

EXCHANGE RATE AND MONETARY POLICY IN CHINA

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By most metrics China's currency remains undervalued. Its current account surplus increased sharply over the past two years, rising from \$17 billion or 1.5 percent of gross domestic product in 2001 to \$46 billion or 3.2 percent of gross domestic product in 2003. China ran a trade surplus of \$32 billion in 2004 compared with a surplus of about \$25.5 billion in 2003. However, China's underlying current account surplus in both 2003 and 2004 is almost certainly significantly higher than the measured surplus for two reasons.

First, as discussed in greater detail below, the Chinese economy recently has been growing at a record-setting but clearly unsustainable pace. High growth has stimulated an unprecedented demand for imports, which grew by 40 percent in 2003 alone, making China the world's third largest importer. In 2004 China's imports grew an additional 36 percent. When economic growth eventually slows to a more sustainable pace, it is quite likely that import growth will slow down relative to the growth of exports and China's trade surplus will widen. That was the pattern in the last macroeconomic cycle when the trade account strengthened substantially between 1993 and 1997.

Second, largely because of the peg of the yuan to the dollar, the real trade-weighted value of the Chinese currency has declined since the beginning of 2002 when the value of the U.S. dollar reached a peak. The positive effect of this depreciation on the trade balance occurs with a lag so it is likely that, *ceteris paribus*, the current account will strengthen further. The combination of these two effects likely makes the underlying current account surplus about 1.5 percent greater than the measured value.

China also has run a surplus on its capital account every year since the Asian financial crisis. Not counting the exceptionally large capital inflows in 2003, which appear to reflect an expectation of exchange

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rate appreciation rather than underlying economic fundamentals, the capital account surplus since the Asian financial crisis has averaged about 1.5 percent of gross domestic product. This may be taken as a measure of China's normal net capital inflows.

One commonly used analytical framework to examine a country's balance of payments, the so-called underlying balance approach, identifies the equilibrium exchange rate as one that results in an overall equilibrium in the balance of payments—that is, normal capital inflows plus the underlying current account position sum to zero. The International Monetary Fund has used this approach extensively in its own work on exchange rates. On this metric China's current exchange rate is far from equilibrium.¹

China's Exchange Rate Policy

Why has China not revalued its currency? The classic case of not revaluing in the face of a large external surplus is when there is a conflict with domestic macroeconomic objectives. A country with a fixed exchange rate and a strong (weak) external position typically would be reluctant to revalue (devalue) during a period of weak (strong) aggregate demand since revaluation (devaluation) would increase (decrease) the demand for imports and reduce (increase) the demand for exports thus reducing (increasing) already weak (strong) aggregate demand.

China did not face such a dilemma in 2003 or in the first quarter of 2004. In 2003 China's officially reported growth rate rose to 9.3 percent, the highest since the Asian financial crisis. Investment as a share of gross domestic product surged to a near all-time historic high, fueled by a record increase in bank lending. In short, China in 2003 was in a credit-led investment boom that propelled growth to a new high level.

The unwillingness of the authorities to adjust the exchange rate in 2003 is particularly surprising given the frequency with which they adjusted the exchange rate in the 1980s and in the first half of the 1990s. Chinese defenders of the fixed nominal exchange rate today invariably cite the need for "stability" as the primary rationale for not changing the rate or introducing more flexibility. This preference for "stability" is puzzling on two counts. First, the only thing that has been stable over the past nine years is the nominal exchange rate. Given the volatility of the dollar against major currencies such as the

¹For an analysis of the magnitude of revaluation necessary for China to achieve an overall equilibrium in its balance of payments, see Goldstein and Lardy (2003a, 2003b) and Goldstein (2004).

Japanese yen and the euro, a fixed nominal exchange rate is a guarantee that the yuan on a trade-weighted basis will be quite volatile. For example, when the dollar depreciates against the yen so does the yuan.

