Why China Cannot Tackle its Currency Challenges Without Deeper Reforms

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July 2016

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This essay is adapted from work that originally appeared as Chapter 4 of the 2016 China Financial Risk and Stability Report, published by China Business News Research Institute, China National Institution for Finance and Development, and CES Capital.

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Introduction

China's August 11, 2015 decision to reform its currency regime was aimed at addressing one major longstanding problem in the yuan exchange rate—namely, flaws in the daily central parity formation mechanism governing its value. Before this decision, the central parity formation mechanism had been tightly controlled by China's central bank, the People's Bank of China (PBOC). And this formation mechanism was not very transparent. Indeed, since the start of 2015, there had been a consistent deviation between the previous day's closing rate and the next day's central parity rate. This, in turn, weakened the role of market forces in determining the exchange rate governing the yuan's value.

The August 11th decision should thus allow market forces to play a bigger role. Under the new arrangement, the daily central parity rate is a weighted average of the quotes submitted by major market makers in China's onshore yuan market. The quotes submitted by market makers reflect several factors: the previous day's closing rate, these market makers' expectations about supply and demand conditions in the foreign exchange market, and the movement of other major world currencies.[1]

But despite this move toward a more transparent and market-based exchange rate regime, there have been significant capital outflows from China, as well as yuan selling pressure, throughout the period since the August decision. The yuan has depreciated by close to 5 percent and total capital outflow exceeded $300 billion in the second half of 2015. As a result, and even though the PBOC has deployed a series of measures to stabilize the exchange rate, China lost some $275.8 billion of foreign exchange (forex) reserves in the second half of 2015 alone.

China's currency is thus in a difficult position. For one thing, China's exchange rate reforms and capital account liberalization efforts are not yet completed and further actions will be required if Beijing is to meet the liberalizing goals laid out in the decisions of the Third Plenum in November 2013. At the same time, such challenges as depreciation and capital outflows have actually made these badly needed reforms more delicate to pursue. China will need to deal with this contradiction.

This memorandum aims to help. It begins with an overview of China's major currency challenges. It then provides some baseline prescriptions for China to continue the pursuit of currency reform even as it tackles these various challenges. The central argument of the memorandum is that further reform is the best way to address the challenges that China and its exchange rate regime now face.

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Current Challenges to China's Currency Regime

Depreciation pressure, capital outflows, and the loss of forex reserves are all important challenges that still need a proper solution. Indeed, a careful examination of China's balance of payments (BoP) data reveals that the *true* size of China's capital outflows might actually be larger than the headline numbers have suggested.

A Vicious Cycle

Immediately after the August 11, 2015 decision, the daily central parity rate was lower than the previous day's closing rate for two consecutive days. And the closing price was close to the weak end of the daily floating band. This fueled market speculation that China had joined the global race to competitively devalue its currency.

The true size of China's capital outflows might actually be larger than the headline numbers have suggested.

To tackle the resulting expectation in the markets that the yuan would further depreciate, the PBOC took such steps as selling forex reserves, implementing macro prudential regulations, and strengthening checks on capital outflows. Beijing also repeatedly promised that China would not manipulate its currency to support gains in trade.

Still, from early July to December 2015, the average daily yuan/dollar exchange rate spread between the onshore market and the more market-driven offshore market widened to 352 basis points. This was significantly higher than the pre-August 11th average of 57 basis points.

As a result of persistent depreciation expectations, capital outflows increased significantly. In anticipation of further yuan depreciation, Chinese households and enterprises chose to increase holdings of their net foreign assets by such means as converting the Chinese currency into dollars, delaying receipt of payment for Chinese exports, pre-paying for imports, and so on. In addition, households and enterprises reduced their foreign currency borrowing and pre-paid foreign currency debts.

In 2015, for example, Chinese private sector entities (households and firms) increased their holdings of foreign assets by $392 billion, even as their foreign liabilities were reduced by $93.6 billion. Taken together, this yielded a private capital flow deficit of $485.3 billion in 2015.[2]

To reduce the impact of such large private capital outflows on the yuan exchange rate, the PBOC has taken counterparty positions for the majority of private capital outflows, which greatly eased yuan

selling pressure. But as a result of this currency intervention by the central bank, China's forex reserves shrank by $275.8 billion in the second half of 2015, the period that accounted for more than 80 percent of that year's depletion of forex reserves (see Figure 1).

Ultimately, it appears that the decrease in China's forex reserves and concomitant tightening of capital controls has further fueled yuan depreciation expectations. And this Chinese private sector demand for foreign assets is likely to continue.

