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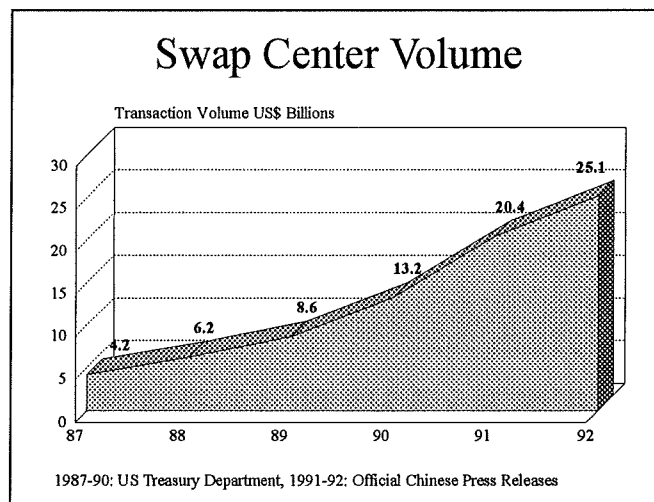
**PROSPECTS FOR THE RENMINBI**

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## PROSPECTS FOR THE RENMINBI

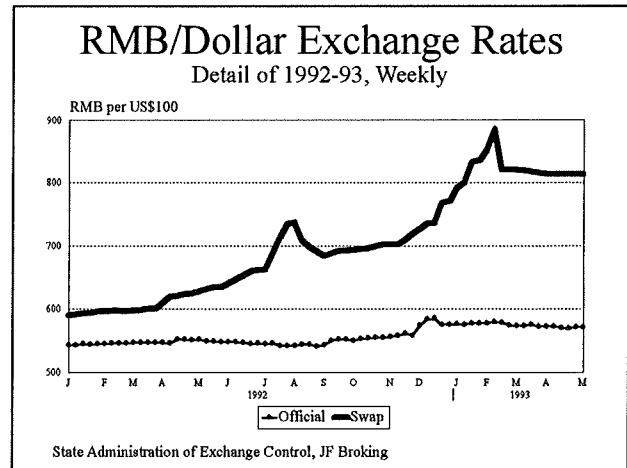
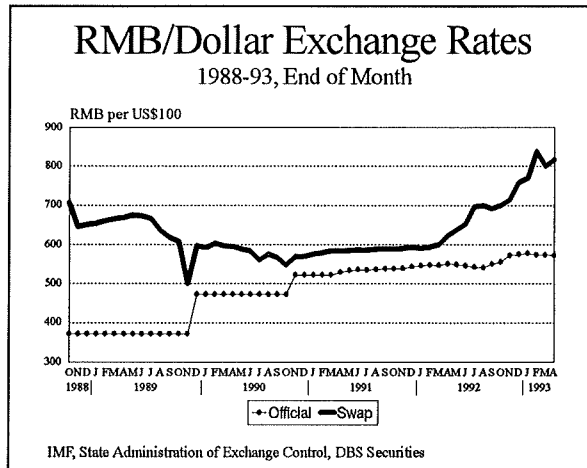
China's principal currency, the renminbi or yuan, is in a halfway house between third world controls and the market. Foreign and local businesses in China can trade foreign currency for renminbi and vice versa in "swap centers" that exist in each major city. The largest ones, particularly Shanghai and Shenzhen, normally match bids and offers in an administered approximation of a free market. Those who do not have registered businesses in China (e.g., tourists) must trade at an official rate, which currently values the renminbi about 40 percent higher. Chinese businesses in priority sectors may acquire foreign exchange at the official rate, which effectively subsidizes their purchases of foreign technology.



In addition to the official and swap markets, there is a small black market serving people like tourists who would normally have to trade at the official rate. The black market rate tracks the swap rate but values the renminbi slightly more weakly than the swap centers. China also issues Foreign Exchange Certificates in return for foreign currency; these are valued at par with the renminbi but can purchase certain luxury goods that are off limits to renminbi holders--most notably luxury hotel accommodations, air and train tickets for foreigners, and imported liquor.

People's Bank of China senior officials have repeatedly declared that China will eventually move toward a fully convertible currency, which would imply moving the official rate to coincide with the swap rate. In December 1990, the official and swap rates were so close that unification seemed imminent, and in 1991 China followed a policy of mini-devaluations that kept the official rate moving in the same direction as the swap rate. However, by April 1992, the swap rate began to depreciate to a degree that apparently took Chinese officials by surprise and the gap has subsequently widened to about 40 percent. While such a gap is small by comparison with the huge gaps between official and market rates common in Eastern Europe and much of the third world, it constitutes a major setback for the policy of moving toward convertibility.

