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Case of China

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Sunanda Sen[*]

In this note we focus on some aspects relating to China's currency, which of late, have opened public debates, in literature as well as in policy statements.

Apprehensions and concerns as above have more to do with the *negative* balances as have been surfaced in China's financial balance since the last quarter of 2011. The negative sums were respectively (-)$ 3.02 and (-)$ 4.21 billions during the second and third quarters of 2012, and preceded by an even larger sum at (-)$ 29.0 bn in Q4 2011. Deficits as above contrast the usual surpluses in China's financial account which, while contributing to the twin surpluses, amounted as much as $13.20 billion during Q4 of 2010. Changes as above in the financial account have led the country's official reserves to slide *downwards*, by as much as $6 trillions between March to June 2012. (safe.gov.cn). With negative financial balances and reductions in official reserves, downward pressures were there on the RMB rate which actually depreciated, from 6.30 per dollar in April 2012 to 6.41 by August 2012. The rate, however, reverted to its earlier pattern with appreciation, and RMB was found moving up, from RMB 6.38 to RMB 6.31 between 24th July 2012 and 18th January 2013.[1]

As a background we would deal with the twin surpluses which have been continuing in China's external payments, especially in relation to trade which went hand-in hand with the exchange rate appreciations of the RMB. In this regard the RMB has often been considered to be undervalued and responsible for China's surpluses in trade.[2] As a

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1 www.xe.com/currencycharts

2 See, for example, Paul Krugman, "Taking On China" http://www.nytimes.com/2010/10/01/opinion/01krugman.html?_r=2&partner=rssnyt&emc=rss&

remedy it has been claimed that there is a need to rebalance the Chinese economy, supported by upward adjustments in the exchange rate.

New concerns as have arisen in recent times relate to the recent deficits in the financial balance in China's external payments with tendencies for its official reserves to slide downwards. Changes as above, along with the announcements in September 2011 for a "two-way floating" of the RMB in the foreign exchange market, have introduced sharp changes in the state of expectations in the market. We would deal with above in the following pages, as a matter which is capable of bringing about further reversals in China's flow of external payments.

We also need to decipher the sources of the changes in China's financial balance which, as held by us, can be explained by the changes in the level of expectations. Aspects mentioned above also relate to the prevailing arguments for an internationalization of the Chinese currency; the plea for which has probably been considerably modified with the current developments in China's BoP as mentioned above.

Twin Surpluses and the Managed Exchange Rate of the RMB

As is widely known, integration to the global markets has been matched by a twin surplus in China's balance of payments with spectacular increases in its trade surplus as well as in net capital inflows to the country. Trade was interrupted briefly with modest declines in exports during the global economic crises of 2008-09.[3] China's trade balance, considered in the context of USA's current account deficits, have been viewed by some as a major source of global payments imbalances. The country's trade surplus, as held by the US monetary authorities, is related to the undervalued RMB rate, which is managed by the Chinese monetary authorities in the foreign exchange market.

Payments imbalances, of major economies like China or USA, have also been viewed as a potential factor behind the global financial upheavals which of late have become rather systemic. Policies advocated to restore a balance in the external accounts of trade surplus countries often include deflationary strategies along with a revaluation of the national currency, as in the package of 'rebalancing' recommended by US monetary authorities to China. As held by Ben Bernanke, the Fed Chairman, the US has been a 'passive' partner, adjusting to the "savings glut" of the East Asian countries including China, which have been investing in US Treasury Bills denominated in dollar.[4] With such arguments, the

3 http://elibrary-data.imf.org/DataReport.aspx?c=1449311&d=33060&e=161868

4 Ben Bernanke, "The Global Saving Glut and the U.S. Current Account Deficit" March 10, 2005 http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/

current account deficit of the US can be viewed a *consequence* of the 'savings glut' in China and in other East Asian countries.

As opposed to above, it has been argued that China, by holding a large stock of US Treasury Bills, has got trapped in the rigmaroles as well as the uncertainty around the dollar-RMB exchange rate[5]. Incidentally, speculation today is rampant in the Chinese economy despite the recent official clamp- down in the housing /real estate markets as well as on the underground credit network.[6] It is also pointed out that US needs to rebalance its own economy by keeping consumption growth below GDP growth while strengthening international competition.