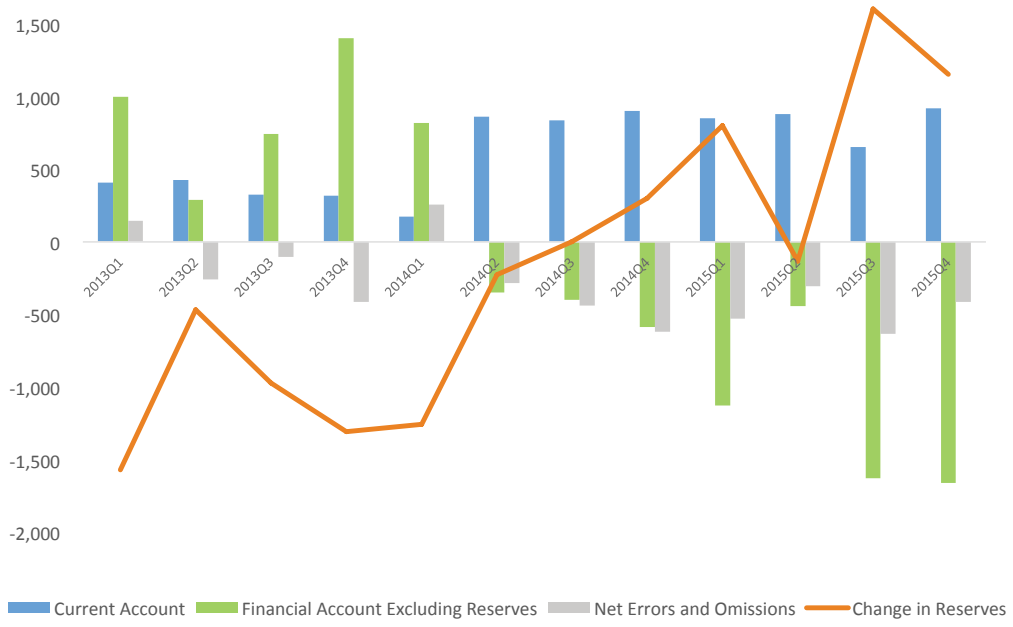
To put the resulting problem simply, China cannot rely solely on PBOC intervention. It still needs a long-term solution if it is to fundamentally solve the problem of capital outflows and self-fulfilling depreciation expectations.

Yuan Internationalization: A Double-Edged Sword

It is well understood that a currency mismatch can have harmful effects. What is less well known, however, is that yuan denominated foreign debt can also contribute to yuan sell-off pressure.

In anticipation of yuan depreciation, foreign entities will logically reduce their holdings of yuan assets, including

Figure 1. China's Balance of Payments (2013-2015)



Source: State Administration of Foreign Exchange (SAFE).

by reducing their holdings of yuan-denominated bonds. The repayment of yuan-denominated foreign debt will not, in itself, require domestic Chinese borrowers to sell their yuan in exchange for foreign currency. But when foreign lenders choose to cut their yuan exposure, they will inevitably refuse to roll over their yuan lending and will sell their yuan holdings. Both these steps will accelerate depreciation of the Chinese currency.

This is exactly what happened during the post-August 2015 sell-off. After the August 11th reform, Hong Kong investors sold their Chinese currency and purchased Hong Kong dollars. This created a large and sudden increase in the demand for HK dollars, driving the HKD/USD exchange rate to the strong end of the currency peg. The Hong Kong Monetary Authority was forced to intervene. China's foreign liabilities dropped by $263.9 billion in the second half of 2015, more than 40% of the drop was in yuan-denominated foreign debt.[3]

Problems with China's BoP Data

In BoP accounting, financial accounts are composed of two parts: a government held portion (forex reserves) and a privately held portion. The sum of these two parts should always be equal to the current account. But in China's 2015 data, there was a difference equal to negative $188.2 billion. Since this amount cannot be accounted for by looking at either private or government-held capital flows, it must be accounted for as net errors and omissions.

There are many explanations for the source of these net errors and omissions, and in fact all countries have a non-zero net errors and omissions piece to their BoP data. But in addition to universal issues, such as the errors introduced by rounding of data, there are some China-specific issues that could lead to such non-zero net errors and omissions.

For instance, many Chinese firms over-invoice their exports to claim government tax rebates and incentives. This would inflate the current account surplus and result in negative net errors and omissions equal to the size of the over-invoicing.

In addition, net errors and omissions do not, in themselves, equate to the illegal flow of capital. There are, for instance, also *legal* capital outflows that are undocumented.

