OPINION

Overvaluing the 'Undervalued' View of the Yuan

The Chinese currency has no real 'equilibrium value,' even if Treasury wishes it did.

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Since Jan. 1 the yuan has fallen 2.9% against the dollar, reversing the Chinese currency's 2.9% appreciation in 2013. Such a dip would be a small fluctuation for a freely traded currency, but it's a big drop in China. The yuan hasn't fallen so much or for so long since July 2005, when Beijing introduced what it calls "a managed floating exchange rate based on market supply and demand with reference to a basket of currencies."

The U.S. Treasury Department has taken notice. In an April 15 report to Congress, Treasury called the yuan "significantly undervalued" and urged Beijing to bring the currency to its "equilibrium value." Recent developments, Treasury warned, would "raise particularly serious concerns, if they presage a retreat from China's announced policy of allowing the exchange rate to reflect market forces."

Perhaps the yuan is indeed selling for less than it's worth. The Chinese currency would, of course, be considerably stronger absent the People's Bank of China's interventions in foreign-exchange markets, particularly since mid-February. In 2013 the PBOC accumulated $510 billion in foreign-exchange reserves, a record for a single year. Then it bought $120 billion more in the first quarter of 2014, bringing the total to almost $4 trillion. This buildup of international reserves pushes down the yuan's value by creating artificial demand for the dollar.

Treasury and others see this as part of an attempt to bolster China's recently sluggish GDP growth. Yet this is probably not the PBOC's primary objective. Rather, the central bank is likely laying the groundwork for the deposit-rate liberalization set to take place by the end of 2015. This will remove the current cap on deposit rates and allow commercial banks to set rates based on supply and demand.

The reform could cause China's interest rates to spike. State-set benchmark rates now range from 0.35% for current accounts to 4.75% for five-year deposits. Market forces would drive up these rates into the range of yields on wealth-management products sold by Chinese banks, which aren't under PBOC control. Currently those yields average 4.7% for offerings with maturities of less than a month to 6% for those maturing in more than a year. Lending rates, which have already been liberalized, would also rise as banks passed on higher costs to borrowers.
Interest-rate increases of this magnitude would be a severe shock to the Chinese economy. The state sector, which is the main beneficiary of the current regime, would incur heavy losses. Private-sector firms would also suffer as higher rates at state banks pushed up already high rates in the informal lending sector. The residential property market could be especially vulnerable. As rates rose, households might keep wealth in bank accounts instead of investing in, say, new apartments or condominiums.

The PBOC will need to loosen monetary policy to mitigate these contractionary effects. The bank has two main tools to increase the money supply: outright dollar purchases and cuts in the Chinese banks' required reserve rate. Dollar purchases create new money because the central bank issues new yuan to pay for the dollars it buys. Reserve rate cuts free up funds for banks to lend, which expands deposits across the economy. The inevitable result, regardless of which approach the PBOC chooses, will be downward pressure on the yuan as its supply increases relative to the dollar.

Allowing the exchange rate to be set by market forces, as Treasury officials are urging, would require the PBOC to stop buying dollars altogether. All other things being equal, the result would be a stronger yuan. But all other things are not equal. In reality, the central bank would have to cut reserve rates even further to achieve the same reduction in market interest rates. Market forces would then move the currency lower, not higher.

In fact, the yuan has no real "equilibrium value," even if Treasury wishes it did. As the late-British economist Joan Robinson pointed out in 1947, nearly any exchange rate will be an equilibrium for some set of economic conditions. But economic conditions are always in flux, and so the "equilibrium exchange rate," as she famously put it, is a chimera. The yuan is a case in point. A move toward equilibrium may weaken the Chinese currency in the midst of the monetary easing required to smooth deposit-rate liberalization.

Treasury should be careful what it wishes for. The adjustment it's advocating might end up causing further yuan depreciation—the precise opposite of what Washington wants.

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