Market move for China's yuan

For first time in a decade, Chinese shift currency peg off the dollar and allow it to float in a narrow range

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Following months of speculation and behind-the-scenes wrangling, China's central bank yesterday took a small step toward letting its currency rise to market rate, a move that could help reduce the U.S. trade deficit but might also lead to higher U.S. inflation and interest rates.

The new policy takes some pressure off the Bush administration, which is facing criticism from American companies who say China's currency policy gives its manufacturers an unfair trade advantage.

For a decade, China has pegged its currency, the yuan, to the dollar. Yesterday it shifted, raising the yuan, to 8.11 to the dollar versus the previous rate of 8.28 to the dollar. The move allowed the yuan to appreciate against the dollar, though only by 2 percent.

Chinese authorities also said they will now peg the yuan to a basket of currencies and allow it to fluctuate within a narrow 0.3 percent range.

Economists disagreed about the significance of the change, some arguing it's a harbinger of China's eventual move to a free-floating currency, and others saying it is too minor to have even marginal impact on the U.S.-China trade relationship.

The U.S. currently carries a $162-billion trade deficit with China, meaning we are buying far more goods and services from Chinese companies than they are purchasing from us.

If the yuan were allowed to float on the open market, conventional wisdom says, it would shoot up in value, reflecting the underlying strength of the Chinese economy. If that happens, Chinese goods will become more expensive and products from the U.S. and other countries will be more competitive.

Economists believe the yuan is undervalued by 15 percent to 40 percent because of the peg. But at 2 percent, the revaluation announced yesterday was much lower than many experts had predicted.

Rather than a meaningful solution to the trade deficit, "this is primarily intended to give the president some political cover on the Hill, where he's been taking a lot of heat about accommodating China on a lot of fronts," said University of Maryland economist Peter Morici.

"Until we start to see double-digit revaluations, this will have no bite at all," he added. "We'd have to see a revaluation of at least 20 percent to see an appreciable change in the trade imbalance."

According to Morici, the yuan's intrinsic value - or, the value of the currency as a reflection of the strength of China's economy - has been rising about 4 percent each year. So a 2 percent revaluation only sets the yuan back by about 6 months.

But Mark Zandi, chief economist at Economy.com, said it's important to view China's move in a longer time frame. "This event by itself is very small, but it's the start of a very significant process" that might include future revaluations, he said.

Within three years, he predicts, the yuan will rise 25 percent to 30 percent. Such a shift would likely result in higher retail prices, interest rates and inflation in the United States as the cost of Chinese products rises and China slows its voracious purchase of U.S. treasury debt.

On the upside, economists and policy makers hope a fairly valued Chinese currency will stanch the loss of U.S. manufacturing jobs to a workforce in Asia where the pay scales are typically lower.

In a statement, U.S. Treasury Secretary John Snow said, "China's full implementation of its new currency regime will be a significant contribution toward global financial stability."

But equilibrium in the global economy is still a long way off, said Usha Haley, professor of international business at the University of New Haven.

Yesterday's move "doesn't mean much. It's basically a token measure," Haley said.