Second, the Chinese have made many major adjustments in the exchange rate of the yuan since 1978, when economic reform began. In January 1981, the authorities cut the value of the yuan by half in trade transactions by introducing an internal settlement rate of 2.8 yuan to the dollar while the official rate remained 1.5. Between January 1981 and the end of 1984, the authorities steadily depreciated the official rate until it reached 2.8, at which time they abolished the internal settlement rate. But the authorities continued to gradually devalue the official rate, which reached 3.2 by mid-1986. And on July 5, 1986, the authorities reduced the value of the currency by 15 percent in a single step, putting the rate at 3.7 to the U.S. dollar. After that the authorities allowed exporters to retain a significant portion of their foreign exchange earnings and introduced a formal secondary market where these earnings could be sold at a market-driven price. In late 1989, the authorities again significantly devalued the official rate, this time by 21.2 percent. In the next few years, the authorities allowed exporters to retain an ever-larger share of their foreign exchange earnings, and transactions on the secondary market continued to expand accordingly. The government also made a couple of minor adjustments in the official rate. Then, in January 1994, the government unified the two rates at the prevailing secondary market price of 8.7.² After unification the currency began to gradually appreciate, reaching a value of 8.28 by mid-1995. Even though the nominal rate has remained fixed since mid-1995, the value of the yuan on a real trade-weighted basis has been anything but stable. After the nominal rate was fixed at 8.28, the yuan continued to appreciate in real trade-weighted terms. Cumulatively from the beginning of 1994 through the end of 1997, the yuan appreciated by fully one-third. Then in 1998–99 the yuan depreciated by 14 percent, in 2000–01 it appreciated by 13 percent, and in 2002–03 it depreciated 10 percent.³

²Since the official rate prevailing just before unification was 5.8, this move has been described frequently as representing a 50 percent devaluation of the Chinese currency. Some have even claimed that this move was so large that it set off the Asian financial crisis. These views are both completely mistaken and ignore the fact that before the unification of the two rates, 80 percent of all foreign exchange transactions were already occurring at the 8.7 market determined price. On the basis of a weighted average of the price in the two markets, the currency devaluation was only 10 percent.

³Calculated on the basis of the J. P. Morgan series on China's real effective exchange rate index.

In short, the often-expressed recent preference for “stability” of the yuan has little basis in China’s exchange rate experience since 1978. The nominal rate has been adjusted repeatedly by large amounts and, even in the past nine years when the nominal rate has been fixed, the real trade-weighted exchange rate has been anything but stable.

The internal policy environment that has prevailed in China since the 16th Party Congress in the fall of 2002 can better explain China’s fixed nominal exchange rate. When Hu Jintao assumed power in the fall of 2002, a domestic credit boom was already gathering steam. The 2002 targets for M2 growth and the expansion of domestic currency loans, set early in the year, were 13 percent and RMB 1.3 trillion (Chinese Finance and Banking Society 2002: 7). These numbers were in line with the pace of monetary and credit expansion that had occurred in prior years.⁴ But the actual numbers turned out to be 16.8 percent and RMB 1.85 trillion, respectively. Much of the overshooting of the monetary targets occurred in the fourth quarter. Not long after Hu became Party Chairman, the monetary targets for 2003 were fixed at a relatively high 16 percent and RMB 1.8 trillion, respectively (Chinese Finance and Banking Society 2003: 8). In short, the new leadership adopted a much stronger pro-growth strategy than their predecessors. They were strongly supported by leadership at the provincial and local levels. Two-thirds of these individuals were new in their positions and they were anxious to promote job growth through local infrastructure projects, many of which were financed with funds borrowed from banks.

Misguided Monetary Policy

Despite the reservations of the People’s Bank of China, monetary policy became substantially more expansionary in the first quarter of 2003. In retrospect the cause appears to have been a mistaken overreaction to the potential adverse effect of SARs on economic growth. China’s top leadership initially was kept in the dark about the spread of the disease, which first occurred in Guangdong Province in November 2002. Months later, when they finally learned about the disease, it had spread to many provinces. Fearing that SARS could lead to a drastic slowing of the economy, sometime in the first quarter of 2003 the leadership decided to raise the targets for broad money growth and credit expansion to 18 percent and RMB 2.0 trillion,

⁴For example, in 2000 and 2001 M2 expanded by 12.3 percent and 14.4 percent, respectively, and outstanding credit expanded by RMB 1.08 trillion and RMB 1.33 trillion, respectively.

respectively (People's Bank of China 2003a: 32). They also indicated that they were prepared to accept the risk that this would lead to somewhat higher inflation because the target for inflation, as measured by the consumer price index, was raised from its initial 1 percent to a range of from 1 to 2 percent. These new targets were disclosed in early March when the National People's Congress, China's legislative body, approved them.

