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AUGUST 2005

Without A Net

On July 21st, 2005, the People's Bank of China (PBOC) announced that China's currency, the yuan, "will no longer be pegged to the U.S. dollar." With this announcement, the central bank ended a currency regime that had endured for over a decade: the yuan had been fixed at an exchange rate of about 8.3 per dollar since the first quarter of 1995.

The fixed exchange rate mechanism, commonly referred to as the "peg," was heralded within China as a secure anchor for the economy. The peg was perceived to have delivered ten years of steady growth, social stability, and generally rising prosperity. In particular, the peg was deemed to have attracted a great deal of foreign direct investment (FDI): multinationals, already eager to build or buy businesses within China, were pleased the peg reduced currency-related risks. The fixed rate allowed such companies to "lock in" their margins without concern that fluctuating currencies might undermine their profits. China quickly became the world's leading destination for FDI, attracting over $50 billion in 2004.

Overseas, the perception of the peg was generally quite different. For the better part of the last decade, few of China's trading partners were closely attuned to the peg's existence. The yuan was considered a "soft" currency whose value was established solely by its reference to the "hard" dollar. Traders had little use for a niche currency that had no real worth outside China.

China's currency policy did briefly win it praise when, in 1997, the authorities kept the peg in place during the financial crisis that struck the Asian region. Had China lowered its currency to safeguard export growth, as much of its neighboring countries did, it might have touched off a competitive round of "beggar-thy-neighbor" devaluations: each country would push its currency lower than the next to promote exports, impoverishing all in the process. China's firm stance did much to stabilize the region's volatile markets, paving the way for recovery. However, this decision was not without cost – China's domestic market suffered a severe bout of deflation that persisted for the next five years.

Praise for China's difficult undertaking was short-lived. As growth in the Asian region picked up once more, exports to western economies accelerated. The U.S., already running a large trade deficit with the rest of the world, was alarmed to discover that its deficit with China was a leading cause of its overall shortfall. In 2004, the U.S. ran a $162 billion trade deficit with China alone, versus a $618 billion total deficit. Politicians around the world grew alarmed at such large imbalances, and public outcry began to highlight the yuan's peg as the primary source of China's "unfair" trade advantage.

Certainly, the peg generated some short-term advantages for Chinese exporters. However, whether this arrangement would have delivered long-term benefits is a much more complex question: had the peg been maintained, China might have become susceptible to high levels of inflation, potentially swamping the domestic economy. In any case, the true question is not whether China pegged its currency to the dollar by choice, to gain a competitive advantage, but rather whether it was forced to do so out of necessity.

A key component of the demand for a currency is its ability to function as a store of value. In the U.S., we require dollars because they provide a means to earn income and accumulate wealth. What we don't spend, we often place in banks, bonds, equities and other savings products; our aim is to protect our wealth from inflation, and perhaps

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CHINA

Economic data released in July indicated that China's real GDP grew 9.5% in the second quarter year-on-year, after expanding 9.4% in the previous quarter. The strong economic growth was attributable to robust fixed asset investment and exports, which rose 28.8% and 30.6% respectively. China's exports grew twice as fast as the growth of imports during the same period. The country's trade surplus to U.S.$39.6 billion in the first half of the year, compared with a U.S.$6.7 billion deficit in the same period last year. Domestic retail sales of consumer goods grew 12.9% in June year-over- year; a continuation of a three-month upward trend, as urban and rural incomes rose 9.5% and 12.5% respectively in the first half of the year. The consumer price index (CPI) rose 1.6% in June year-on-year, suggesting that inflationary pressure remained relatively benign. Shortly after the release of the official economic figures, the People's Bank of China (PBOC) announced the adjustment of the exchange rate of the renminbi against the U.S. dollar from 8.28 Rmb to 8.11 Rmb. In addition, the reform of the exchange regime ended the decade-old peg to the U.S. dollar by moving to a managed rate that will be linked to a basket of currencies.

HONG KONG

The latest employment statistics indicated that the seasonally-adjusted unemployment rate stood at 5.7% in June, unchanged from the previous month, still the lowest level recorded in more than three years. The Census and Statistics Department noted that total employment grew to a new high of 3.36 million and the total labor force also increased by a similar magnitude upon the increased entry of fresh graduates into the labor market. Meanwhile, Hong Kong's Court of Final Appeal's has unanimously ruled that the Housing Authority has the legal power to divest its retail and parking facilities through listing of a Real Estate Investment Trust (REIT). The Housing Authority reaffirmed the intention to launch the listing again, although the exact timetable is yet to be determined.