The renminbi decline also appears to have led to a policy setback in management of the swap markets. As this is written, the swap market rate has not moved by a single decimal point for several weeks. This is statistically so unlikely in a pure market that the government must be actively managing the swap rate. Additional evidence for this is the current divergence between the black market rate (around 9.5 renminbi per dollar) and the swap market rate (8.13).



## Pressures on the Exchange Rate

In an economy where a high proportion of all foreign exchange trades are at non-market rates, it is impossible to know the "correct" value of the currency. Tens of millions of Chinese would like to hold foreign exchange assets to which they currently lack access. Conversely, large numbers of foreigners, including some of the world's largest companies, would like to acquire renminbi assets to which their access is limited. The proper exchange rate is the one which would be set by a market in which both sides would have free access to what they want. Since one cannot determine the scale of either side of the supply-demand equation, the equation is unsolvable. But one can analyze the pressures pushing the currency one way or the other.

China is experiencing an extraordinary boom that goes well beyond what the economy can sustain. GNP rose 12.8 percent in 1992 and was rising at a 14 percent pace in the first quarter of 1993. Fixed capital investment grew by 38 percent in 1992. These numbers were accelerating upward in early 1993, with fixed capital investment in the first quarter of 1993 up an utterly unsustainable 70.7 percent over first quarter 1992.<sup>1</sup>

**Inflation** - China's national retail price inflation rate in 1992 was a manageable 6.9 percent, held down by gluts of grain and consumer goods in the rural areas. But that rate is probably not a useful guide to the effect on exchange rates. In 35 major cities, where most of the foreign exchange decisions are undoubtedly taken, official statistics showed inflation at 11 percent. Actual inflation was probably a bit higher than this, since the statistics tend to lag reality: lower on the way up, higher on the way down. This number of 11-plus percent, however, must be discounted

<sup>1</sup>China Economic News XIV, 17 (May 10, 1993), p. 1

by the fact that perhaps 5 percent of the urban inflation was probably caused by one-time increases in the administered prices of non-traded services such as rents, education, medical care, and the like. (These estimates are extremely rough, particularly since Beijing does not publish the basket of goods on which inflation rates are based.) Subtracting that out, one is back to 6 or 7 percent for 1992. The difference between that rate and the U.S. 1992 inflation rate of 2.9% explains only a fraction of the depreciation of the renminbi in 1992.

Anticipation of future inflation may explain more. National retail price inflation was up to 8.6 percent by first quarter 1993 (and 15.7 percent in major cities). Producer prices have been rising far faster than retail prices. Urban inflation rates rose above 15 percent in the first quarter of 1993 and are clearly accelerating. Money supply grew 46.2 percent from March 1992 to March 1993.



**Interest Rates** - China's average interest rate on savings deposits has been 6.89 percent, raised in mid-May to 9.07 percent<sup>2</sup>, against a February retail price inflation rate of 10.8 percent. Thus real interest rates have been negative, and there has been a disincentive to save. The government has been unable to place its bonds because their real interest rates are negative. Despite two generations of socialism, the Chinese people seem to react very quickly to this. In 1992, China became the largest consumer of gold, with private consumption of gold at 250 to 350 tons (and some estimates as high as 700 tons) in 1992. Bank deposits registered a net reduction of 4.5 billion yuan from February to March 1993, despite rising incomes.<sup>3</sup>

The sense that foreign currencies are superior is universal in China. An estimated 30 percent of Hong Kong's total currency circulates in Guangdong Province. In distant desert areas of the Silk Road, each hotel keeps large stacks of foreign currency, especially U.S. dollars. The opening of foreign currency bank accounts by individual Chinese has accelerated very dramatically in 1992 and 1993.