The problem for China, then, is that given the size of such large net errors and omissions and its rapid increase during recent quarters, it is very likely that at least *part* of it is, in fact, represented by illegal capital outflows. This, in turn, suggests that the scale of capital outflows from China is probably larger than the headline BoP data suggests. The fact that large amounts of capital could be moved out of China without Beijing being aware is, of course, worrying.[4]

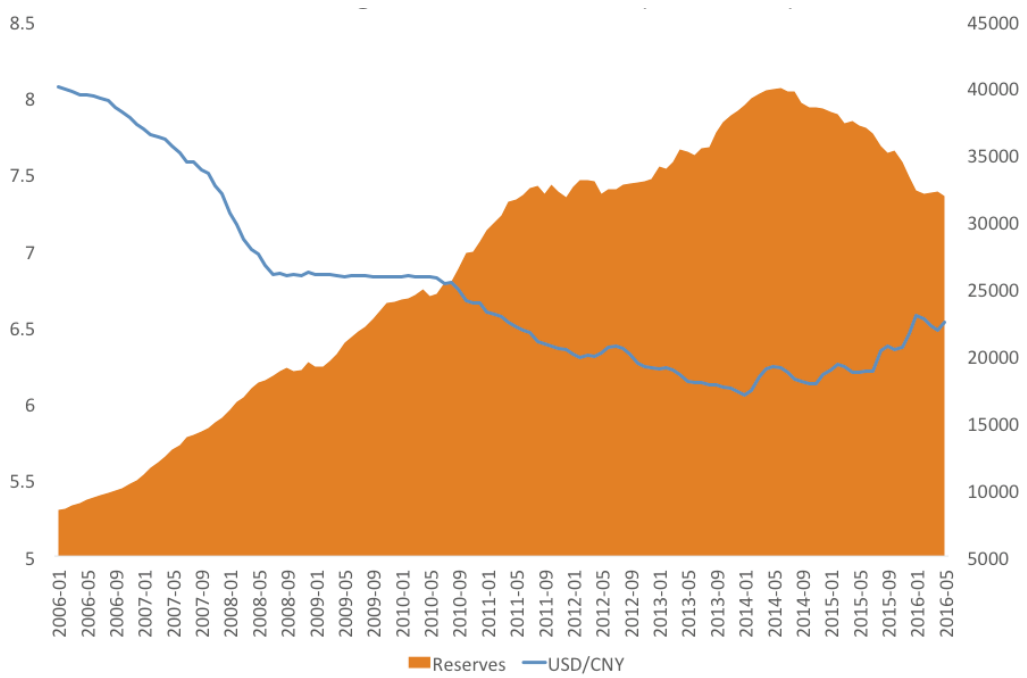
Deeper Currency Reforms Needed

The PBOC has played an active role in the balancing of capital flows through market intervention. In the past, such interventions have resulted in the large and rapid accumulation or else depletion of foreign reserves, which then has had significant effects on domestic liquidity (see Figure 2).

Theoretically, capital flows *could* be balanced either through exchange rate adjustments or central bank intervention. In normal times, central banks should allow private capital flows to determine exchange rates, since that would provide the central bank with greater freedom to conduct monetary policy.[5]

Fixed exchange rates limit the space for other domestic economic policies, including monetary policy. Indeed, a great deal of international experience has demonstrated that the combination of free capital movement and a fixed

Figure 2. Exchange Rate and Foreign Exchange Reserves (2006-2016)



Source: US Federal Reserve; SAFE.

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exchange rate is the worst possible macroeconomic policy combination. For one, a fixed exchange rate makes speculative currency attacks more likely. And as a result, many countries have adopted a more flexible exchange rate regime over the past decade.

As China's economy continues to grow, there will of course be greater foreign demand for yuan and yuan-denominated assets. And domestic investors in China will also wish to diversify their portfolios by purchasing foreign assets. This will mean that greater capital flows both into and out of China are inevitable. So a more flexible exchange rate regime will be required to accommodate the growing cross-border flow of capital.

Ultimately, China's exchange rate policy should be a secondary priority to the pursuit of domestic targets for inflation and unemployment.

But that is not all: The current heightening of global economic and geopolitical risks is likely to persist over the medium term. And since the Chinese yuan is not yet a safe haven currency, the increase in global risk, taken together with investors' general propensity to be risk averse, will cause abrupt change in the yuan exchange rate independent of China's prevailing economic fundamentals. As such, China needs a more flexible exchange rate regime to cushion against global shocks.

Ultimately, China's exchange rate policy should be a secondary priority to the pursuit of domestic targets for inflation and unemployment. One reason is that an appropriate interest rate matters much more than a stable exchange rate. Since short-term exchange rate movements are increasingly influenced by cross-border capital flows, it will be difficult, if not impossible, to figure out the "right" exchange rate for China. By contrast, the right domestic interest rate should be easier to find—and will directly affect such important variables as the unemployment rate and inflation.

