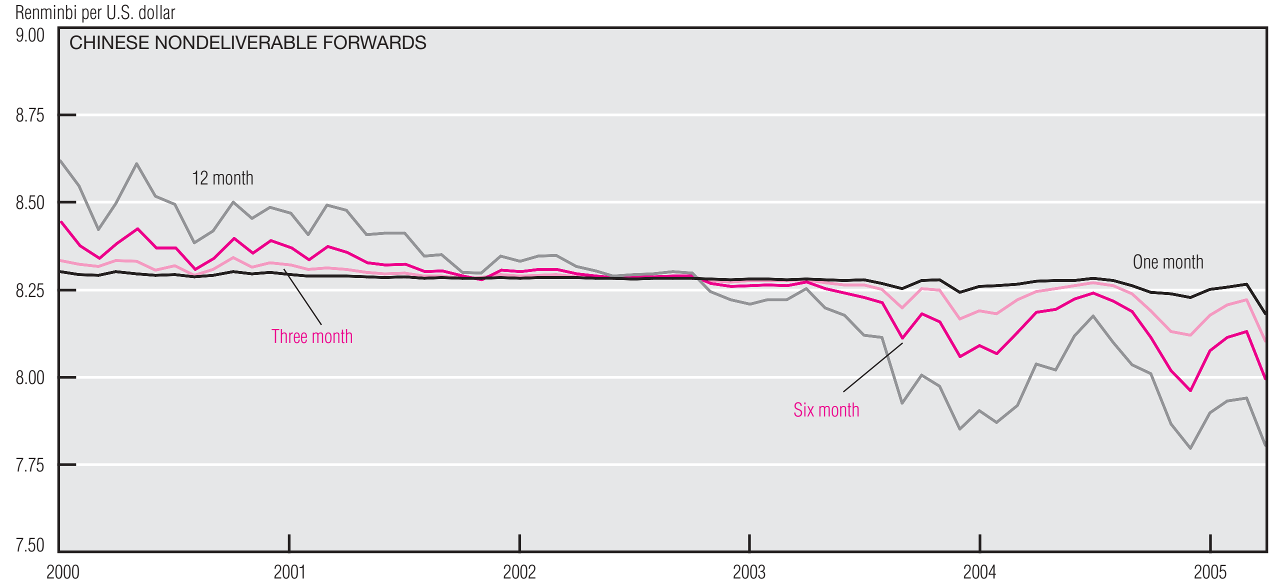
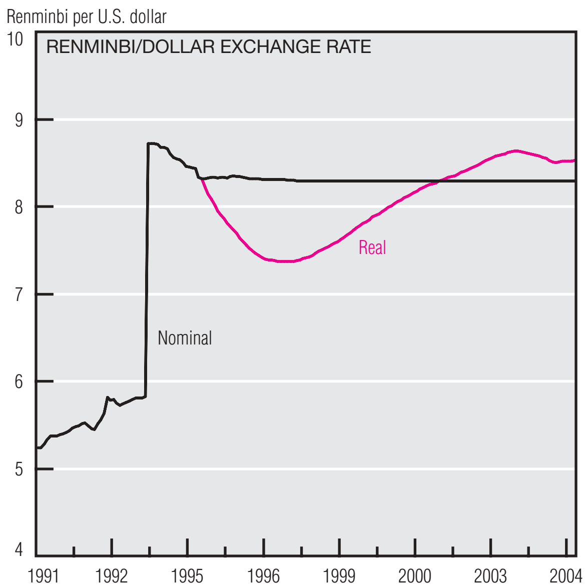
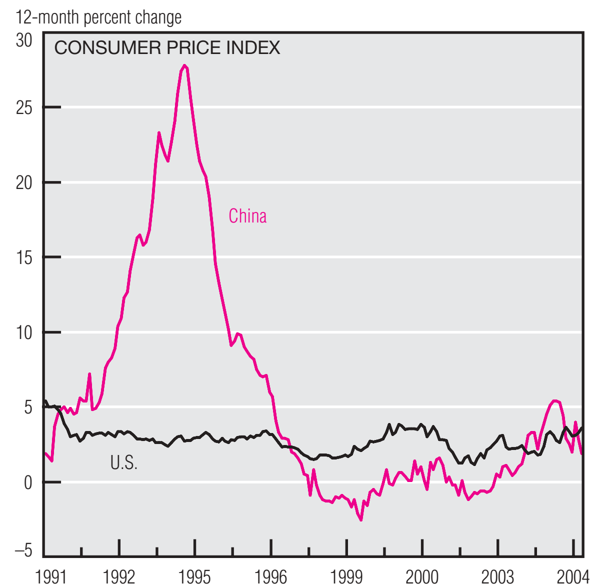
9

Betting on a Renminbi Revaluation







SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10; National Bureau of Statistics of China; and Bloomberg Financial Information Services.

The U.S. has turned up the heat on China to revalue the renminbi: The Treasury has threatened to label China a currency manipulator, and Congress may impose tariffs if China does not comply. Some pundits maintain that such threats will only stiffen China's resistance to revaluation. So, how is the smart money betting?

Forward exchange rates often reveal the market's best guess about a currency's future path, but no forward renminbi market exists because China restricts such trading. Recently, a market in nondeliverable forwards (NDFs) has arisen to provide cover for companies trading in renminbi. An NDF contract sets an exchange rate for the future purchase or sale of renminbi. But unlike a standard forward contract, delivery on an NDF is made not in renminbi, but in an equivalent amount of a convertible currency, such as U.S. dollars.

Forward rates on renminbi NDFs have been below Rmb 8.28 per dollar since mid-2002, suggesting that the market expects a renminbi appreciation. Recently, NDFs generally have fallen to new lows.

A renminbi revaluation seems an eventual certainty, but betting on how it might affect trade is still risky. Trade depends on the real, or inflation-adjusted, exchange rate. A change in the peg will certainly affect the real rate for a while, but few economists expect it to have a lasting effect on the real exchange rate.