

China's Risky Currency Policy

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John H. Makin

American Enterprise Institute

Overview

The risks attached to China's policy of heavy intervention in foreign exchange markets aimed at preventing appreciation of the yuan to market clearing levels go well beyond the serious, chronic trade tensions that have arisen from such measures.¹ The results of massive dollar purchases totaling over \$700 billion since 2004 include: a damaging distortion of resource allocation inside China, building inflation pressure, and intensifying asset market bubbles. These problems are being exacerbated by the surfeit of liquidity that results largely from China's heavy currency intervention.²

As Chinese monetary authorities attempt to deal with the rising inflation pressures in markets for goods, labor, and assets, risks increase for a return to a 1997-style Asian financial crisis that could entail damaging global financial turmoil. Already, modest tightening measures in the form of small increases in official interest rates and higher reserve requirements for banks aimed at absorbing excess liquidity have resulted in increased turbulence in China's Shanghai-based stock market. China's A-share market fell by 9 percent on February 27 initiating, in turn, sharp falls in equity prices worldwide that erased well over \$1 trillion in wealth while causing higher volatility in asset markets. More such turbulence will follow if China continues the dollar buying that is the equivalent of printing too much money even as its economy and asset markets continue to overheat.

Rising Trade Tensions

Compounding the rising tension in Chinese and global asset markets tied to China's heavy currency intervention is the rising tension tied to China's resultant ever-rising trade surplus. An undervalued currency, like China's, results in too many resources in the traded goods sector and rising pressure to rely on exports for growth—a chronic problem in most of Asia, but one that has grown especially acute in China. The irritant arising from China's trade surplus has grown even more acute this year. The February 2007 trade surplus for China was \$23.76 billion—three times larger than the market's expectation. For the first two months of 2007, China's trade surplus totaled \$39.6 billion, 226 percent above the same period a year ago.

While these trade figures may contain some distortions, such as export shipments of steel, textiles, and other manufactured goods being rushed out in anticipation of reduced export subsidies, the evidence of ever-rising pressure to utilize excess capacity in China's export sector is unmistakable. The surge in Chinese exports tied to an undervalued currency and to export subsidies is boosting trade tensions globally. The rising probability of trade wars threatens one of the pillars underlying unequalled global growth and wealth creation over the last several decades.

Inadequate Chinese Adjustment Measures

China contends that it is allowing the adjustment of its exchange rate to occur slowly while it attempts to rein in rising domestic inflation pressure. Last April 24th, Zhou Xiao-chuan, Governor of the People's Bank of China, contended in the *Wall Street Journal* that “The speed

of moving forward (on yuan appreciation) is ok. It's good for China and welcomed by many other countries.”

At that time, the yuan had appreciated against the dollar by a total of 3.3 percent, even including the initial 2.1 percent yuan revaluation on July 21, 2005. Since then, the yuan has appreciated against the dollar by about another 5 percent, but on a trade-weighted, inflation-adjusted basis (inflation has been held down in China below U.S. levels by price controls) the yuan revaluation is far less. The reality of continued yuan undervaluation is underscored by the rising level of dollar-selling intervention required to cap yuan appreciation, not to mention China's surging trade surplus in 2007.

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 continuing to build up potentially disruptive inflation pressure inside China.

Chinese Currency Intervention Has Been Massive

While the degree of undervaluation of China's currency is underscored by the continuing rise in its trade surplus and the continued upward pressure on domestic liquidity, it is probably useful to put the scale of Chinese currency intervention into historical perspective. The \$250 to \$300 billion being spent annually by China to contain yuan appreciation is the equivalent of nearly 15 percent of China's GDP. U.S. intervention on that scale would amount to over \$1.5 trillion annually.

Beyond that, China's currency intervention has persisted at extraordinary levels—even as measured against heavy past intervention 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 30 times to above \$1 trillion or nearly half of GDP.

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

Currency Manipulation is Destabilizing

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 25 years the share of its population above 60 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 the narrow range of government 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 stocks and real estate even higher, leading eventually to the turbulence and collapse already hinted at during February in Shanghai's stock market.