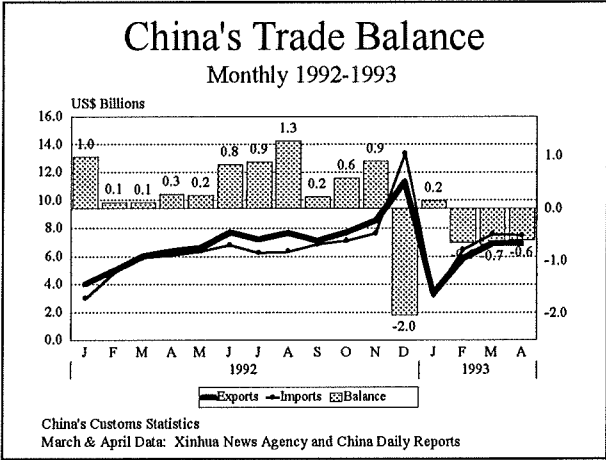
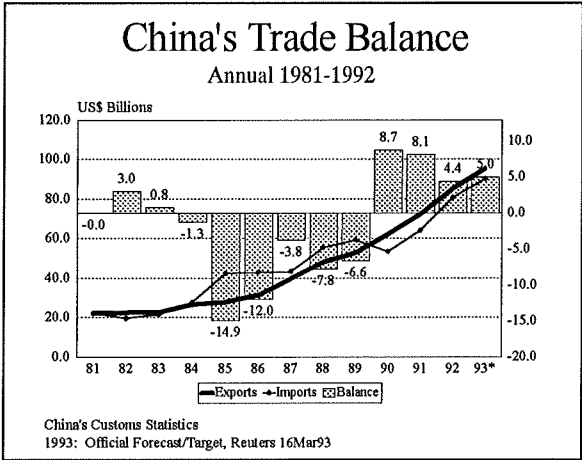
China's savings need to be monitored closely. China has had one of the world's highest savings rates, often around 38 percent of GNP, and this has created a huge reservoir of savings in the banking system. Such a reservoir is good for the country, making adequate funds available for investment, so long as the reservoir does not spring a big leak. If individuals suddenly start dumping their savings, this could create very serious inflation. At the moment, this phenomenon seems limited, and the tendency to put the renminbi savings into gold and foreign currencies limits the impact on retail price inflation. There has been no panic buying and none seems immediately in prospect.

<sup>2</sup> South China Morning Post, "China Acts to Reduce Inflation", May 15, 1993.  
<sup>3</sup> China Economic News XIV,17 (May 10, 1993), p. 1.

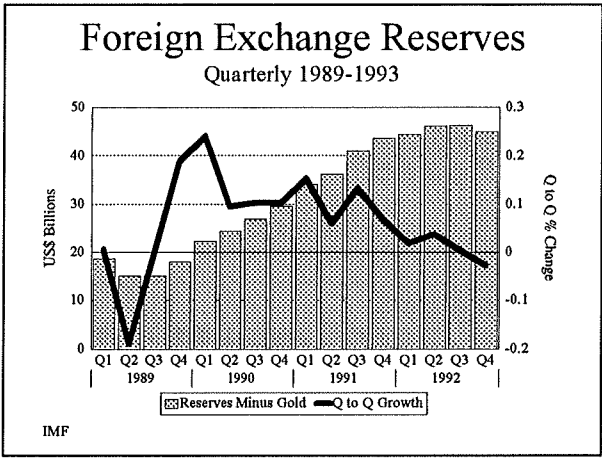
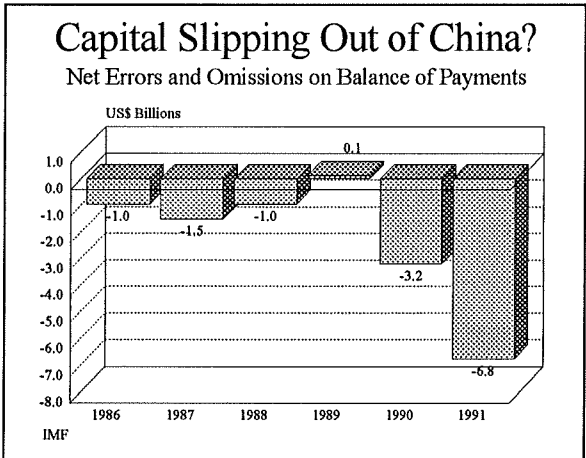
In fact, what seems to be happening is a response to inflation that is fundamentally different from China's previous cycle. Then, people feared shortages of basic goods, so inflation stimulated panic buying of bicycles, food and other basic consumer goods. This time, the country is flooded with basic consumer goods, so even the freeing of prices of basic foods in early 1993 has not led to panic buying of goods. Instead, people have responded to rising inflation by purchasing financial assets, principally gold, foreign exchange, and stocks, and by turning away from cash, savings deposits and bonds. As a real estate market develops in China, one would expect heavy investment in land and houses, but that market remains diminutive in most of the country. Chinese companies and wealthy individuals have, however, made huge investments in the one large real estate market available to them, namely Hong Kong real estate.

