China’s Last Option: Let the Yuan Soar

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After their sold-out concert last month, legendary American punk band NOFX met with Beijing's leading musicians at the trendy club D22. Music is moving forward as quickly as everything else in this wildly interesting country, and as they interacted drunkenly with the cream of Beijing's underground, members of NOFX expressed surprise at the dizzying speed of change.

It is probably a safe bet that the FX in the band's name is not a reference to foreign exchange, and that the changes they noted have nothing to do with the financial sector, but it turns out that a rock band is not a bad metaphor for China's markets. Monetary conditions are clearly out of control, and the country is drunk on excess money. What's worse, there is a hangover still to come. At some point China must make a monetary adjustment, and with so few alternatives left among policy options, this adjustment is increasingly likely to involve a one-off maxirevaluation in which the financial authorities engineer a revaluation of the currency designed to stop capital inflows without causing a banking system breakdown.

Why would the authorities do something they have steadfastly and sincerely insisted they will not do? By coincidence, the day NOFX performed in Beijing, newspapers around the world noted with awe the huge $136 billion first-quarter increase in central bank reserves reported the previous day. This latest number brings total reserves held by the Chinese central bank to $1.2 trillion. First-quarter imports amounted to $206 billion, up 18% from 2006 first-quarter numbers (exports were up 28%), so that total central bank reserves cover nearly 18 months of imports – well beyond the six- to nine-month coverage ratio that most economists recommend.

A $136 billion rise in first-quarter reserves – equal to 21% of first-quarter GDP – is by any measure an astonishing number. For comparison, during all of 2003 China's reserves grew by $117 billion, to an already hefty $403 billion. At the time there was a serious debate about the implications of this level of reserve growth.

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Many commentators expressed concern that the accompanying monetary growth – which takes place as the People's Bank of China, the country's central bank, is forced to fund the purchase of reserves by issuing currency or central bank bills – was beyond the needs of the economy. Such rapid monetary growth was likely to lead to excessive loan growth at the nation's already weak commercial banks, to overinvestment in a number of industries, including real estate, and perhaps eventually to inflation, which once ignited would be hard to control.

Since then, reserve growth, and with it the growth in money supply, has accelerated. In 2004, reserves were up $207 billion to $610 billion. In 2005 they increased by another $209 billion to $819 billion. In 2006 reserves climbed $247 billion to just over $1 trillion, comfortably ensconcing China in the position of holding the world's largest hoard of central-bank reserves. Add to this the first-quarter growth of 2007, and it becomes clear that growth in reserves is out of control, and with it, growth in the nation's money supply.

What explains this first-quarter jump, which surprised most China-watchers long inured to surprising numbers? Part of it of course comes from China's rising trade surplus, which hit $46 billion in the first-quarter of 2007, double last year's $23 billion first quarter surplus. China also received $16 billion in foreign direct investment during the period. Although the composition of the central bank's reserves is a secret, Brad Setser, senior economist at Roubini Global Economics, estimates that currency appreciation, mainly of the euro, may have added $5 billion, which when aggregated to another $10 billion to represent returns on investment, still leaves nearly $60 billion unaccounted for.

In order to head off concern that this might represent a resurgence of hot money inflows, Chinese authorities took the unusual step of trying to explain the first-quarter surge. Three days after the news was released, Wu Xiaoling, a deputy governor of the People's Bank of China, speaking at a seminar in Guangzhou, said that the unwinding of swap agreements between the central bank and Chinese commercial lenders had resulted in foreign exchange coming back onto the PBoC's books during the first quarter. In addition some of the funds raised in offshore initial public offerings by Chinese banks and other enterprises had also been brought back onshore, driven by the desire to take advantage of the rising yuan.

Wu Xiaoling's comments eased market concerns somewhat. However they gave no information on the actual size of other inflows (although these were probably still small), and they didn't address the fundamental problem that these first quarter inflows, which included capital inflows that were a postponement of inflows generated in 2006, will still

have an adverse monetary impact. Excessive monetary expansion is as much a stock problem as it is a flow problem, and the fact that reserves are growing rapidly is much more important than the precise timing of the initial cause of the growth.

THE MONEY TRAP

What the first quarter numbers did highlight is that for the past several years China has been caught in a money trap, and it is not at all obvious how it can escape. The trap consists of self-reinforcing structures in which cause and effect are intertwined. At the heart of this is the trade surplus. China's trade surplus means, by definition, that it produces more than it consumes. If it produces substantially more than it consumes, as it currently does, the Chinese economy is forced to run a substantial trade surplus.

This trade surplus is self-reinforcing because it generates too-rapid growth in reserves as dollars pour into the country through the export account. As the People's Bank of China is forced to buy the incoming dollars, it expands the domestic money supply, either by creating money or by issuing a close substitute for money, short-term central bank bills. The money creation itself forces further expansion in investment, either directly or through the banking system, which results in ever-greater production and with it ever-greater trade surpluses.

