China's Currency Conundrum

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It seems the People's Bank of China (PBOC) cannot win. In late February, the gradual appreciation of the renminbi was interrupted by a 1 per cent depreciation (to $1:¥6.12). Though insignificant in overall trade terms, especially when compared with the volatility of floating exchange-rate regimes, the renminbi's unexpected weakening sparked a global furor.

This is hardly surprising. After all, China has been under constant pressure from foreign governments to revalue, in the mistaken belief that a stronger currency would reduce China's large trade surplus. And, since July 2005, when the exchange rate was $1:¥8.28 (and had been held constant for 10 years), the PBOC has implemented more or less steady appreciations of about 3 per cent per year through 2013.

But the international outcry over the depreciation obscured another, unintended but perhaps more troubling, feature of China's exchange-rate policy: the tendency for sporadic renminbi appreciation (even small movements) to trigger speculative inflows of 'hot' money. With short-term interest rates in the United States near zero, and the 'natural' interbank interest rate in faster-growing China at nearly 4 per cent, an expected 3 per cent appreciation would, for example, translate into an 'effective' interest-rate differential of 7 per cent. This is an enticing spread for currency speculators who borrow in dollars and circumvent China's capital controls to buy renminbi assets.

Western demands for renminbi appreciation — in the hope of taming China's current account surplus — are misguided anyway. In reality, the trade imbalance reflects the difference between China's large savings surplus and the even bigger US saving deficiency, largely explained by the US fiscal deficit. Indeed, the wholesale price index —

the best measure of tradable-goods prices in China — has been falling by about 1.5 per cent annually, which suggests that the renminbi may even be slightly*overvalued*.

Exchange-rate movements do not correct trade imbalances between open economies, but they *can* increase hot money flows. Hence February's surprise devaluation was designed to upset speculators. In mid-March, the PBOC announced that the daily movement in the yuan/dollar rate would be increased from plus or minus 1 per cent to plus or minus 2 per cent, to further dampen the enthusiasm of hot money speculators. While this is all well and good, speculative inflows would be further dampened if today's central rate, say $1:¥6.1, was stabilised into the indefinite future.

And there is another justification for holding the currency stable. The adjustment mechanism usually provided by a flexible exchange rate could instead be delivered by wage changes. For example, if employers (particularly exporters) fear a future renminbi appreciation, they may hesitate to raise wages in line with productivity increases. But if they can be confident that the exchange rate will remain stable, wages will rise — and China has experienced 10 to 15 per cent annual wage growth already. From higher wage growth at a stable nominal exchange rate, China's real international competitiveness would be better calibrated by encouraging unit labour costs to converge to those in developed economies.

As a result of policymakers' heavy focus on the exchange rate, China's State Administration of Foreign Exchange has now accumulated more than $4 trillion in reserves — much more than it would need in any imaginable currency emergency. Worse, the very act of currency intervention can undermine the PBOC's control of monetary policy. Buying dollars increases the domestic base money supply, risking inflation and asset-price bubbles.

Efforts to 'sterilise' these purchases and dampen domestic credit expansion also have adverse consequences. The PBOC frequently does this by selling bonds to commercial banks or raising their reserve requirements. But this has reduced these banks' effectiveness as financial intermediaries, while encouraging the rise of shadow banking to circumvent the restrictions.

So what are the PBOC's options? It could let the renminbi float without official intervention or controls on capital inflows. Again, this would inevitably trigger hot-money inflows, as speculators take advantage of the spread between Chinese interest rates and the near-zero, short-term rates in developed economies, thereby driving up the renminbi further (and creating yet more opportunities for speculation). There would be no well-defined market equilibrium or upper bound for the dollar value of the renminbi.

Even without hot-money inflows, the renminbi's exchange rate would still face upward pressure, owing to the absence of net outflows of financial capital to balance China's trade surplus. As an immature international creditor, China would not be able to offset its trade surplus by making renminbi loans abroad. Nor would it want to make dollar-denominated loans. Private (non-state) banks, insurance companies, pension funds, and so on, have limited appetites for building up liquid dollar claims on foreigners when their own liabilities — deposits, insurance claims, and pension obligations — are in renminbi. The potential currency mismatch requires the PBOC (which cares little for exchange-rate risk) to step in as the principal international financial intermediary by buying liquid dollar assets on a vast scale. Foreign investors do not show much appetite for borrowing in renminbi either.

China is therefore caught in a currency trap because of its own savings surplus and near-zero interest rates on dollar assets. If China tries to liberalise its financial markets, hot money finance flows the wrong way — into the economy rather than out. Although fully liberalising China's domestic financial markets and internationalising the renminbi someday may be possible, that day is far off. In the meantime, China will retain controls on inflows of financial capital while the PBOC intervenes to stabilise the exchange rate.

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