**Expectations about the Official Rate** - From 1992 until early 1993, Chinese officials believed they would become contracting parties to the GATT in 1993 and that this would require a convertible currency. (The General Agreement on Tariffs and Trade, or GATT, is the club of relatively free-trading countries who subscribe to a code of trade conduct.) This in turn meant that the official rate would have to be devalued. Thus enterprises with access to concessional official-rate financing for their imports must have feared loss of their subsidies. This probably led to anticipatory acquisitions of foreign exchange and anticipatory imports of equipment. Such acquisitions and hoarding of foreign exchange would have added to the hoarding of foreign exchange, and anticipatory purchases, by businesses using the swap market. However, it has subsequently become clear that Chinese entry into GATT will be delayed, probably for years, so that anticipatory purchases no longer make sense. Thus some hoarded foreign exchange may be sold.

**Trade Account Changes** - Because of import demand stimulated by the boom, China's balance of trade has swung from very large surpluses (\$8.7 billion in 1990, \$8.1 billion in 1991) to deficits beginning in December of 1992 and has remained negative in the first four months of 1993.



**Capital Account Changes** - Publication of data on China's capital account lags far behind the trade accounts, and the numbers on both sides of the ledger are very large. Foreign investment is rising fast. In 1992, new foreign investment commitments were \$57.5 billion. But actual inflows of direct investment were about \$11 billion. A significant proportion of China's foreign investment now comes from what the Chinese call "false foreign devils": Chinese companies that have shifted funds to Hong Kong and reinvested them into China in order to take advantage of the superior tax and other conditions available to foreign investors. So some part of the \$9 billion does not create a real inflow. And unlike before there is substantial outflow. The "Net Errors and Omissions" entry in China's balance of payments, often used as a proxy for capital flight, hovered around \$1 billion of outflow or less through 1989 but then net outflows rose to \$3.2 billion in 1990 and \$6.8 billion in 1991. They may have been substantially larger in 1992.



While we do not know the values of all the components of China's capital account, we do know that, while reserves rose rapidly from the third quarter of 1989 through the third quarter of 1992, they began to fall in the fourth quarter of 1992. With foreign exchange reserves and gold at almost \$50 billion, China is very far from having to worry about a foreign exchange squeeze, but the pressures on the currency have definitely shifted.

**The Currency Today**

China's currency is certainly not seriously overvalued at the moment. China's wage rates and other measures of the input costs of exports remain among the lowest in the world. Chinese goods are successfully flooding world markets. The 40 percent depreciation of the swap rate, from levels that seemed to represent fair market prices, goes far beyond any measure of the differences between renminbi and dollar inflation. What seems to have occurred is an anticipatory overshooting. Such overshooting will not be corrected, however, and could get much worse, as long as Chinese authorities allow the current wild boom to continue.

## Policy Responses

China's inflation and currency problems derive from a policy decision in early 1992 to aim for excessively high growth, and from a political environment which makes it difficult to curtail even fairly serious excesses. This boom is a result of Deng Xiaoping's victory over Li Peng's economic planners in early 1992. Li sought a six percent growth rate. Deng wanted ten. Deng won, but in shooting for 10 they hit almost 13. Taiwan in its heyday knew better: they regularly targeted a 7 percent GNP growth rate, and overshot to 10, but ended up achieving that growth without much inflation. While a sensible consensus eventually emerged in Beijing that the appropriate target was 8 or 9 percent, Deng created a wildly bullish political context by announcing that there were very few opportunities for decisive steps toward modernization and that it was important to take advantage of the current one. His total victory--temporarily--over conservative planner Li Peng made it politically dangerous for senior officials to take stern measures to slow the credit-driven investment boom.

The financial consequences of this political context are complicated by the transitional structure of China's financial controls. In the past, bank loans were all more like Ford Foundation grants than market loans. In the future, China intends to have a largely market-based system in which loans will be based on creditworthiness and carry market interest rates. At present, the banking system is only about halfway through its transition, so state enterprises are still getting huge amounts of highly subsidized loans; if they cannot repay the loans, the banks simply turn to the central government, which owns all the banks and is unwilling to force them into bankruptcy. At the moment, the central bank (People's Bank of China) is limited to issuing flexible guidelines on credit growth while the local banks, more responsive to local political pressures than to central bank officials, wildly exceed the guidelines. This is the most serious source of excessive money growth and inflationary pressure.