The risk of destabilizing inflation is rising in China. China's M2 money supply, thanks largely to continued heavy currency market intervention, has been rising at an average rate of about 15 percent over the past year. However, over the last three months, China's annualized money growth rate has jumped to over 20 percent. Meanwhile, the Chinese economy is reported to be growing at a rate of about 10 percent, while the inflation rate for consumer prices over the past year has been 2.7 percent, up from the 1 percent level of a year ago, but still modest. There is a serious discrepancy in these numbers. With the money supply growing at over 20 percent and nominal GDP (the sum of real growth and inflation) rising at between 12 and 13 percent, the ratio of money to GDP must be rising at a rate of about 10 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 (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 over 10 percent given its 10 percent output growth in order to equal M2 money growth rates of above 20 percent.

If the Chinese government is suppressing an inflation problem through price controls or misrepresenting its inflation numbers, it will only succeed in doing so temporarily. Incipient inflation pressures are already building in China with the reported inflation rate having risen from 1 percent to nearly 3 percent over the past year. The Chinese government is showing signs of concern about rising inflation pressures forcing it to clamp down even harder with more administrative controls on prices or to pursue other measures such as higher bank reserve requirements and rising mandated interest rates. These measures have proven inadequate. What's really needed is an end to the currency pegging that allows the yuan to appreciate. Before long, that measure would eliminate the upward pressure on the money supply while mitigating inflation pressure through a stronger currency that would induce the Chinese to purchase more foreign goods made cheaper by virtue a stronger yuan.

China's Alternatives

In the face of rising trade tensions, rising domestic inflation pressures, and rising asset market volatility, China has choices. It could stop intervening to prevent yuan appreciation or it could, alternatively, relax restrictions on capital outflows. More capital outflows would reduce or eliminate excess demand for the Chinese currency that exists under present arrangements. The Chinese, however, 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 to domestically produced goods and would thereby help to reduce the excess capacity put in place after years of overinvestment driven, in turn, by China's prodigious savings.

That said, the outlook for such changes is not promising. 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. While the Chinese have listened politely to entreaties from Treasury Secretary Paulson, concrete measures to reduce the imbalances in China have been limited. Beyond a recent, modest acceleration in the pace of yuan appreciation, on March 17 China raised its one-year benchmark lending rate by 27 basis points to 6.39 percent. This is far below China's nominal growth rate of over 12 percent. Nominal growth provides a rough guide to an appropriate level for a policy interest rate. Meanwhile, the one-year deposit rate will be increased, again modestly, to 2.79 percent from 2.52 percent—still far below the yields outside China.

Consequences of 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 compels 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 from 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 growing 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 sometime in the next twelve months comparable to the Asian currency crisis that erupted in 1997. China's inability to control the rising liquidity growth associated with ever-rising capital inflows and its reduced ability to sterilize the impact of those inflows on the domestic money supply will continue to boost inflation while continuing to push more and more speculative funds into real estate and stocks inside China. If the Chinese try to control inflation simply by putting caps on prices, as already may have been 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.

The severe disruption of a Chinese economy that has accounted for a large portion of the growth of exports, especially in Asia over the last several years, will jeopardize both Japan's shaky economic recovery and growth in key Asian economies such as those of South Korea, Indonesia, and Taiwan. A sharp Asian slowdown would also 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 seize 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. In effect, Treasury Secretary Paulson has said as much, urging the Chinese to speed up yuan appreciation in order to relieve the pressures on global goods markets and global asset markets.

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. 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.

¹ For further analysis of these themes, see: John H. Makin, "China Needs to Float the Yuan—for China's Sake," American Enterprise Institute, *Economic Outlook*, May 2006. www.aei.org

² For further analysis of problems in China resulting from overinvestment and from its shaky, underdeveloped financial system, see: John H. Makin, "China: The Unplannable, Planned Economy," American Enterprise Institute, *Economic Outlook*, June 2004. www.aei.org