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China Needs to Float the Yuan—for China's Sake

By John H. Makin

In their April 21 press release following their spring meeting in Washington, D.C., the G7 finance ministers and central bank governors added an important sentence to their usual bland statement that exchange rates should reflect economic fundamentals: "Greater exchange rate flexibility is desirable in emerging economies with large current account surpluses, especially China, for necessary adjustments to occur."

The G7, significantly, also called for an increased role for the International Monetary Fund (IMF) to help countries, including those in the G7 but also China and others in emerging Asia, "meet the macroeconomic and financial policy challenge of globalization." Specifically, the G7 "supported the strengthening of IMF surveillance, including through increased emphasis on the consistency of exchange rate policies with domestic policies and a market-based international monetary system and on the spillover effects of domestic policies on other countries."

The G7's endorsement of greater exchange-rate flexibility and of an enhanced IMF role in implementing it is important. The IMF, having been founded after World War II to maintain stable exchange rates among major economies, has become an advocate on behalf of the major economies of global exchange-rate flexibility. The lesson regarding the need for G7 currency flexibility was learned after America's August 1971 abandonment of fixed exchange rates, which was followed by a decade of adjustments to higher oil prices that would have wreaked havoc under fixed exchange rates. The lesson for needed currency

flexibility in emerging markets was learned after the disastrous attempt, fostered in part by the IMF, to impose fixed exchange rates during the Asian and Russian crises of 1997 and 1998, which prolonged and exacerbated the market gyrations caused by the crises.

Sadly, China's response to the G7-IMF call for greater currency flexibility has been both negative and misguided. China's foolishly insouciant attitude, captured in a comment by Zhou Xiaochuan, governor of the People's Bank of China, carries with it serious risks both for China and for the world economy. Zhou's remark was quoted on April 24 in the *Wall Street Journal*: "[T]he speed of moving forward (on yuan appreciation) is OK. It's good for China and welcomed by many other countries."

China's currency has appreciated only 1.2 percent since its initial 2.1 percent "revaluation" last July 21. That is less than "OK." The total 3.3 percent revaluation against the dollar really represents no adjustment at all in view of the 1 to 2 percent inflation differential (lower in China) that has persisted between the United States and China over the past two years. If China had allowed prices to rise instead of mandating caps on prices of important commodities like gasoline, there would be less pressure for the yuan to rise in value. Both the intervention to cap the yuan's appreciation and the capping of domestic prices are building up potentially disruptive inflation pressure inside China, as we shall see below.

The most dangerous aspect of China's increased efforts to prevent yuan appreciation, as measured by accelerating reserve accumulation over the past year, is the rising pool of liquidity inside China

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that has resulted. The level of excess reserves in Chinese banks is now larger, relative to GDP, than the level of excess reserves built up in Japan from 2001 to 2005 during the years of a prolonged, desperate struggle against deflation. China's currency undervaluation, coupled with the massive liquidity buildup in its banking system, has resulted in excessive investment in China's state enterprises that have close traditional ties with the liquidity-sodden banks.

The usual Chinese response to excess reserves has been to boost reserve requirements for its banks. But to absorb the huge pool of excess reserves now in place, reserve requirements would have to be boosted by 5 percentage points to 12.5 percent, going far beyond previous moves of 0.5 to 1 percentage point, and far beyond what China's shaky, insolvent banks could endure. When the People's Bank of China boosted its one-year benchmark lending rate on April 26 by 27 basis points (to 5.85 percent), it took a tiny step that will do little to tighten China's monetary stance.

Unprecedented Manipulation

Part of Zhou's rejection of the G7-IMF call for more yuan revaluation is simply absurd. In the same article in the *Wall Street Journal*, he says: "We don't accept the concept of currency manipulation. It's not a clearly defined economic concept."

To contain yuan appreciation to a minuscule 1.2 percent since last July's tiny 2.1 percent revaluation, China's central bank has had to purchase over \$250 billion (the largest reserve accumulation by a wide margin in history), the equivalent of over 12.5 percent of China's GDP. U.S. interventions on that scale would be over \$1.5 trillion.

