

China's Exchange-Rate Regime

The highly anticipated shift in China's exchange rate regime was finally announced, although it seemed a statement of intent rather than a roadmap for future policy.

While details remain thin, it seems likely that China will re-introduce the crawling peg that existed from July 2005 until July 2008, at which time a parity of 6.83/USD was fixed. During the following three years of managed flexibility, the yuan gained 21% against the US dollar (it lost 8% against the euro). Appreciation expectations are more modest today. Non-deliverable forward (NDF) contracts imply an appreciation of around 3% over the next 12 months against the dollar, up from near 0% a month ago but still below the expectations seen earlier in the year (Exhibit 1). More bullish forecasters call for closer to 5% appreciation in the next year.

Exhibit 1
Chinese Yuan Forward Pricing



Source: Bloomberg

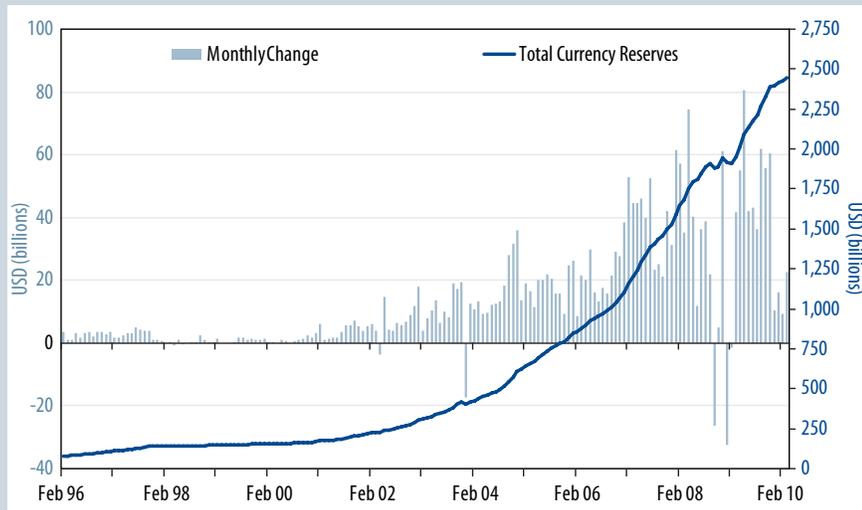
The Peoples Bank of China (PBoC) will allow a +/-0.5% daily trading band about a central parity against the US dollar. Movements may begin to reflect a broader basket of currencies consistent with China's major trading partners. Presumably this would mean managing with reference to the euro, Japanese yen and Korean won in addition to the US dollar. The PBoC seems keen on introducing greater two-sided risks in order to dissuade currency speculation. At this stage, however, it all remains a guessing game.

Why Shift Now? Why Shift at All?

European and US policy-makers have been increasingly vocal in their frustrations with China's exchange rate regime recently. The US Treasury delayed a report to Congress

earlier in the year that could have labeled China a currency manipulator. This would have laid the groundwork for possible protectionist measures. While politics and diplomatic negotiations clearly influenced the timing of China's announcement, there is a fundamental economic rationale for greater flexibility (and revaluation) for all parties involved. For reasons outlined here, we believe yuan appreciation will continue and even gain momentum in the years to come. China's trading partners will continue to pressure China for further revaluation, and China itself should increasingly benefit from revaluation. The biggest beneficiaries should be the handful of highly competitive Asian economies that trade extensively with China. They are in a strong position to capitalize during this phase as China transitions toward a more consumption-driven economic growth model.