Analysing the changes in recent deterioration in China's financial account, one notices at least *four* major breaks in China's exchange rate management policy, with each entailing considerable changes in the management of the currency.

The *first* relates to an announcement in *2005* which ended the prevailing fixed official RMB-dollar rate, largely with pressures from the US. Despite the twin surpluses between the current and the capital account, China had been maintaining, since 1997, a fixed exchange rate at around 8.27 RMB per dollar. The change to managed floating in 2005, still supported by direct purchases of foreign currency (flowing in abundance with the twin surpluses), led RMB rise immediately to 8.11 per dollar, and subject to gradual appreciations since then. However, despite such appreciations which were continuing, the change to a floating RMB did not lead to currency speculation till the third quarter of 2011. The steady de-regulation of China's financial market which started in 2005 continued with rising net inflows of capital. China's twin surpluses which led to inflows of foreign exchange in the market had to be managed by monetary authorities in a bid to avoid possible appreciation of the domestic currency. Purchases of foreign currency as above contributed to an accumulation of official reserves which of late has exceeded $3 trillion.[7]

The *second* break in China's currency management, as mentioned above, came in 2007 when foreign currency was allowed to be privately held. With RMB continuing to

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See for a position along these lines for a think tank in US, Stephen Dunaway, *Global Imbalances and the Financial Crisis*, Council on Foreign Relations, March 2009 http://www.cfr.org/economics/global-imbalances-financial-crisis/p18690

[5] Yu Yongding, "China must avoid lending to troubled Euro-Asia Nations" www.Bloomberg News September 11,2011

[6] Yu Yongding, "The Chinese Bear's Feeble Growl", www.project-syndicate.org 29th November 2011

[7] http://www.chinability.com/Reserves.htm

appreciate, those private holdings did not immediately affect the on-going appreciations of the RMB in the market. Thus, with rapid domestic growth and expectations of further appreciations, the measure did not lead to currency speculation and outflows [8]Currency speculation, however, came later as expectations of a possible depreciation started building up, in turn signalled by the shift in currency management along with downturns in the financial account, which came in the third quarter of 2011.

Above relates to the *third* and a major break in China's currency policy in September 2011 with "…advent of RMB's two-way floating process."[9] A moderate drop in trade surplus and in the financial account balance of China by the third quarter of 2011 led the PBoC to allow a "two-way float" in the foreign exchange market, thus ending a long-standing consensus on an unidirectional movement of the Renminbi rate which prevailed till then. The measure, in principle, permitted the currency to depreciate, for the first time. [10]. However, the "two-way floating" did not automatically reverse the upward movements in RMB which continued appreciating, [11] though at a slower rate. Simultaneously the rise in reserves and direct purchase of foreign exchange by the state also has continued, with reserves currently well above $3billion.[12]

Finally, currency management in China had been subject to a *fourth* change in April 2012 as the daily trading limit of the currency against dollar was officially widened from 0.5% to 1%. The measure, while allowing the rate to move in either direction, was expected, as held by Chinese experts, to encourage wider use of the currency in international markets.[13]

As the RMB continued to appreciate despite the change, expectations, however, were building up on a possible depreciation of the currency[14]. This was reflected in the transactions of the country relating to its capital and financial account which we analyse later.

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8 www. ineteconomics.org/blog/china-seminar

9 http://ineteconomics.org/blog/china-seminar/china-s-fx-flow-frameworkChina Economics Seminar, China's FX Flow Framework by China Seminar on March 27, 2012 1 comment

10 www. ineteconomics.org/blog/china-seminar

11 http://www.exchange-rates.org/Rate/USD/CNY/7-5-2012 and http://www.exchangerates.org/Rate/USD/CNY/1-11-2013

12 www.chinability.com/Reserves.htm

13 www.news.xinhuanet.com/english/china/2012-04/14/c_131526335.htm

14 CHINA MONEY-Yuan depreciation a realistic possibility http://www.reuters.com/article/2012/05/23/markets-china-debt-idUSL4E8GG7BT20120523

Concerns relating to the exchange rate, as pointed out above, has continued to prevail in official quarters of US, holding the exchange rate policy of China as responsible for the continuing global current account imbalances. With pressures as above on China to appreciate the currency the US Treasury even came to the point on April 15th 2010 that it is time to decide whether China can be treated as a currency manipulator[15].