China's currency intervention has persisted at extraordinary levels, even as measured against the heavy past interventions by other major currency peggers like Japan during the 1980s. From 1974 to 1985, just before the Plaza Accord forced the dollar down, Japan's accumulation of foreign exchange reserves from currency intervention had resulted in a trebling of its reserves. In comparison, from 1994 to 2005, China's reserves have risen by over thirty times to nearly \$1 trillion, over half of GDP.

This unprecedented intervention clearly constitutes currency manipulation on a massive scale. It is also becoming unmanageable to a degree that seriously jeopardizes the stability of the Chinese economy and global economy.

There are signs that incipient inflation pressure may be building in China. If it is, either the Chinese government will have to admit a substantially higher rate of inflation, or it will have to clamp down even harder on prices or pursue other measures to absorb excess liquidity.

Better Ways to Store Wealth

China's aggressive currency manipulation both manifests and creates some serious problems facing China's people and policymakers. The Chinese people, having seen remarkable wealth creation over the past decade, increasingly need to find safe and profitable places to store their wealth. China's population is aging rapidly, thanks to its one-child policy. In about twenty-five years, the share of its population above sixty years of age will exceed what will by then be a ratio of about 24 percent in the United States. If China were to reduce restrictions on capital outflows, the pressure for yuan appreciation would ease. At the same time, wealth storage could be diversified outside of the narrow range of govern-

ment bonds and U.S. mortgage-backed securities currently being purchased by the Chinese government with the proceeds of dollar-buying aimed at capping yuan appreciation. Without recourse to global asset (wealth storage) markets, Chinese citizens are left with only the recourse of placing deposits in China's insolvent banks or, alternatively, chasing prices of real estate even higher.

Disturbing Monetary Arithmetic

China's M2 money supply, thanks largely to heavy currency market intervention, is rising by about 17 percent annually while the economy is growing at a rate of approximately 10 percent. The Chinese claim an inflation rate of about 1 percent. There is a serious discrepancy here. With the money supply growing at 17 percent and nominal GDP (the sum of real growth and inflation) growing at 11 percent, the ratio of money to GDP must be rising at a rate of about 6 percent a year. To validate these numbers, either the demand for money in China has to be growing rapidly (unlikely) or, alternatively, the inflation plus growth numbers are way too low. If money

demand is stable, that is if Chinese citizens wish to hold a fairly constant portion of their income as M2 money balances, it is true by definition that nominal growth (the sum of real growth and inflation) has to equal money growth.

Normally, when money growth exceeds nominal GDP growth, which is the best proxy for the increase in the demand for money, inflation follows until nominal GDP rises through higher inflation to equal money growth. In China's case, inflation could rise to 7 percent, given 10 percent output growth, to equal 17 percent money growth.

If the Chinese government is suppressing an inflation problem or misrepresenting its inflation numbers, it will only succeed in doing so temporarily. There are signs that incipient inflation pressure may be building in China. If it is, either the Chinese government will have to admit a substantially higher rate of inflation, or it will have to clamp down even harder with more administrative controls on prices or pursue other measures, like higher bank reserve requirements, to absorb excess liquidity. As already noted, increasing reserve requirements will be inadequate. It would be best to stop pegging the currency and allow the yuan to appreciate. Before long, that would eliminate the upward pressure on the money supply and mitigate inflation pressure through a stronger currency that would make the Chinese purchase more foreign goods, made cheaper by virtue of a stronger yuan.

Chinese resistance to clearly rising pressure for the yuan to appreciate sharply is exacerbating global imbalances and increasing the risk of a sudden burst of inflation in China and elsewhere. Excess liquidity in China, including the hoard created by its intervention policy and subsequent investments in the asset markets of advanced countries, has contributed to a continued global liquidity boom with attendant surges in commodity prices. The steep rise since February in gold and silver prices is clearly related to efforts by affluent Chinese citizens with the ability to move money out of China to store more of their wealth abroad. Similarly, the additional spur to growth in China's traded-goods sector from the persistently undervalued currency is fueling an increasing demand for all commodities. That impetus helped push the price of oil to \$75 a barrel as of April 21,

the day when global imbalances were under discussion at the IMF. Meanwhile, gold surged to \$640 an ounce.