The result can be seen in the numbers. For all the attempts to manage the process over the past five years, including administrative controls, yuan appreciation, numerous increases in minimum reserve requirements, and several interest rate rises, industrial production continues to soar, along with the trade surplus and the money supply. M2 was up 17.3% in the first quarter of 2007, against a target of 16%. Industrial production was up 18.3% over the same period last year, a 10-year record (versus an already high 16.7% for first quarter 2006). With this level of growth in industrial production, it is unrealistic to expect a narrowing of the trade surplus any time soon, and if the trade surplus doesn't narrow, neither money growth, loan growth, nor investment is likely to slow down. As they continue to surge, they will put more upward pressure on China's exports.

The Chinese Academy of Sciences recently forecast this year's trade surplus to be 43% higher than last year's $178 billion. China, it seems, is stuck in what once seemed like a virtuous cycle but is increasingly a vicious one. As in Japan in the 1980s, trade surpluses create the conditions for more trade surpluses. Unless authorities can somehow force down the surplus – perhaps by going on a massive (and probably inefficient) international buying

spree – it is hard to see what can reverse this self-reinforcing process, short of a sudden appreciation in the currency or a sudden contraction in the domestic money supply, which is perhaps just another name for a domestic financial crisis.

UNDERMINING THE BALANCE SHEET

There is an old banker's saying that bad loans are made during good times. Times are as good as they can get for Chinese banks: GDP is growing quickly, corporate profitability seems to be rising (although at least part of this may come from speculating on financial markets, China's latest corporate fad), and China and the world are flooded with liquidity that has kept interest rates low, asset prices high and rising, and has not yet shown up as inflation.

But it is precisely in this sort of Minsky paradise that the financial system is likely to evolve in a direction where risks are built up and even more bad loans are made. Loan growth and investment growth in China have been high – in the first quarter of 2007 loans grew by 1.4 trillion yuan, an amount equal to nearly 28% of first-quarter GDP and more than half of last year's already high loan growth. The authorities have raised minimum reserve requirements an unprecedented seven times since April 2006, they have raised interest rates three times during this period, and they have made tremendous sterilization efforts, with no apparent impact on the economy and without putting a dent in the pace of loan growth or stock-market appreciation.

Even China's much-vaunted administrative controls haven't done much. During the last three years every bout of excessive growth was moderated, to much fanfare, by administrative policies – but never for more than two or three months, after which the country's economy once again picked up speed. Analysts often laud the use of administrative controls as Beijing's ultimate weapon, but the track record seems to provide very weak evidence for their usefulness. They seem temporarily to slow down growth in the areas in which the authorities are most concerned, but have no impact beyond a few months. For all the talk of administrative controls over the past five years, GDP grew by 11.1% in the first quarter of 2007 – after its already heady 10.7% and 10.4% surges in 2006 and 2005. Administrative controls seem mainly effective in shifting problems from where they are noticed to where they are not.

The failure of market and administrative measures will almost certainly increase systemic risk. There are many problems in the country's financial markets, but the two

greatest have to do with the banking system. The most obvious problem, of course, is that the country's financial system is dominated by its banks, whose lending policies tend to be inflexible, whose risk systems are rudimentary, and whose ability to adjust is constrained by a rigid (and opaque) governance structure. This means that since banks are the primary source of financing, contractions in the banking system are likely to be transmitted into the underlying economy. There they can set off more self-reinforcing processes in which banking-sector contractions caused by rising bad loans lead to economic contraction as the banks clumsily attempt to reduce loan exposure, which then leads to further banking-sector contraction as corporate defaults rise in response to bank tightening.

The second problem is that the banking system is already in trouble. While there have certainly been improvements in lending practices in recent years, Chinese banks have a long way to go before they are healthy and prudently managed. If nonperforming loans and other assets were valued correctly, these banks would be technically insolvent. In a November 2006 report, Fitch Ratings calculated that total unrealized losses in the banking system exceeded total capital and reserves by more than one-third. This figure does not include estimates made for the rapid loan expansion of the past two years, which most analysts believe will result in a surge in new nonperforming loans.

The financial authorities have attempted to clean the banks by carving out roughly $300 billion in bad loans and selling them to asset management companies for liquidation. Unfortunately, because the actual liquidation process has been glacial, the cleaning up of the banks, as limited as it has been, fails on two counts. First, liquidating bad loans is not done simply to clean up the banks. It also permits overly indebted companies to eliminate financial-distress costs associated with the debt overhang and begin to operate normally. This not-widely-understood benefit of loan liquidations is a very important element in repairing a badly functioning banking system, but in China it has barely taken place.

