China: In Defense of the Yuan

Notwithstanding an extended period of stability since last fall, the Chinese Yuan remains fairly high on investors' lists of global risk factors. The genesis of this fear seems to have been the sudden one-off devaluation of 2% that followed close on the heels of the meltdown in oil prices and was accompanied by a sudden surge in capital flight. Needless to say, we have seen similar confluences of events many times, especially among emerging economies whose banking systems rarely are prepared for a sudden shift in the terms of trade. China's circumstances, however, are much different than those of small emerging economies. Over the course of just two decades, rapid industrialization has transformed China from an agrarian backwater into a major creditor nation with a still-sizable current account surplus. In most cases, those conditions would portend a strong national currency, not one that is poised for a major shock. Yet perceptions of vulnerability remain and are worth addressing.

Perception #1: Capital Flight Is a Harbinger of Devaluation. One of the telltale signs of financial stress, especially in the emerging world, is a sudden loss of international reserves held by the central bank. On this count, China clearly has raised some red flags. In 2015, the PBOC's enormous holdings of international reserves – shown in Figure 1 - declined almost US$800 billion. Gross outflows were even larger at US$1.1 trillion but were counterbalanced by net inflows from the current account. The presumption is that locals know something is amiss and react by taking their money offshore. In China's case, the economy was slowing, rising costs were squeezing profit margins and Premier Li's anti-corruption campaign was hastening some exodus. In retrospect, three groups seem to account for most of the flight in roughly equal shares: 1) carry traders who often are the same crowd who have falsified import invoices in the past; 2) companies, especially in industries with overcapacity, whose cash flow barely can cover debt service; and 3) companies that had borrowed heavily in foreign currencies, mostly US dollars, which when repaid also draws down the country's international reserves.

Figure 1: China's International Reserves, in US$

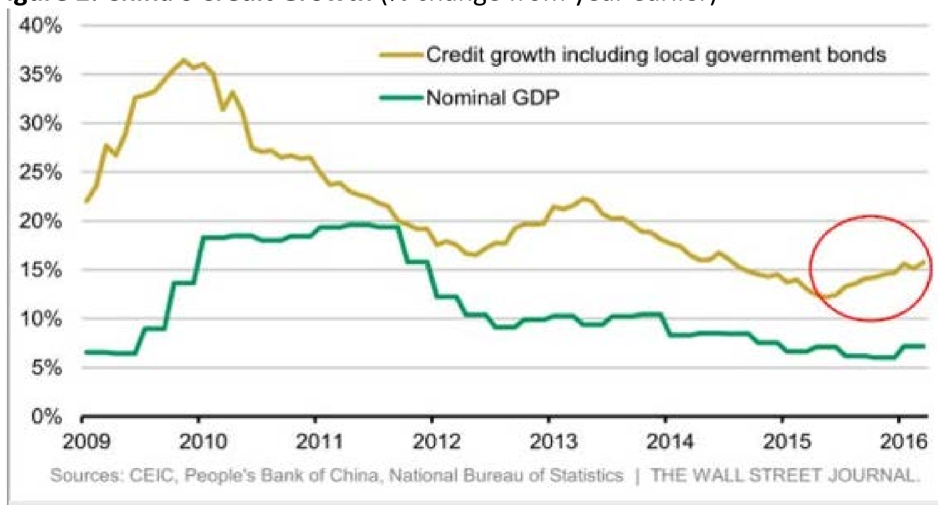
Both carry trades and loans denominated in foreign currency tend to accumulate as foreign liabilities of domestic banks. By contrast, the assets of banks - including property loans, mortgages, consumer loans, and lines of credit - predominantly are denominated in local currency. That currency mismatch, if large, is a critical vulnerability in the financial system if market conditions

change suddenly. Indeed, the ratio of net foreign liabilities of a country's banking system to international reserves is one of the best indicators of a potential currency crisis because any sudden surge in demand for repayment on foreign obligations must be met by the central bank. Foreign liabilities at China's state bank had risen substantially in recent years, although they still were not unmanageable relative to China's huge reserves.[1]

Most carry trades that arbitrage interest rates are unsustainable and the exodus is often swift. In China's case, there were plenty of signs that the arbitrage was losing its allure long before the collapse in oil prices highlighted the downshift in growth. By late 2014, the PBOC had shifted to an easing stance and physical data on the economy was pointing to a major slowdown, particularly for the industrial sector. Nonetheless, much of the initial burst in selling Yuan after the 2% devaluation probably came from arbitrageurs as could be seen in the wide discrepancy between onshore and offshore exchange rates at the time. Although this outflow was finite and posed little threat of an uncontrollable devaluation, it set the stage for the PBOC's untimely mini-devaluation against the US dollar. In the end, the PBOC found other tools – the overnight interest rate and yet another crackdown on fraudulent invoicing – to deal with this group, but much damage was done to the central bank's credibility in managing its transition to a new regime based on a basket of 12 currencies rather than the US dollar.

