China's Yuan Decision

The economic costs of the inflexible exchange rate now outweigh its benefits.

BY CHI LO

A revaluation of the yuan, as some have been pushing for, will not work to correct the global saving-investment imbalance, as I argued in the spring 2007 issue of *TIE*. A recent Bank of England research paper has added a new angle to this view. However, China has likely come to a point where bolder changes are needed to move the development process forward. This is because the distortions resulting from the current policy approach are likely to worsen, raising welfare costs and generating systemic instability down the road. The yuan policy is a case in point. Signs are emerging that the economic costs of the inflexible exchange rate are outweighing the benefits.

China may risk drawing the wrong lesson from the Asian crisis by fixing its exchange rate for too long and focusing on building up foreign reserves. China was least affected by the regional crisis, thanks to its strict capital controls. And by refusing to devalue at that time, it prevented aggravating financial contagion in Asia.

By the same token, the yuan's crawling peg and the consequent rapid build-up of foreign reserves have led to excessive liquidity growth and created serious economic distortions, notably in the asset markets where asset price inflation has been rampant. These economic imbalances could lead to vulnerabilities like the massive capital inflows, credit boom, excessive investment, and economic bubbles in the run-up to the Asian crisis. All this is not to say that China should change its yuan regime at once, but it does suggest that Beijing should seriously think about an exit strategy for the current yuan policy.

The Chinese authorities have long argued that a stable currency is in the best interest of the country. The argument has evolved into curbing the yuan exchange rate from rising on the back of a massive balance of payments surplus in recent years. However, the Chinese authorities' fears about a sharp

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yuan revaluation destabilizing the banking system and the economy, leading to capital outflow and depleting the foreign reserves, are becoming outdated. China's foreign reserves are getting too big, and they are creating excess liquidity and causing economic imbalances under the rigid exchange rate policy.

China's banking system is also much stronger today. Years of banking reforms, including recapitalization of the Big Four state commercial banks, bad loans carve-outs to the four asset management companies and, most recently, flotation of the state-owned banks, have sharply reduced systemic risks by cutting non-performing loans (Figure 1).

The authorities are also worried that a strong yuan would cause big job losses, and thus risk social unrest, by hurting exports. The labor-intensive industries will be hit especially hard, as their margins have already been squeezed by keen competition and the lack of pricing power. However, the importance of these export industries has fallen sharply over the years, giving way to the growth of the higher value-added products (Figure 2).

Meanwhile, the Chinese corporate sector has become much more efficient, with a strong ability to sustain profit growth in the face of no pricing power (Figure 3). All these suggest that China's labor market and corporate sector are in a stronger position to face a higher exchange rate in the policy transition and structural adjustment process.

On the other hand, the benefits of keeping the *de facto* yuan peg have been eroding, with mounting side effects on the domestic economy and global trading system. The cheap currency has induced a massive expansion of the external sector and made the Chinese economy increasingly export-driven. This goes against Beijing's expenditure-switching strategy of boosting domestic demand and reducing the reliance on exports as the key economic growth driver.

The rigid yuan has also created a moral hazard problem of speculators betting on one-way yuan appreciation. This has, in turn, boosted hot money inflows and distorted capital allocation. Combined with a massive current account surplus, the portfolio inflows have added pressure that is generating excessive liquidity in the domestic system, boosting asset price inflation, and risking the ignition of general inflation down the road.

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The biggest domestic distortion is in monetary policy. The central bank's interest rate policy tool has been severely blunted at a time when excess liquidity is causing economic imbalances. Distorted interest rates are increasing savers' incentive to shift funds into the asset markets from bank accounts. The risk-free one-year deposit interest rate (at 3.06 percent) is completely out of touch with the rising expectations on earnings and economic growth. For example, expected return on stock market investments is over 30 percent. This huge gap between the risk-free rate and expected investment return has boosted stock prices to the bubble territory.

On the trade front, since China's productivity gains will continue to outpace those of its trading partners in the medium-term, a fixed yuan will only aggravate the competitive stress on global trade. China's bulging trade surplus has already become a political issue, creating trade protectionist pressure around the world, including recently from Mexico and emerging Asia. Indeed, China's trade deficit with Asia has been narrowing (Figure 4). Some Asian economies, such as India and Singapore, have seen their trade surpluses with China turned into deficits recently. The fear is that this could be the start of a trend where China is reaping all the gains from trade at the expense of its trading partners.

