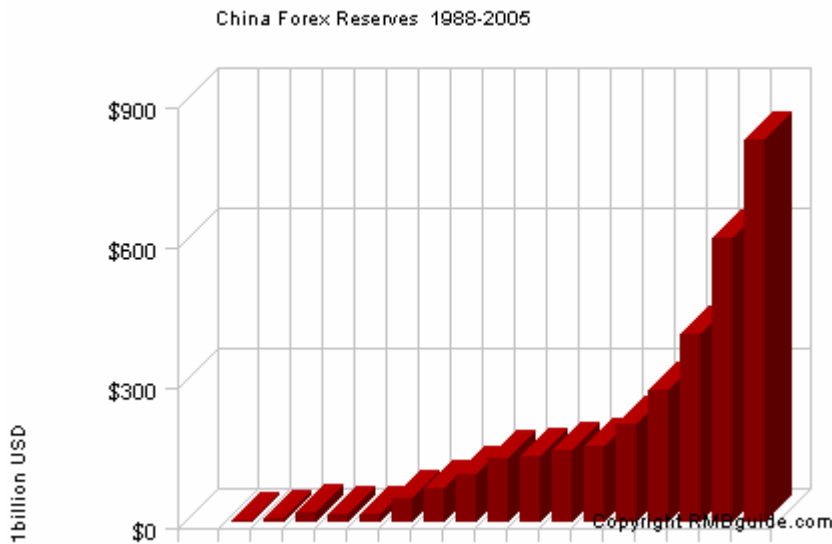


Whither the Yuan?: China's FX Conundrum

Last month, unbeknownst to many, we came to the brink of war with China! By that I mean a trade war, of course. A bipartisan bill in the Senate sponsored by Sen. Schumer (D) and Sen. Graham (R) last month threatened punitive tariffs on China unless they hastened the appreciation of the yuan. It seems politicians on both sides of the aisle were seeking a quick fix to the US' bloated trade deficit with China. Unfortunately, such threats seem to have little effect on Chinese policy. Instead, we see that behind-the-scenes efforts may be more successful in the long run in influencing policy in Beijing. Treasury Secretary Hank Paulson visited China in the past month to persuade the Chinese government to allow the yuan to appreciate at a faster pace. The IMF has estimated that the yuan could be undervalued by anywhere from 4% to 37%.¹ Currently, the Chinese Renminbi stands at around 7.91 per US dollar and has appreciated at around a 10% pace since the beginning of the year. However, the currency is still not allowed to float freely and the government maintains unsuccessful capital controls as part of the strategy of a planned economy.

The current undervaluation of the renminbi has led to domestic problems for the Chinese government. The consequences of undervaluation are large capital inflows into the country and a tremendous boost in liquidity. China must buy foreign currency and sell yuan to keep the rate stable further increasing the currency float. In turn, one would then see inflationary pressures as this increased amount of money flows through the economy. Moreover, excess capital itself tends to cause resources to be spent unwisely. Currently, China counteracts these capital inflows through a policy of sterilized intervention. In particular, they sell government bonds in order to remove excess capital. With banks under state control, these bonds can deliver below normal rates of return. However, at this rate it is unclear how long the central bank can keep issuing bonds. The sustainability of such sterilization is questionable. It is unknown how long China can keep issuing bonds to balance the inflow of capital. History tells us that unsustainable trends often reverse themselves in large violent moves (remember the Asian Crisis in 1997). The current level of FX reserves is unprecedented and worrisome to many economists for this reason.



Source: <http://www.rmbguide.com/China Foreign Exchange Reserves.htm>

One may then ask, ‘What is the problem with this?’ Firstly, the effects of this sterilization problem must be borne by the Chinese citizens. With no choice, they must deposit funds in the state owned banking system and earn low rates of return. In effect, the high national savings of the people are invested in low return assets. This is even more surprising given the capital shortfall for infrastructure in Western China.ⁱⁱ Secondly, the central bank is forced to accumulate larger and larger stockpiles of foreign currency. Their foreign reserves have ballooned in the last 5 years to over \$1 Trillion. These foreign reserves earn very low returns. Additionally, these reserves could be much more efficiently spent domestically (on education or infrastructure) and get a higher return. Furthermore, as the yuan appreciates over time, this \$1 Trillion foreign reserve loses value reducing seigniorage (income from US T Bills for instance) as a source of revenue for the Chinese government.

There are several reasons why China has adopted such a policy. The lower exchange rate fuels the country’s export driven industries. Chinese goods are more competitive abroad especially in consumer countries like the United States. With GDP growth in the 10% range, China’s economy is booming. In effect, they are facilitating this growth with a cheap currency. This path to growth is unsustainable and should lead to higher domestic interest rates in the future. Additionally, the debt that China must float to sterilize the capital inflows crowds out private debt leading to higher costs for internal development. The United States would like China to move more quickly to an appreciated yuan consistent with an exchange rate that a free market would determine. Treasury Secretary Paulson envisions a free market system that would drive consumption on the part of the Chinese economy. This in turn would make great strides in reversing the trade surplus that China has with the United States. The benefit to the United States will be increased exports to mainland China. The benefit to China

would be more efficient use of capital. "It takes \$5 to \$7 of investment in China to generate a dollar's worth of gross domestic products, vs. \$1 to \$2 in the U.S. and Japan."ⁱⁱⁱ For a country ready to make the leap to a market based economy, China needs to develop a more productive use of capital. The answer to this problem lies with the Chinese government's willingness to appreciate the yuan. A task that could take some years to accomplish. The hope is that the situation comes under control before the markets force the change. A crisis in China could easily lead to a recession across the globe.

ⁱ "Tough Call as IMF tries to value China yuan", Reuters, Oct 13 2006
http://today.reuters.com/news/articleinvesting.aspx?type=bondsNews&storyID=2006-10-13T215840Z_01_N13422684_RTRIDST_0_ECONOMY-IMF-YUAN.XML

ⁱⁱ "The More Foreign Exchange Reserves the Better?", Chi Hung Kwan Feb 14, 2003
<http://www.rieti.go.jp/en/china/03021401.html>

ⁱⁱⁱ "Paulson's China Challenge", Brian Bremner, BusinessWeek, Sept. 15, 2006,
http://www.businessweek.com/globalbiz/content/sep2006/gb20060914_175135.htm?chan=top+news_top+news+index_global+business