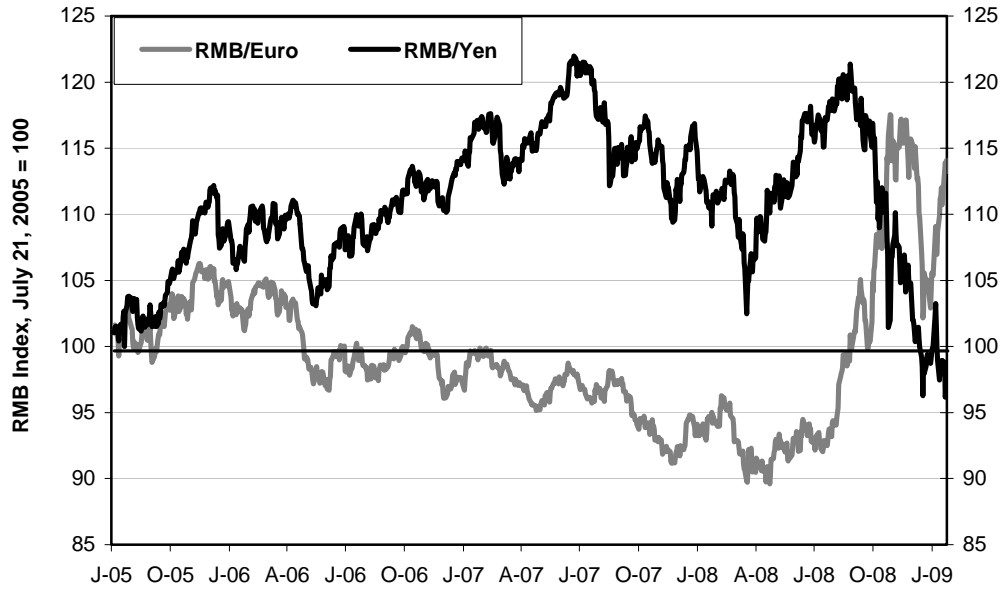
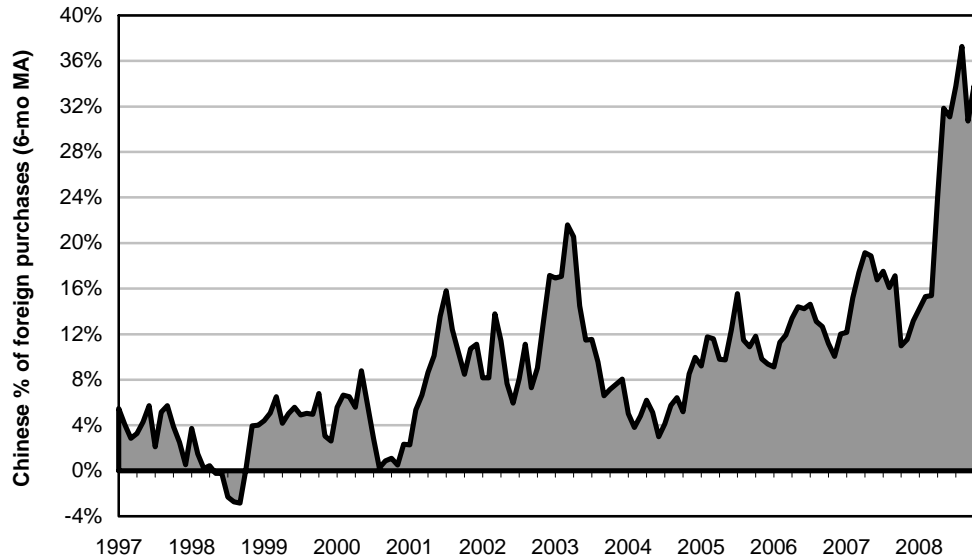


Figure 4: Chinese Share of Global Purchases of Long-Term US Securities



Note: 6-month moving average with data ending in November 2008