JAPAN

Unemployment fell to a seven-year low of 4.2% in June, down from4.4% in the previous month. The economy added a total of 830,000 jobs during April and May, but job growth was somewhat reversed in June with 350,000 jobs lost. Households headed by salaried workers saw incomes rise 1.1% in June, according to the government. However, household spending decreased 1.4% over the same period on a month-on-month basis. While Japan has experienced falling land prices on a nationwide basis for the past thirteen years, the pace of land deflation subsided to 3.4% in 2004. Real estate in Tokyo bucked the national trend with land prices increasing 0.4%, the first such increase in thirteen years. On the political front, Prime Minister Koizumi continued to push forward his bill to privatize Japan's postal service, winning an important vote in the lower house of Parliament. The bill, which would split the postal service into four entities by 2007 and sell off the savings and insurance business by 2017, faced internal opposition from both the Liberal Democratic Party (LDP), as well as 300,000 postal workers. The bill still needs to pass the upper house of parliament where it is expected to face stiff opposition.

KOREA

Korea's gross domestic product (GDP) expanded 3.3% year-on-year in the quarter ending June 30. Domestic consumption, as measured by department store sales rose 1.6% in June, the fifth consecutive month of increasing sales. The consumer price index increased 2.5% year-on-year in July, a slowdown from the 2.7% increase in June. However, business confidence, reported by the Federation of Korean Industries, fell from 96.5 in June to 91.7 in July, with a reading below 100 indicating a negative short-term outlook. According to the survey, Korean exporters remained concerned with the 14% appreciation of the won over the past year. Standard & Poor's raised its rating on Korea's foreign currency debt to A from A-, the highest rating since the Asian financial crisis. The rating agency pointed to the strengthening of the financial system as one of the factors behind the upgrade; however it also stressed the continued geopolitical risks arising from North Korea. At the end of July, North Korea engaged in six-party talks, the first meeting of its kind in thirteen months. However, at the time of writing it remained to be seen whether or not this round of talks would lead to any constructive resolutions.

TAIWAN

The Chairman of Taiwan's New Party, along with a 30-member delegation, made an eight-day visit to mainland China. The New Party, a small opposition party in Taiwan, is more open to reunification with the mainland. The New Party's chairman is the third opposition party leader to meet with mainland's leaders this year, following the Kuomintang (KMT), and People's First Party (PFP). On the domestic front, statistics released by the Financial Supervisory Commission (FSC) indicated that Taiwan posted a record high of NT$17.9 billion (U.S.$526.47 mn) in delinquent credit card spending in the first half of the year. And due to excessive issuance of credit cards, 70% of the new credits issued were discarded in June alone. FSC officials urged banks in Taiwan to adopt more vigorous and stricter criteria on screening credit card applications.

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generate some growth in the process. Our demand for dollars is underlined by the highly efficient financial system that makes this savings and investment possible. Despite the scandals plaguing markets over recent years, the U.S. financial system is comparatively healthy. It is capable of processing trillions of dollars, at relatively low cost, and relatively high return. The system's breadth, depth and liquidity are presently unmatched.

China lacks such a system, and consequently, the demand for the yuan is intrinsically less stable. China's financial landscape is dominated by commercial banks which historically functioned as an arm of the state rather than as profit-oriented institutions. As a consequence, China's financial system has been notoriously weak, plagued with large losses. Estimates of those losses vary widely, but at a minimum they are twice those of the U.S. S&L crisis (measured relative to current GDP).

This systemic weakness is precisely what drove China to fix the yuan to the dollar in the first place. China's intention was not to gain an "unfair" trade advantage; had it been, the yuan would have been devalued promptly during the early days of the Asian financial crisis. Instead, China's primary goal was always to "piggyback" on the strength of the U.S. financial system.

By tying the value of the yuan firmly to the dollar, the peg established a degree of trust in the Chinese currency. Chinese citizens were somewhat more willing to hold the yuan as a store of value, despite the frailties of the domestic banking system. A key element of this trust arose from the workings of the peg itself: in order to maintain a fixed exchange rate, China was forced to purchase U.S. treasuries in quantities proportionate to its trade surplus with the U.S.

Many observers felt that China would abandon this arrangement because of the unattractive yields available on U.S. treasuries. Yet the peg was a tacit admission that China was better off plowing its hard-earned export "profits" back into low-yielding U.S. bonds than it was to re-circulate those profits in its own feeble system back home. Effectively, the peg forced China to "save and invest" its earnings in the U.S. at a time when its own domestic financial system was incapable of performing this function.

And this brings us to the present, where China has declared an end to the peg. With the health of the Chinese financial system still in question, this decision might appear risky, and indeed it is. However, apart from the obvious political component to China's decision, the underlying meaning is far more substantial: the country has taken an explicit step towards relying on its own financial infrastructure, in lieu of the U.S. system. To be sure, the PBOC's announcement represents a small step, but a crucial one - it is akin to the circus ringmaster who pulls the safety net out from under the novice tightrope walker.

That action can be a very dangerous one, as there is no guarantee the performer will cross safely to the other side – just as China's banks may still face failure. Yet by removing the net, the ringmaster signals a tremendous vote of confidence in the performer, and simultaneously instills a powerful incentive for a better performance. This is precisely what the Chinese authorities have done: they have signaled to the world, and especially to their own citizenry, that the domestic banks are on the mend. They have also given recalcitrant banks a strong incentive to undertake reforms. For once the ringmaster removes the net, it cannot be replaced – otherwise, the audience will most certainly head for the exits.

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