If the Chinese response to the inflation pressure is additional administrative controls, then the resource misallocation already rife in China will be exacerbated, and the incipient pressure for yet-higher inflation will be accentuated by the negative impact on China's growth potential.

China's Options

China has choices. It could stop intervening to prevent yuan appreciation or it could relax restrictions on capital outflows that would reduce excess demands on the Chinese currency under present arrangements. The Chinese have made it clear that they do not think that their insolvent banking system could survive substantial capital

outflows, and they are probably correct in this assessment. Therefore, the only viable alternative is to allow a steady, measured, substantial appreciation of the yuan, perhaps at a rate of 10 percent per year. The result would be a gradual slowdown of the liquidity flows into China and a gradual reduction in the growth rate of its traded-goods sector. Demand would shift onto domestically produced goods and would thereby help to reduce the excess capacity put in place after years of over-investment driven, in turn, by China's prodigious savings.

The needed adjustments, particularly those in China to reduce global imbalances, have been known for some time, but little progress has been made by the Chinese in undertaking those adjustments. The lack of substance in Chinese president Hu Jintao's recent discussions with President George W. Bush on these issues does not bode well for the future.

Risks of Chinese Inaction

When thinking about the problem of global imbalances and China's role therein, the high probability that what should be done will be left undone impels one to anticipate what the actual result of persistent global imbalances will be.

The danger is even greater for the Chinese economy than for the U.S. or global economy. The disruption in the Chinese economy from a surge in inflation—and

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from subsequent attempts to curb it with administrative controls—would be substantial. That said, the fallout from an inflation surge in China would spread well beyond its borders. Indeed, this prospect represents a more immediate danger to the global economy than do the possible restrictive trade policies that may result from frustration over China's currency manipulation and attendant rising trade surplus.

If China continues on its current path, we may expect to see a crisis erupt some time in the next eighteen months comparable to the Asian currency crisis that erupted in 1997. China's inability to control the rising liquidity growth associated with more and more capital inflows and less ability to sterilize the impact of those inflows on the domestic money supply will cause inflation to rise while pushing more and more speculative funds into real estate and other available assets inside China. If the Chinese try to control inflation simply by putting caps on prices, as may already be the case given the discrepancy between money growth and nominal GDP growth, the result will be rising shortages of goods whose prices are being held below market level and attendant rising social disorder. Long gas lines already exist in China, and signs of social unrest are on the rise. If, alternatively, the Chinese simply permit inflation to rise rapidly, the result will again be more social instability.

A severe disruption of the Chinese economy, which has accounted for a large portion of the growth of exports, especially in Asia over the last several years, would jeopardize both Japan's important economic recovery and growth in key Asian economies, such as

those of South Korea, Indonesia, and Taiwan. A sharp Asian slowdown would reduce capital flows to the United States while reducing the growth of U.S. exports to that dynamic region. The same would hold true for Europe. In short, the vibrant global economy that we have enjoyed for a number of years could be put severely at risk by negative repercussions from China's intransigence on currency policy.

The United States might take the initiative by directly indicating, more forcefully, its desire to see the dollar depreciate (as opposed to calling just for yuan appreciation) as a necessary condition to move toward reducing its external deficit. A concerted statement by the U.S. government that it desires a broad, trade-weighted dollar depreciation of at least 10 percent over the coming year would send a strong signal to the Chinese, as well as to the rest of the U.S. trading partners, on the need for adjustment.

Some yuan appreciation would help to signal a need for appreciation of most Asian currencies, including the Japanese yen, which on a real or trade-weighted basis has weakened by nearly 15 percent over the past several years. As Treasury Secretary John Snow stated in a *Washington Post* op-ed on April 21, the day of the IMF conference on "Growing Imbalances," the Chinese and the leaders of other major nations of the world economy cannot continue, simultaneously, to complain about global imbalances while resisting exchange rate adjustments, specifically a weaker dollar, that would help to mitigate those imbalances. The longer we wait to address the problem, the worse, and more disorderly, the resolution will be.