In July 2005 pressures, especially from the US to adjust the currency upwards led, in terms of an official announcement, to a delinking of the RMB from US dollar. Above led to a moderate but steady revaluations of the currency in the market with the RMB rate to dollar rising immediately from 8.28 to 8.11 per dollar. The currency had been appreciating gradually since then. However, such movements in the exchange rate have not been responsible for currency speculation till end of 2011, and more so with the prevailing appreciations in the RMB rate.

"Two-way floating" of RMB announced and reversal in capital account flows

The situation, however, changed dramatically since then, especially as the monetary authorities announced the "two-way floating" of RMB in September 2011. A moderate drop in trade surplus and in the financial account balance of China by the third quarter of 2011, led the PBoC to allow the "two-way float" in the foreign exchange market, thus ending a long-standing consensus of the one-way Renminbi appreciation which prevailed till then. The measure, in principle, permitted the currency to depreciate, for the first time, from RMB6.30 per dollar in April 2012 to RMB6.41 by August 2012[16].

Attention however, needs to be drawn to the fact mentioned earlier, that the mandatory sale of foreign exchange had already been deregulated since August 2007, a measure which enabled the domestic companies and households to hold foreign currency as they wanted. This also implied that dollars, if desired, could flow out from private channels and cause deficits in the capital account. Interestingly, this did not happen till 2011 because Chinese growth was rapid and expectations of a Renminbi appreciation was continuing to prevail in the market. The changing scenario since September 2011 relating to the expected changes in the exchange rate of the RMB and its management brings us to the renewed debates in recent times relating to China's exchange rate, especially when

15 "Avoiding a US-China Currency War: Need for Rational Calculation" Wang Yong (Peking University) April 11, 2010. http://www.xe.com/currencycharts/?from=USD&to=CNY&view=2Y

16 "China's FX Flow Framework " http://ineteconomics.org/blog/china-seminar/china-s-fx-flow-frameworkChina Economics Seminar

situated in the context of unforeseen deficits in the country's financial balance in the BoP account[17].

Changing pattern of financial balance: Some details

Announcements of 'two-way floating' of the RMB and the possible losses expected by holding it with a possible depreciation, has affected the external payments balance of the country. The above also raises further concerns about the sustainability of the prevailing patter of China's external transactions in the global economy.[18]

Dwelling on official statistics, one observes a sharp *fall* in China's financial account balance since 2011, which, as already mentioned above, records *negative* balances for the *first* time, to the tune of (-)$29.0 bn and (-)$4.1 bn respectively in Q4 2011 and Q4 2012. Changes as above has even thrown open the question whether there is a capital flight from China.[19] The change also opens up fresh concerns relating to the movements in the RMB rate for the coming years, aspects which need to be addressed carefully.

Between April 2012 and August of 2012 RMB actually depreciated, moving from 6.30 to 6.41 per dollar. However despite the above developments appreciations in the RMB rate, however, has been continuing, though at a decelerated pace. The rate however, has moved up later, from RMB 6.38 to RMB 6.31 between 24th July 2012 and 18th January 2013. In effect the exchange rate of RMB appreciated, by 23.2% between November 18, 2005 and November 18, 2011.[20]

Looking at China's BoP, we notice the following: *First*, that there was hardly much of a change from the prevailing trend in the trade balance on goods and services, but for the moderate dip in Q4 2011, which recovered to even higher levels by Q2 and Q3 of 2012.[21] *Second*, net investment income, the other item in the current account which did consist of a reinvestment of earnings, showed a larger *negative* net flow of $1.93bn by Q2 of 2012, largely with incentives on part of foreign corporates to remit abroad their earnings in