Exhibit 2
China's Currency Reserves



Source: Bloomberg

The Economic Rationale for China's Trading Partners

It's all about *purchasing power*. As Ken Rogoff, former chief economist at the IMF, noted, China's exchange-rate regime is its chief "expenditure compression policy."¹ The PBoC has sequestered more than \$2.5 trillion in purchasing power over the past decade, keeping it away from domestic consumers and in the hands of low-risk US borrowers instead (Exhibit 2). Thus, the PBoC actively exported China's newfound wealth—or purchasing power—to the US and other advanced economies for safe storage. European and US politicians want China's purchasing power to be redirected toward their goods and services rather than their assets. This would help boost exports

and help sustain an economic recovery in the face of both household and government deleveraging. It would also reduce the possibility of asset price bubbles; arguably, the flow of cheap funding from China encouraged excessive household borrowing, helping to inflate the housing bubbles in the US and UK and supporting increased leverage in their respective banking systems.

Bond market sterilization is the mechanism that redirects China's purchasing power: the PBoC mops up China's newfound wealth with issuance of domestic yuan-denominated bonds, and then uses the proceeds of this issuance to buy Treasury and agency mortgage-backed bonds. As Chinese producers learn to generate more purchasing power, the government must sequester an increasing amount and then buy low-risk bonds in US markets in order to keep the yuan undervalued against the US dollar.

The Economic Rationale for China

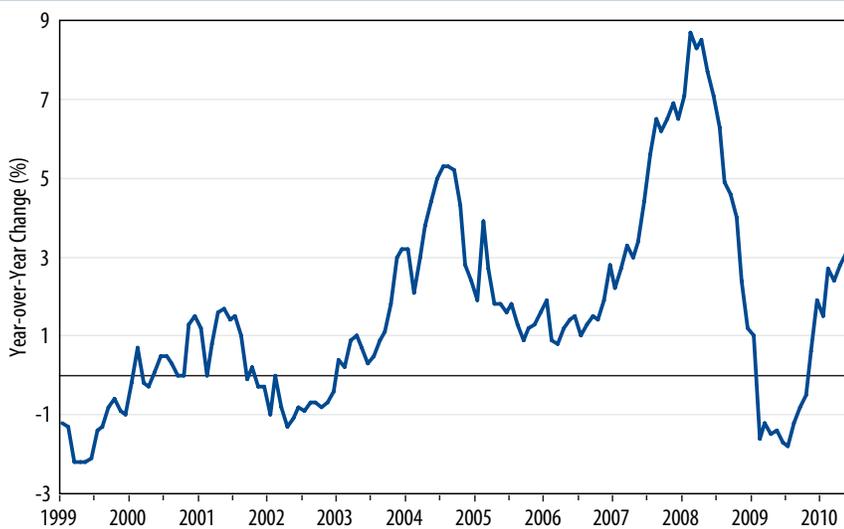
The risk to China is that this sterilization process becomes increasingly ineffective. China is in a relatively unique position in that sterilization works so effectively. This allows the PBoC to fix the exchange rate while simultaneously conducting an independent monetary policy. This is not possible for most large, open economies. Central bankers must normally choose a single monetary anchor: nominal exchange rates or nominal interest rates. Not so with China. Strict controls on the flow of capital, a severely underdeveloped financial market and heavy sterilization operations give the PBoC the rare luxury of adjusting nominal interest rates as it sees fit while at the same time independently fixing the exchange rate.² This separation is a powerful advantage for economies at the low end of the development spectrum. GDP growth can be supported by an undervalued exchange rate but inflation can also be kept under control by raising interest rates or controlling bank lending.

However, China may have already passed the stage of development where such an approach is advantageous. Capital controls, financial market underdevelopment and sterilization operations all cause distortions and allocative inefficiencies throughout the broader economy. At the early stage of development, these are usually minor and easily offset by the advantages of inflation-free, export-led growth. Eventually, however, these distortions grow to become more than a minor nuisance. They begin to corrupt economic fundamentals and jeopardize potential growth.