Perhaps more importantly, the cleanup of bad loans has consisted largely of transferring the loans from the banks' balance sheets, where they were effectively contingent obligations of the government, to other entities where they are direct obligations. This wouldn't be a problem if the government's credit were unassailable, but the government's total liabilities, including contingent liabilities, have been rising and may well exceed 60% of GDP. It is not obvious that the government's credit can withstand much more increase in contingent debts, which would probably occur if some event were to set off an economic contraction. Because of this shuffling of bad loans, the credit-

worthiness of Chinese banks has barely improved in the past 10 years – while the banks' direct credit has improved, that of their guarantor has deteriorated.

MONETARY POLICIES

During the National People's Congress in March, Premier Wen Jiabao said that the economy is "unstable, unbalanced, uncoordinated and unsustainable." China's feverish economy and weak national balance sheet are largely the consequence of the past several years' explosive monetary growth, and as it accelerates, it is clear that some sort of adjustment needs to happen. Perhaps it is possible that the adjustment will take place in a benign context and the consequences will be mild. If China is lucky, if global growth and liquidity conditions are maintained for at least another five to seven years, and if the government gets serious about cleaning up the banking system and developing alternative financial markets, China may muddle through.

But this may be a lot to hope for. It is not clear that anyone can count on benign conditions for so long, and it is even less clear that the financial authorities are seriously repairing the financial system. In retrospect the financial authorities have made two major mistakes. The first was to have dragged their feet on cleaning up the banks, when they should have been strengthening and clarifying the governance framework, carving out bad loans, liquidating them as quickly as possible, and so limiting their current and future impact on the country's credit. The second mistake may have been harder to predict at the time, but it now seems that the financial authorities waited too long in beginning the appreciation of the yuan. By waiting until 2005, and then only permitting a gradual upward creep, they forced the yuan to stay too low for too long.

As things stand now, there is little that the authorities can do to rectify the currency problem. To continue allowing the yuan to appreciate at its current glacial path means that the monetary imbalances will persist, and as they do, the combination of a further weakening in the national balance sheet and the greater monetary pressure will make the eventual adjustment more difficult. To allow a more rapid appreciation of the yuan brings equally serious difficulties. It would almost certainly cause a pick-up in hot money inflows, which would exacerbate monetary conditions and increase the set of problems – overinvestment, excessive loan growth, and asset-price bubbles – that the authorities need so urgently to fix.

None of the standard policy options seem to be working – domestic monetary contraction via interest-rate increases, minimum-reserve increases, and administrative measures have proven as ineffective as faster or slower appreciation of the currency. Another as-yet-untried option, however, which now seems so unlikely that most economists dismiss it out of hand, will eventually draw much wider support – not because it is obviously good policy but rather because it may be the only option left.

The central bank can engineer a large one-off jump in the value of the yuan, followed by a peg, which would halt hot money inflows and after a period of adjustment reduce the trade surplus, to bring China's monetary system back into balance. If the revaluation is sufficiently high, and is followed by a credible peg, it will cause an import-related boost in consumption that will help bring down the trade surplus while also reducing or even reversing capital inflows. The slowing of reserve growth will slow investment, which by reducing production will limit export growth.

This policy option is not without significant risks. A too-great revaluation could hurt export industries and lead to capital flight which, by weakening bank loans to export companies and simultaneously creating deposit outflows, could jeopardize the banking system and precipitate the crisis it was designed to modify. And of course anything that reverses the self-reinforcing process of investment and growth may result in a rise in unemployment in the short term.

Although the relative attractiveness of this policy option is increasing and will continue to increase over time, there is still great resistance because of its potential impact on the banking sector. That is not surprising given the risks, but what else can the financial authorities do? Monetary growth is caught in a self-reinforcing trap whose consequence is an ever-weakening national balance sheet. The failure of market measures places even more emphasis on the use of administrative measures, but administrative measures are most powerful when least used. The threat of using them is often more effective than the actual measures, and because of their overuse no one now expects them to have much effect. The market has already been trained to buy every dip.

In April Xia Bin, director of the finance division of the Development Research Center and advisor to senior government officials, told members of a financial forum that "The central bank of China's current monetary policy is a bit weak. In other words, money supply is a bit out of control." This is an admirably (and surprisingly) frank assessment, and if true implies an uncomfortable future. China is muddling through its monetary management and will probably continue to muddle through for the foreseeable future, but

at some point there must be a substantial adjustment made, in which not only does money-supply growth slow significantly but also the previous excess money-creation is wrung out of the economy.

The authorities have tried nearly every gradualist tool at hand and nothing seems to work. They can't even get the attention of financial journalists, who relegate these moves to the back pages of their newspapers. No one seems to care what the authorities do. China's latest reserve-increase announcement (up 50 basis points, to 11%) made two days before the May 1 holidays saw the stock market respond contemptuously the next day by surging 2.17%.

This is not surprising if the root problem is excessive monetary growth caused by ballooning reserves, because none of the tools have so far been able to address the root problem. Until they do so, it is hard to see how this story can end well. Perhaps the best thing for Chinese bankers, investors and businesses to do now is to enjoy the party and try not to think too much about tomorrow's hangover. That's probably what the punk band NOFX would do.