One popular scenario holds that the central government has lost control over provincial branches of its major banks and that this means ever-accelerating money supply, inflation, and currency depreciation. Taken to an extreme, this would put China in the situation of the Soviet Union, where the Yeltsin government lacked control of the banking system and therefore slipped into hyperinflation. In China, however, conditions are very different. The central government has control of its central bank, and the central government can force the local banks to rein in their lending if it feels sufficiently motivated to do so. The problem is that top officials do not desire to do so at the moment for fear of offending Deng Xiaoping in his drive for rapid modernization.

Under what conditions could this political context change? The answer is straightforward. The fact that foreign exchange reserves have begun to fall sharply has already caught the attention of Beijing. More importantly, Chinese officials understand that inflation was a primary cause of the Tiananmen Square crisis of June 1989. People on inflexible incomes were becoming desperate. Panic buying and shortages were becoming widespread. As a result, faith in the authorities was deteriorating. At that time, national retail inflation was around 18 percent and inflation in major cities around 40 percent. If inflation rates get within striking distance of those that the leadership associates with Tiananmen Square, then the political context will change very decisively. Given the rate at which inflation has been rising, that political limit may not be very many quarters away.

Will the central government be able to change the behavior of its banks once the political context changes? Mild exhortations certainly will not be enough. Those have been tried, and have failed. There has been some tightening of credit by banks, but, like the interest rate rise, it appears to be--so far--too little too late. But this does not mean the central government is helpless. Its credit tightening policy is already having some effect nationally. If the leadership becomes convinced that it faces a serious problem, heads of major banks around the country will probably be told that guidelines are now fixed, not flexible, and that if they exceed them they will lose their high ranking jobs or in an extreme even go to jail. China's central government is still demonstrably capable of sending anyone it wishes to jail. While this is a very extreme scenario, it illustrates an important difference between the situations of China and certain East European countries which have completely lost the will or authority to control money supply. It is noteworthy that the roughly 30 percent rate of money supply growth in calendar 1991 and 1992 was almost identical to money supply growth in the peak of the previous cycle (1987 and 1988) and therefore manageable.

Thus the reaction will come, and when it comes it will be effective--absent some far-out scenario after the death of Deng Xiaoping. (While there will be a power struggle after Deng's death, scenarios for complete loss of control are very low probability because there is a broad consensus among the successors about the basic direction of policy even though there is substantial disagreement about the pace of reform.) Because the tools available are crude, the policy change is likely to be abrupt and disconcerting. Interest rates, bank credit, and fiscal policy will all shift toward restriction. The cycle of boom and bust will continue. The bust part of the cycle is very painful, but in the past two cycles, reserves have remained at comfortable levels, growth has remained high by Western standards (4 percent at the bottom of the most recent and most severe cycle).

### **Prospects for the Renminbi**

The key question in determining prospects for the Renminbi, then, is how long it will take the government to react and how crude its levers will turn out to be.

At one extreme, if recent tightening of credit guidelines turned out to be fully effective, then the renminbi could be expected to stabilize and appreciate somewhat. Last time, when credit brakes were applied, the renminbi strengthened from 7.06 per dollar in October 1988 to 4.98 in November 1989. There has in fact been considerably more, and more effective, tightening of banks' credit policies than most foreign reports suggest. But a scenario of fully effective policy today seems as unlikely as complete loss of control; the significant but inadequate raising of interest rates is an appropriate proxy for overall policy today. This means that a completely soft landing is unlikely.

If decisive tightening occurs in the third quarter, then additional depreciation should be negligible to modest, and the swap market should return fairly quickly to being a real market. Chinese enterprises which have embarked on major projects and find themselves in a credit squeeze will be

forced to disinvest in gold, foreign exchange, and Hong Kong real estate, and this will cause a significant appreciation of the renminbi.

If the current environment persists into the first quarter of next year, then pressures on the currency will become more severe. The current administrative control of the swap market will become full control, and that will create a psychology of pessimism about the currency which will increase the downward momentum. Black market rates will decline much further than swap market rates. Interest rates will be raised very high. (In 1989, they were raised to 25 percent, a full 6 percent above inflation.) Import controls will be imposed even though this will exacerbate trade friction with the U.S. at a delicate moment. A very serious decline in the currency will be succeeded by more dramatic appreciation than in the previous scenario, but the currency would settle at a lower level than in the more moderate scenario because the inflation would semi-permanently reduce peoples' faith in the currency and would also diminish foreign investment for a year or two.