First, rather than tying up \$2.5 trillion in low-yielding assets in the US, China could deploy those resources to improve the lives of its citizens, boosting human capital and the social safety net, and ensuring the country's economic potential. Second, China's financial system, nearly entirely state-owned, is spectacularly inefficient. Banks lend based on official decree rather than according to market incentives. Many bank loans are directed toward the more than 8,000 Local-government Investment Companies (LICs) which finance local infrastructure projects. Most LICs were shut down in the late 1990s due to irresponsible borrowing, but their numbers began surging in 2008 when Beijing initiated a massive fiscal stimulus program. Their return on capital tends to be low and loan losses tend to be high. But this is all part of the program; bank capital injections by Beijing following bad loans are simply a hidden form of fiscal transfer. In this sense, China's financial system is simply an instrument of Beijing's fiscal program. The objective of the state-owned banks is to provide subsidized credit to government-selected projects, not to maximize profits or allocate capital efficiently. Privatizing the banking system and allowing financial market deepening would help improve China's allocative efficiency, helping to channel resources toward more productive uses.

As financial markets deepen and capital controls are loosened, the PBoC will surrender its advantage in conducting interest-rate policy independently of the exchange rate. It will have to choose a single monetary anchor. If not, economic fundamentals will likely deteriorate until the undervalued exchange rate is justified. This is obviously not what China wants. Fundamental economic deterioration would most likely surface first in the form of inflation. There are already worrying signs (Exhibit 3).

Exhibit 3
Inflation

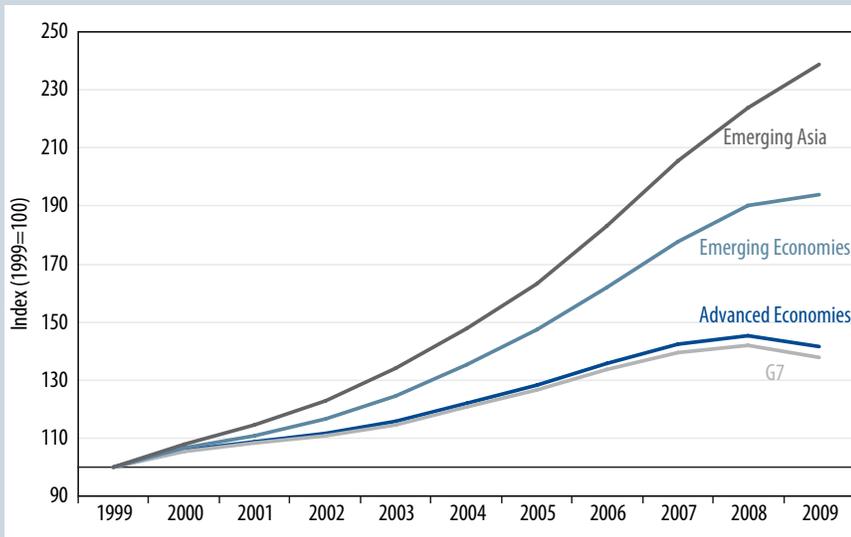


Source: National Bureau of Statistics of China

Market Implications

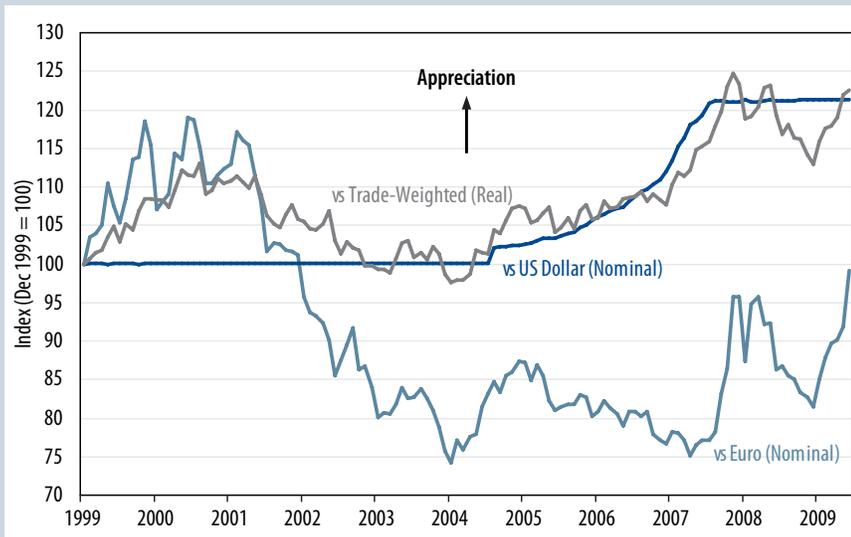
To put the current 12 month market forecast of 3% appreciation in perspective, economists at the Peterson Institute estimate that the yuan requires a one-off revaluation of roughly 15-25% to restore equilibrium. This dwarfs the expected 3% appreciation. Of greater significance, the yuan would have to appreciate by close to 7% every year going forward just to keep pace with China's relative rise in purchasing power, according to trends of the past decade. From 2000 to 2009, Chinese per capita GDP expanded by 9% per year. In comparison, US and European per capita GDP expanded by less than 2% per year