Of greater interest was China's response to demand for hard currency from local companies, some of which had the wherewithal to pay down US dollar debt and others whose owners were primarily interested in 'cashing out' while they could. The PBOC probably viewed repayment of foreign debt as a sensible use of its reserves. State banks would reduce their foreign liabilities, thereby easing pressure on the exchange rate. The only glitch was that state banks would have to extend more Yuan loans and roll over old loans, sometimes to companies whose cash flow could not support more debt (see Figure 2). In effect, China opted to strengthen its external balance sheet in exchange for greater domestic credit risk. The consequences now are becoming more evident as

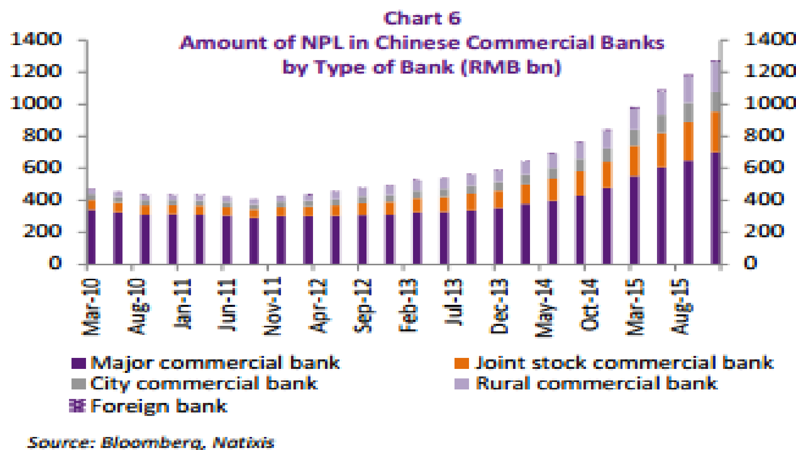
Figure 2: China's Credit Growth (% change from year earlier)



[1] In countries with few international reserves and no capital controls, carry trades can accumulate very large net foreign liabilities in the domestic banking system, so much so that a mass exodus often precipitates a major devaluation. This past fall, a broad exodus from carry trades was instrumental in precipitating large currency devaluations in Brazil, Turkey, Poland, Hungary, Australia and New Zealand.

commercial banks report more nonperforming loans (see Figure 3) and the incidence of defaults on Yuan-denominated corporate bonds has risen sharply this year. The good news is that authorities are allowing companies to default, which is the first step in reducing excess capacity. It is yet to be seen whether authorities can stomach the next phase of actually closing plants and mines and laying off workers, especially at state-owned companies. In the interim, corporate credit spreads will widen further and bad loans will pile up as long as banks continue to roll over loans to zombie companies. As bad as that sounds, **China's debt woes are a potential fiscal problem, not a currency risk.**

Figure 3: China's Non-Performing Loans



Perception #2: China Will Devalue to Help Manufacturers. This rationale was often mentioned after the one-off 2% devaluation against the US dollar last fall but has lost credibility as the Yuan has appreciated this year. China cannot abandon its strategy of industrialization, despite signs that this economic model is rapidly approaching a saturation point. Manufacturing accounts for about 30% of GDP and remains the foundation for the next phase of development. At the same time, many industrial sectors already face tough competition. Chinese labor costs now are higher than those in Mexico, India and Vietnam, to mention a few, and labor-saving technology is moving inexorably forward.

The question is how will China choose to compete? The options include i) to redirect investment from capacity to productivity; ii) to subsidize the displacement of weaker firms and their workers; and iii) to devalue the currency to prop up profit margins. Of those three, the best choice is to incentivize investments in technology and other operational efficiencies, even though that raises the specter of letting weaker firms fail and displacing workers. Devaluation is the worst choice. Although it might seem to promise a quick fix to ailing companies, this remedy is fleeting, most likely leads to retaliatory measures, and threatens the Yuan's ascension to reserve currency status. In effect, China throws the baby out with the bath water if it proactively chooses to guide the currency lower. Instead, the PBoC has chosen to deemphasize the longstanding link to the US dollar and to embrace currency stability as measured by a trade-weighted basket of currencies of China's twelve major trading partners. No doubt this shift in basis was motivated in part by the dollar's extraordinary rise against almost all currencies over the past two years, which served to drag up

the Yuan. In any event, the change in basis follows the lead of other countries (such as Chile) that transitioned from fixed to flexible exchange rate regimes by adopting currency baskets.

In lieu of devaluation or forced plant closures, Chinese officials have opted for option #2, namely to cushion the blow to losers, notably those companies and workers in industries with excess capacity such as steel and coal mining.