One policy conclusion is that exchange rate policy should make way for monetary policy whenever the two policies are in conflict. Exchange rate fluctuations partially reflect market expectations about future domestic and global economic conditions. So China will also need to "get its house in order," as it were, if it is to strengthen the Chinese currency. This, too, means that the exchange rate should be seen as the *result* of *other* policies rather than as a policy goal in itself.[6]

There is, in fact, considerable room to let market forces play a greater role in China's exchange rate regime. Useful policy steps could include loosening up, or even removing, controls on the trading band in the onshore market, and further weakening the benchmark role of the central parity rate.[7]

Some additional policy options that could help China transition to such a more liberalized exchange rate regime would include the following:

Learn to Worry Less about the Exchange Rate

If China is eventually to let the exchange rate make way for interest rate and other domestic policy considerations, it will need as a precondition to allow the yuan to float. Bluntly put, Beijing should learn to tolerate a certain degree of exchange rate fluctuation, instead of intervening in the currency market whenever the exchange rate deviates from Beijing's desired level.

Photo: Flickr/Faungg

Only when a central bank halts its propensity to intervene can an exchange rate regime be categorized as "floating." Under a managed floating regime, the PBOC would still reserves the right to intervene when there is undue fluctuation in the exchange rate. But the bank should refrain from regular interventions.

This would mean, too, that market participants should also adapt to an environment with greater two-way yuan exchange rate fluctuations. Market participants need to learn to manage and hedge currency risk, instead of relying on PBOC actions.

For China to move toward a managed floating exchange rate regime, its exchange rate should eventually have the following features:

First, the market exchange rate should be subject to two-way fluctuations.

Second, these fluctuations should be the result of market forces, not central bank intervention.

Third, the exchange rate level should be consistent with market expectations, and onshore and offshore rates of exchange should always be the same.

Fourth, intervention by the PBOC should take place only in exceptional circumstances; in other words, the government should basically stop intervening and let the market play its proper role.

Under such a policy regime, any exchange rate fluctuation could be traced back to economic fundamentals or policy choices, rather than to central bank policy.

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To be sure, some in China may fear that yuan exchange rate fluctuation will endanger internationalization of the Chinese currency. But promoting internationalization by maintaining an overvalued and artificially stabilized currency is not in China's best interest. By maintaining an overvalued yuan, China is effectively redistributing demand to other countries. Internationalization of the Chinese currency should thus be the result of both domestic "push" and foreign "pull" factors, rather than a unilateral initiative.

Capital Account Liberalization

China should also take steps to prepare itself for the possibility of a sudden change in cross-border capital flows. In my view, free and unregulated capital flows are not socially optimal. Indeed, the International Monetary Fund has recently encouraged emerging countries to use macro prudential measures to control cross-border capital flows whenever necessary.

China should draft emergency plans to handle potential financial risks, including an abrupt change in capital flows. These plans should be constantly refined and updated on the basis of stress test results.

China should use more market-based instruments to manage these capital flows and reduce its use of administrative measures. As Chinese households and firms increase their overseas investments—and as foreigners also acquire greater freedom to invest in China—cross-border capital controls will need to be reformed to accommodate the changing nature and composition of capital flows.

Traditional *administrative* means of capital control are less effective and efficient. And they are also inconsistent with the long-term goal of capital account liberalization. So the guiding principle for any future Chinese capital control regime should be that it primarily works through market-based instruments such as the Tobin tax. [8]

Enhanced regulation will be needed to address the issue of large undocumented capital outflows. Although *illegal* capital flows should be tackled through tightened law enforcement, enhanced regulation should not come to mean tighter administrative control.

That is because tighter controls will inevitably affect international trade and investment, and, in any case, are also inconsistent with the PBOC's ultimate goal of greater liberalization. A large percentage of the currently undocumented capital flows into and out of China are not, in fact, illegal. So the best way to solve the undocumented capital flow problem would be to gradually liberalize capital controls so as to satisfy the need to move capital across borders but through *legal* means.

Central Bank Communication with the Markets

At present, short-term movement in the yuan exchange rate appears to be subject to multiple equilibria. The exchange rate can move in both directions without meaningful change in China's underlying economic fundamentals.

But as the size of gross financial capital flows begins to outstrip trade flows, short-term exchange rate movements will increasingly be determined by financial market sentiment rather than by such fundamentals as the trade balance. Market expectations will play an increasingly important role in determining the short-term movement of the yuan exchange rate.[9]

This means that the PBOC will need to improve its communication so as to properly guide market expectations for the yuan, especially during the transition period to a new exchange rate regime.

To properly communicate and guide market expectations, the PBOC needs to do the following:

First, the central bank should avoiding commenting on the *level* of the exchange rate, or giving a specific exchange rate target. Second, the bank will need to be both timely and more transparent. The PBOC should share its thinking and intentions with the public whenever it moves to introduce a new policy. In other words, the PBOC should try to get ahead of the curve and avoid explanations that are vague in character.

Taken together, these various recommendations would simultaneously deepen liberalizing reforms while helping China to manage the difficult adjustment.

Endnotes

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