Exhibit 4
Per Capita GDP Growth



Source: International Monetary Fund, World Economic Outlook Database, April 2010

Exhibit 5
China's Exchange Rate—Nominal versus Inflation-Adjusted, Trade-Weighted (REER)



Source: Bloomberg, JP Morgan

(Exhibit 4). This convergence in the ability to generate purchasing power should have been reflected in an annual 7% (9% less 2%) exchange-rate appreciation. It was not, and China's current account surplus ballooned. The implication is that a 3% yuan appreciation would leave it even more undervalued 12 months from now. Appreciation is now finally occurring, and cumulative effects over the next few years may begin to have an impact, but we are still some way off before asset prices or the composition of GDP growth are altered (Exhibit 5).

Investment Implications

China's new exchange rate regime is of little immediate consequence. In the near-term, the risk of the US Congress passing protectionist measures has declined. This should be positive for risk assets. However, far stronger implications should be gradually realized over time.

The Chinese economy casts a wide influence across developing Asia and we would expect yuan appreciation to encourage similar appreciation of the Malaysian ringgit, the Singapore dollar, the South Korean won and the Indonesian rupiah. Many of these currencies are themselves managed with an eye toward maintaining international competitiveness vis-a-vis China. For example, the Malaysian ringgit had also been pegged to the US dollar until July 2005; it was allowed to float just hours after China allowed the yuan to float. Malaysia, along with the rest of developing Asia, exports heavily to

China. Respectively, 13%, 11% and 25% of Malaysian, Singapore and South Korean exports are destined for mainland China. The shares rise to 19%, 23% and 31% when including exports destined for Hong Kong. The terms-of-trade boost for these economies should be positive for GDP growth, fiscal balances and corporate profitability. We suspect that similar currency appreciation across much of Asia will follow in time.

One concern is the potential for government yields in the US (and UK) to increase without the flow of funding from China. As Rogoff noted, "Chinese [exchange rate] policy is subsidizing the country's export of current consumption power in the world asset markets, thereby keeping

world real interest rates below their true equilibrium levels.” The corollary of this statement is that real yields would rise in the US and other economies that had previously been recipients of these inflows. The US Treasury’s cost of borrowing would have to increase considering that China may not have such a large appetite for Treasuries going forward. Further, as the yuan appreciates, the rising cost of imported goods from China could add to inflationary pressures. We find this argument weak for the time being. Domestic US household savings are rising and the pressure for fiscal austerity should mean government budget deficits diminish in coming years. Generally, the decline in surplus savings exported by China should be more than offset by an increase in savings by domestic US households. It easily has been so far. Treasury rates can remain low and disinflationary pressures continue to be our predominant concern in the US and across much of Europe.

Footnotes

¹ Rogoff and Obstfeld (2009)

² This is possible because the PBoC does not compete with private capital flows. Normally, if interest rates increase, private capital would flow into the economy and put upward pressure on the exchange rate. Controls on the flow of private capital, as well as scarce investment vehicles (shallow financial markets), tip the advantage in favour of the PBoC, making sterilization an effective instrument.

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