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[17] Is Capital Flight Taking Place in China? http://ineteconomics.org/blog/china-seminar November 29, 2012

[18] CHINA MONEY-Yuan depreciation a realistic possibility http://www.reuters.com/article/2012/05/23/markets-china-debt-idUSL4E8GG7BT20120523

[19] http://ineteconomics.org/blog/china-seminar
Is Capital Flight Taking Place in China? by China Seminar on November 29, 2012

[20] http://www.futureofuschinatrade.com/fact/chinese-yuan-us-dollar-exchange-rate-daily

[21] The sum was at $6.87bn and $ 7.28bn respectively by Q2 and Q3 of 2012, which was even higher than $554bn in Q4 2011. http://www.safe.gov.cn/wps/portal/

foreign currency, and due to the prevailing tendencies for a depreciation of RMB[22]. *Third*, we mention the noticeable changes in China's financial account, recording *negative* balances at $ 3.02 bn and $ 4.21 billions respectively by Q2 2012 and Q3 2012. Contrasting the earlier surpluses in the country's financial account which amounted to $13.20bn during Q4 of 2010, the negative financial account causes concern and demands explanation.[23] Above include a new set of concern, especially with the possibility that China's exports will be even more competitive than before.

Analysing the components of the changes in the financial balance, one witnesses: (a) the reversal in the financial account from the large surpluses to deficits in the more recent period Above cannot be explained by proportionate declines in Foreign Direct Investment inflows which fell only marginally between 2010 and 2012. (b) Rise in net portfolio asset flows, presumably with prospects of a rising dollar *vis-a-vis* RMB. While liabilities related to portfolio investments also moved up, those were more than neutralized by rise in assets. (c) A reversal in 'other investments' with a *drop in net short term trade credits* from nil in Q4 2010 to a negative of (-) $ 3.3bn in Q2012. The change can be interpreted in terms of the rise in trade credits advanced abroad against China's imports, presumably lucrative with expected rise in dollar rate for RMB. *(d) T*here were increases in loans advanced, both short and long term, with a negative balance of (-)2.5bn in Q2 2012. (e) There were also changes in entries relating to 'currency and deposits' which recorded steep increases in negative balance at (-)$6.39bn by Q2 of 2012, much due to the withdrawal of foreign currency (mostly dollar) from banks with expected rise in dollar rate *vis-a-vis* RMB. (f) There also was a rise in liabilities, led by trade credits advanced abroad against China's imports, which bounced from a negative (-)$3.1bn in Q2 of 2011 to a positive sum of $2.70bn in Q2 of 2012. Expectations of a depreciating RMB, especially with the announcement of a 'two-way floating' of the currency, seems to have prompted the domestic agents to collect trade credits in dollar against imports from abroad, thus inflating the sum as above. (g) Finally, there have been changes in China's exchange reserves, which dropped from $3.30 trillion in March 2012 to $3.24trillion by June 2012[24] . This was reflected in the flow of reserve assets (or foreign exchange), the residual item in the BoP, declining by $1.12bn during Q2 of 2012[25].

It can also the observed that net exports over the calendar year of 2011 *fell short* of cross-border receipt/payments balance of FX by (-)600bn. This contrasts the usual pattern before September 2011, when net receipt of foreign currency was usually larger than net

22 http://www.safe.gov.cn/wps/portal/
23 *ibid*
24 http://www.safe.gov.cn/wps/portal/!ut/p/c5/04
25 http://www.safe.gov.cn/wps/portal

exports. The change can be interpreted by tendencies on part of traders to advance/delay payments and receipts according to their expectations of changes in the exchange rate of the RMB *vis-a-vis* dollar. Net export earnings of China before September 2011 were subject to delayed payments by importers and advance receipts by exporters in the country in order to gain from the on-going Renminbi appreciation. The pattern clearly changed after September 2011 as uncertainty and expectations were building up that RMB may actually depreciate. Not surprisingly, trade credits account showed huge increases during this period, totalling $33.2 billion between the first two quarters of 2012 and expected to be even larger in Q3.