Allowing market forces to set the yuan's exchange rate is a natural solution to prevent its economic distortions from inflicting excessive volatility on the Chinese and global systems. With diminishing benefits and mounting costs of keeping the fixed exchange rate, the current environment of low inflation, strong corporate profitability, and steady demand growth indeed provides a favorable backdrop for making a policy shift.

In practice, Beijing still prefers a gradualist approach. Indeed, any sudden change in the yuan regime, such as a big revaluation, is a lose-lose situation for everyone, as I argued in the spring issue of this magazine. However, signs suggest that China is moving in the right direction by pursuing a two-pronged approach to exiting the yuan peg over time: unlocking the capital account along with loosening its grip on the exchange rate.

Before China's current account surplus turns around, it will continue to add to foreign exchange supply (inflows). Unlocking the capital account and allowing more convertibility, of say 10 percent of funds in the domestic banking system, would generate more demand for foreign exchange to absorb the capital inflows. This is precisely what the recently approved Qualified Domestic Institutional Investor (QDII) scheme and the newly created State Foreign Exchange Investment Corp. (SFEIC) can achieve.

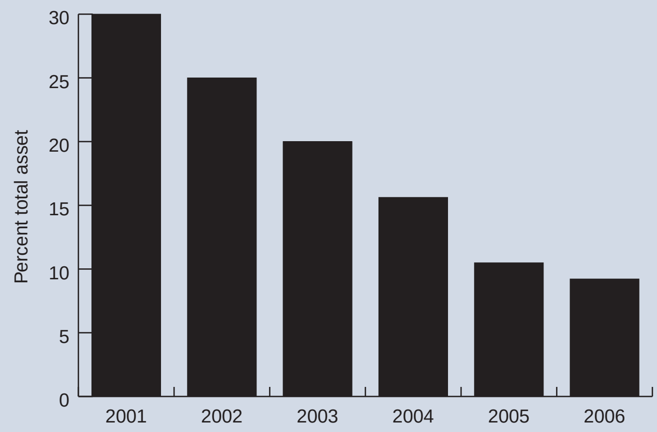
The government has indicated that it would allow approved institutions, including local banks, insurance companies, trusts, and fund management companies, to invest up to 5 percent of their investible assets in foreign markets under QDII. The SFEIC, meanwhile, will invest US$200 billion of China's foreign reserves in overseas markets. All these are solid steps towards capital account convertibility and generating capital outflow to offset some of the yuan appreciation pressure and, hence, its economic distortions.

Beijing's long-term plan is to gradually allow a rising portion of liquid yuan assets to be freely convertible into foreign assets. The move will not only help improve China's domestic capital allocation efficiency. It will also contribute to a more effective functioning of the global markets.

Before the yuan can be floated, Beijing could take an unconventional move to help resolve the yuan riddle at this stage of the economic cycle. Consider this. Foreign exchange intervention to keep the yuan fixed creates excess liquidity and, hence, the potential to fuel domestic inflation. Thus, the central bank has to "sterilize" the intervention by issuing bonds to mop up the liquidity. But what if this conventional wisdom is wrong in China? Then the inflation fear, and hence the need for sterilization, will become irrelevant. Less sterilization will boost China's demand, including that for imports, and thus help resolve the bulging trade surplus problem.

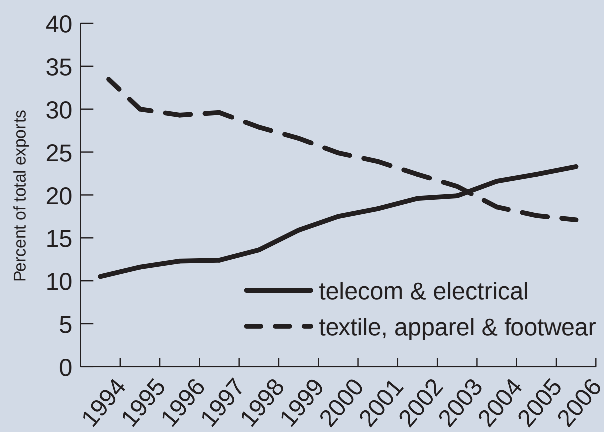
Now consider China's money supply, which is growing at an annual rate of 17 percent, compared to GDP growth of 11 percent, yet inflation remains very low. While there may be some overheated pockets in the Chinese economy, there is still excess capacity all around. Import growth has not shown a rising trend, suggesting that China still suffers from