From the middle of 2003 onward the People's Bank of China and the newly created China Bank Regulatory Commission became increasingly concerned that monetary policy was too expansionary. But they found little if any support at higher levels. In mid-June the central bank announced new policy guidelines to restrict lending to an overheated property sector. But when the State Council, China's cabinet, announced more specific regulations in August, they fell far short of the guidelines that the PBOC had proposed two months earlier. The central bank's monetary report for the first half of 2003, released on August 16, contained alarming numbers (People's Bank of China 2003b: 2). Domestic currency lending in the first six months had grown by RMB 1.8 trillion, an amount three times the average annual increase in loans in the first half of the prior four years and equal to 90 percent of the targeted RMB 2.0 trillion increase for the entire year. The bank report highlighted the need to strengthen credit risk management, improve the structure of loans, and prevent new lending for "duplicate construction projects."

Despite its desire to do so the central bank was unsuccessful in its efforts to persuade China's top leadership to consider the desirability of either revaluing the currency in order to reduce aggregate demand or to raise interest rates to curtail the rapid growth of credit that was fueling an unprecedented boom in fixed asset investment. Thus, the bank had to rely principally on window guidance to try to moderate credit growth. These initiatives were actively resisted by a coalition of local leaders and sectoral interests, particularly on lending to real estate projects. China's premier Wen Jiabao did not weigh in publicly in favor of slowing credit growth until February 2004.⁵

The result was that in 2003 credit growth, as measured by the increase in outstanding loans, reached an all-time high of RMB 2.99 trillion (of which RMB 2.8 trillion was domestic currency credit) or 25 percent of gross domestic product, and the investment share of gross domestic product reached a near-record level of 42.3 percent.

This credit binge is likely to prove quite adverse for China's

⁵"Wen Calls for Reining in Excessive Lending," *China Daily*, February 11, 2004.

frequently reiterated objective of moving to capital account convertibility. In all likelihood loan quality deteriorated significantly in 2003 and in the first quarter of 2004. Over the next few years as the authorities seek to reduce the rate of growth of fixed-asset investment spending to bring the investment share of gross domestic product to a more sustainable level, the economy will likely slow, perhaps significantly. This slowdown in top-line growth in the corporate sector will likely be accompanied by an even more significant decline in profitability. In sectors in which investment was characterized by the central bank as “blind expansion of low quality, duplicative building” the emergence of excess capacity likely will put further downward pressure on prices and profitability (People’s Bank of China 2004: 30). Thus, a significant share of the massive increase in lending that occurred between the start of 2002Q4 through 2004Q1 could become nonperforming. In the first three years of the last downturn (1994 through 1996), 40 percent of a smaller boom in credit extended in 1989–93 became nonperforming, even on the rather lax loan classification criteria prevailing at the time.

China’s leadership has long understood the risks of liberalizing the capital account when large portions of its banking system are insolvent. To date it has allocated more than RMB 2 trillion to improve the balance sheets of insolvent financial institutions. Much of this may be washed out by the new nonperforming loans that emerge in 2005–07.

Household savings deposits in state-owned banks at mid-year 2004 amounted to about RMB 12 trillion, an amount slightly more than 100 percent of gross domestic product in 2003. Few depositors have had the chance to diversify the currency composition of their financial assets. If capital account convertibility is introduced while portions of the banking system remain insolvent, banks could face disintermediation that could lead to a banking crisis.

Conclusion

China’s current leadership appears to have failed to understand the lessons of China’s last macroeconomic cycle and appeared to believe that they could use unprecedented monetary expansion to achieve their pro-growth agenda. They resisted the efforts of the central bank to consider greater exchange rate flexibility as a tool that would both reduce aggregate demand and also allow the use of interest rate policy to slow the pace of investment spending. As a result fixed-asset investment grew at the fastest pace in a decade, driving the investment share of gross domestic product to within a percentage point of the previous all-time high in 1993.

The central bank by the third quarter of 2004 had achieved some success in bringing down the rate of credit growth to a more sustainable level. That, in turn, contributed to a marginal slowdown in fixed-asset investment. But it is far premature to declare that China is on a glide path to a so-called soft landing. China's monetary authorities need to maintain moderate credit growth for a period of several years to successfully lower the investment share of gross domestic product to a more sustainable level. That, in turn, will likely take as much as four to five percentage points off the growth rate. The slowdown is likely to lead to an increase in nonperforming loans that could be of a magnitude to substantially set back the government's program to raise the capital adequacy of China's banks. The latter is a key prerequisite to a full liberalization of the capital account. Thus, the unintended consequence of excessive monetary stimulus in 2003 could be a further delay in liberalizing the capital account.

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