Figure 4: China Ramps Up infrastructure Financing

Perception #3: Skepticism about the Great Transformation. A more daunting challenge than these immediate concerns is China's ambitious plan to transform the country's export-driven economic model into one powered by domestic demand. At the heart of this issue is the country's enormous saving rate at almost 50 percent of national income. For the transformation to gain traction, policymakers must find a way to change saving behavior of businesses and households. Of the 50 percent, business saving represents about 30 percentage points, household saving is about 15 percentage points, and government saving is nil. Of those three groups, households are the least likely to change their behavior anytime soon. The aging adult generation in particular has little incentive to spend because they have no safety net of pensions or health care. About 1% of the working age population will retire EACH year during the next decade. Younger generations of middle class Chinese might be persuaded to adopt more profligate spending habits if some form of national pension plan and broader health coverage were instituted. So far those reforms have made slow progress as more rural migrants have been granted access to urban education and health care.

That leaves two options – government dissaving and less corporate saving. The government has proposed a larger budget for 2016; analysts estimate the federal deficit at 3.3% of GDP compared with 2.5% in 2015 in large part because of reforms to the VAT tax. A big part of those tax cuts will be saved, not spent. So the government also has announced various investment plans, including Rmb2.5 trillion in railway and road projects plus others to develop renewable resources, electricity generation, pipelines and urban transport networks. As in the past, local governments appear to be financing about 30% of these infrastructure projects with debt issuance, while the central government is using off-budget special debt issues. Altogether these initiatives might add 8% to investment outlays. That fiscal stimulus has been enough to stem the slowdown in economic growth, at least temporarily, and has been perceived as a positive sign by global financial markets. From a longer perspective, however, this stimulus only makes a small dent in the broader challenge of excess savings and has added to the debt burdens of local governments.

In the business sector, there are some signs that corporate saving is declining, although the reasons are unclear. Contrary to intuition, less corporate saving and investment in China should be viewed as a positive sign for rebalancing the world economy. Excess capacity in a wide range of sectors is the root cause of deflationary pressures on prices of industrial goods and commodities as well as on manufacturing wages in western economies; investment in yet more capacity will prove to be wasteful. What make sense for Chinese industries is to move up the technological ladder so as to improve quality and profit margins and to secure market share. US manufacturers, for example, use 10 times as many robots as their Chinese counterparts, so there is enormous room for mechanization. Moreover, the cost of robotics has declined close to that of manufacturing labor costs in China. Modernization, however, will come with a huge social cost in terms of displacing workers with the least skills. China already is struggling with how to retrain and relocate workers displaced by plant and mine closures. Widespread adoption of robotics could be an even worse nightmare for officials, so gradualism both with plant closures and mechanization would seem to be the most likely course.

The only reform that could speed China's transformation, in my opinion, would be the introduction of a national pension plan, preferably one similar to the mandatory defined contribution plans that have been so successful in Chile, Colombia, Peru and Mexico. These savings accounts are vested with individuals and are portable from one employer to another. Contributions are paid by employers. For a populous country like China, this would amount to a huge and expensive proposition whose implementation would cut into profit margins and hence would open the door to short-term misperceptions for the domestic equity market. On a longer view, such a retirement plan also would be a giant step toward redistributing the gains of a quasi-capitalist system that so far has created tremendous inequality along the way to raising living standards for the masses.

Long-run Implications of a High Saving Rate: Contrary to convention wisdom, a persistent high saving rate in China is a prescription for yet slower growth, lower rates of return on capital and a much higher Yuan. Consider, in particular, what would happen to China's capital/income ratio if the saving rate remain at 50% and potential growth in national income slows to 5%. Presuming the rate of return on capital is 5%, the value of the capital stock owned by China's residents and businesses would climb to ten times GDP; the norm for western economies is four to six times GDP.[2] Japan, for example, had a similar surge in its capital/income ratio during competitive heyday of the late 1980s, also on the strength of a high saving rate and a large current account surplus. That is what happens to savers – they accumulate assets. We already see Chinese companies buying up foreign resources and companies at handsome prices much the way Japanese firms did 25 years ago.[3] Foreign investments in turn create a virtuous circle of repatriated earnings, current account surpluses, and an appreciating currency even as domestic living standards rise.

For a small country this scenario could unfold with few consequences for the rest of the world. Other things will not stay the same, however, if China as the world's second largest economy fails to redistribute its savings glut. Most likely, rates of return on capital will fall, global growth will slow

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[2] For a historical perspective on capital/income ratios, see Thomas Piketty, *Capital in the Twenty-First Century*, Harvard University Press, 2014. The calculation here is Piketty's so-called second law of capitalism: Beta = s/g where Beta is the ultimate capital/income ratio, s is the saving rate and g is potential growth.

[3] Recall when Japanese property developers were snatching up marquee properties such as Rockefeller Center and Pebble Beach in the late 1980s.

further, protectionism will intensify, and social tensions will persist. In that context, China's leaders should view an appreciation of the Yuan will be a small price to pay. Likewise, investors might be skeptical about whether China can pull off an historic transformation from a low-wage producer to a high-income consumer-driven economy, but they should hope it does for the alternatives are very unattractive. Countries become high-income, consumer-driven societies in part because they enjoy strong currencies, not weak ones.

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