Figure 1 The Big Four state commercial banks' NPLs



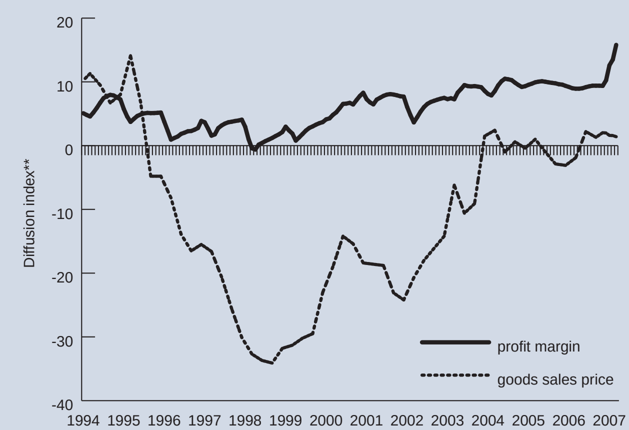
Sources: CEIC, Hoover Institute, CBRC.

Figure 2 Declining importance of low value-added exports



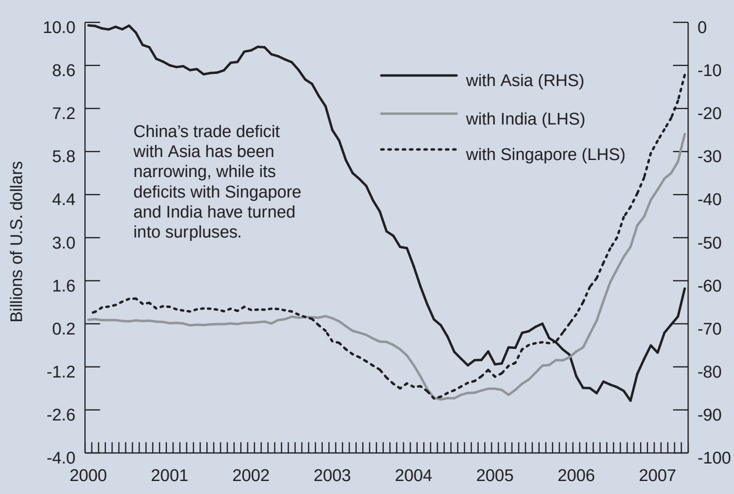
Source: CEIC.

Figure 3 Profits improved without pricing power*



* Three-month moving averages.
** Number of firms reporting improvement / number of firms reporting deterioration.
Source: CEIC.

Figure 4 China's trade balance



Source: CEIC.

weak domestic demand, despite massive inflow of foreign exchange in recent years.

Behavior of the Chinese households suggests that this weak domestic demand is not a result of central bank sterilization. The extra yuan created from foreign exchange intervention just did not filter through to Chinese consumption, but instead went to satisfy the desire to hold yuan (for precautionary motives under the broken social safety net) and yuan assets (for investment purposes to maximize returns under financial liberalization).

The Chinese are saving record amounts as they get richer. The savings cannot go abroad due to capital controls, so it is invested at home in production capacity beyond the need for domestic consumption. This creates excess capacity, erodes pricing power, and forces companies to export. Meanwhile, there is an excess demand for money for saving and speculative purposes; the latter underscores the saving motive. Since the excess money demand does not fuel consumption, there is no goods price inflation, but just asset price inflation. So far, there is no wealth effect on consumption from China's stock market.

The central bank's sterilization effort is restricting money supply from rising to meet this money demand, thus perpetuating the imbalance of over-investment and under-consumption. If the central bank were to ease off sterilization, the demand for yuan would be satisfied. This would result in an increase in domestic demand and imports and, thus, help cut China's trade surplus and reduce international tension.

This may sound like a bet on inflation. After all, China's money demand function is inadequately understood, as structural changes in the economy have made it unstable. This should be an area for further research. But intuition suggests that inflation may not rise due to excess capacity. Some prices may actually fall as companies achieve greater economies of scale under domestic demand expansion.

The implications of all these on China's asset markets are quite positive. The strong precautionary and speculative demand for money will provide a medium-term support for Chinese asset prices. The argument for the central bank to ease up on sterilization also means a bull market backdrop for asset prices over the medium-term. Lastly, full convertibility of the yuan will be slow to come, due to institutional and political constraints. But Beijing is moving towards that goal gradually and surely. ◆