One observes a difference between cross-border receipt/payment balance and banks' net foreign currency *purchases*, which measured the net funding by Chinese companies from domestic banks. The difference usually was negative before October 2011, thus indicating that Chinese companies sold more dollars to the banks than they received from international trades. [26] Data also shows that foreign currency loans by banks kept increasing much faster than foreign currency deposits in the past few years.

Before September 2011, Chinese importers/exporters as well as domestic and foreign corporates were borrowing dollar from banks and converted them to Renminbi. However, this long-lasted trend reversed by October 2011. With shorting of RMB by traders and corporates, seeking to reduce dollar liabilities and increase dollar assets, such moves also contributed to net outflows in the financial account. As mentioned by Chinese officials, "two vital drivers of the capital outflow resulted from … speculation activities", on part of both traders and corporate.

To repeat, with expected depreciations in RMB, domestic importers tend to advance payment of USD, which affected the foreign exchange settlement between importers and banks. In addition, domestic exporters receiving dollars from exports are inclined to hold USD asset rather than exchange it to RMB, similarly affecting the foreign exchange settlement between exporters and banks. Between the two, there emerged a tendency to short RMB and hold dollar long. As for the foreign corporates, before Sep 2011, the foreign companies with a long-Renminbi bias preferred to receive in Renminbi and pay in USD. By Q4 2011, the foreign companies suddenly tended to pay in Renminbi and receive in USD. Consequently, the RMB settlement receipt/payment ratio for banks shifted from 1:2.2 in Jan-Aug 2011 to 1.4:1 in Sep-Dec of 2011, but the overall ratio in 2011 was still 1:1.3 (it was 1:5.3 in 2010)[27].

[26] http://ineteconomics.org/blog/china-seminar

[27] http://ineteconomics.org/blog/china-seminar/china-s-fx-flow-framework

Changes as above also affected the supply of liquidity in the domestic economy. Unlike the previous years when inflows of foreign currency was quickly transformed into RMB, the new pattern allows less of liquidity creation. This is because of the tendencies to hold dollar in the face of a possible rise in dollar rate. Moreover, privately held stocks, as was officially permitted since 2007, now worked to pre-empt dollar held by state and/or their conversions in RMB. On the whole, the monetary authorities in China now has a much reduced capacity to generate credit, a situation which calls for attention in the face of the renewed threat of a global recession originating from Euro-land.

Concluding Observations

Looking back, the recent downslides in China's financial account balance, bringing to a close the 'twin surpluses' and initiating, after a long time, a modest slip in the stock of official reserves, reflect a reversal in the state of expectations relating to the future of the Chinese currency. While gradual appreciations in the RMB rate, as managed by the monetary authorities, boosted the holding of RMB until the 'two-way floating' was announced by the state, the latter brought a change in the state of expectations regarding the RMB-dollar rate in the market. As pointed out above, this was reflected in the drop in foreign exchange assets which was caused by a jump in short term trade credits to prepay (for imports) in dollar, a rise in dollar advances from banks and withdrawal of dollar deposits with banks. The consequences also included a moderate decline in the stock of official reserves.

It is important that we do not miss out the fact that the recent changes in China's external account (which include sharp deteriorations in the balance of financial account and declines on forex reserves) have mostly been related to changes in expectations with uncertainty in the foreign exchange market relating to the RMB rate in terms of dollar and other currencies. Our analysis above, of China's external payments in relation to changing expectations, reminds us that with changing expectations, one needs to start from an assumption of uncertainty, and not one of perfect information. As formulated by Keynes in 1936 with the publication of *The General Theory*, the 'weight … of events, viewed on a 'subjective' basis, was to determine probability under uncertainty'. And in case the 'weight' happened to be too small, uncertainty was considered as irreducible while probability could not be ascertained. Keynes reiterated the point in 1937 with the statement that 'About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know.'

Experience of China in the context of the changing scene as has emerged with speculation affecting her external balance in recent times, provides a confirmation of the message left by Keynes many years back.

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