China Considers Currency Changes as Pressures Mount

A Benjamin Franklin US 100-dollar banknote and a Chinese 100-yuan banknote depicting late Chinese chairman Mao Zedong are seen in a photo illustration, Jan. 21, 2016. ~Reuters

Under pressure from a slowing economy, rising tariffs and skittish investors, China's government appears to be considering looser controls on the value of the yuan.

On Oct. 31, the official English-language *China Daily* published a report citing experts' conclusions that "the government much preferred a freer [yuan] renminbi, or allowing the market to decide its value."

In the past, such articles in state media have been seen as a way for the People's Bank of China (PBOC) to gauge market reactions before announcing reforms of exchange rate policy for the currency, also known as the RMB.

Economists were quoted as saying that eased controls on the yuan's value "could be a wise choice for China, against the backdrop of trade conflicts and economic downside risks."

One option under consideration would be to widen the band for onshore trading of the currency against the U.S. dollar, which is currently allowed to fluctuate by up to 2 percent from a "central parity rate" set by the PBOC each business day.

The 2-percent limit has been in place since 2014, when the PBOC widened the band from 1 percent up or down. Previous expansions of the corridor took place in 2012 and 2007.

The second and more daring option for liberalization would be to adopt a freely floating exchange rate policy, as practiced by most of the world's advanced economies.

Such a move could theoretically get the PBOC out of the business of managing exchange rates altogether. Aside from the *China Daily* gambit, there have been few signs that the government is prepared to go that far.

The *China Daily* article focused on the implications of exchange rates for monetary policy and the economy in an environment of rising U.S. interest rates and a strengthening dollar.

The experts quoted by the report cited a “dilemma” facing policymakers, whether “to defend the currency by tightening liquidity, which may lead to credit defaults and the fast bursting of asset bubbles; or to tolerate a relatively weaker currency … but ensuring a low interest rate level (that) could sustain strong economic growth.”

Counter-cyclical factor

Yukon Huang, senior fellow at the Carnegie Endowment for International Peace in Washington and a former World Bank country director for China, was quoted as saying that Beijing doesn’t “need to make the renminbi stronger than it should be, as the U.S. dollar is surging in its value.”

The statement appeared to argue against the PBOC’s decision in August to re-introduce a “counter-cyclical factor” in the China Foreign Exchange Rate System (CFETS) to fight further depreciation.

The currency started the year trading at about 6.5 to the U.S. dollar and ended October at 6.97582, down 6.7 percent.

On Monday, China set the parity rate at 6.9245 to the dollar.

The depreciation this year has spurred long-standing U.S. concerns that a cheaper yuan will boost China’s exports unfairly and more recent charges that the slide is intended to mitigate the cost of tariffs that have been imposed so far.

China has responded with repeated assurances that it has not deliberately weakened its currency.

Speaking in Beijing on Nov. 6 at a meeting with major international institutions, Premier Li Keqiang insisted that China “will not engage in competitive devaluation.”

In a semiannual report to the U.S. Congress last month, Treasury Secretary

Steven Mnuchin declined to designate China as a currency manipulator but cited "particular concern" with the country's lack of transparency and the weakness of the yuan.

Psychological barriers

But regardless of the international reactions, China has its own concerns with its currency.

Beyond the implications for interest rates and economic growth, China's policy choices face the challenges of two psychological barriers, which may have little consequence for economists but can carry considerable weight with investors.

The first psychological barrier that China may defend against is the exchange rate of seven yuan to the U.S. dollar, a threshold that the currency has not crossed since the global slump of 2008.

If the PBOC widens the trading band or switches to a free floating currency, the line could be quickly overstepped.

Although seven to the dollar is only another number to economists, "passing that number would be significant symbolically," *The New York Times* said in an analysis last month.

"It would suggest China is prepared to let its currency weaken further still," the paper said. How far and how fast are open to question, but investors could get more nervous quickly, raising the risk of capital flight.

That may be one reason that state media are testing the waters with a story on possible changes in exchange rate policies. Regulators came close to breaking the seven-to-the-dollar limit in December 2016 but pulled back as the year came to a close.

The PBOC may see the exchange rate barrier as crucial, but it has been skating close to another psychological limit it doesn't want to breach.

In October, the bank's foreign exchange reserves declined for the third month in a row to U.S. $3.053 trillion, barely exceeding the $3-trillion mark.

The narrow margin could put the bank in the position of breaking one psychological barrier to defend against another.

A Chinese bank teller counts US dollar notes next to stacks of Chinese 100 yuan at a bank in Huaibei, eastern China's Anhui province, Sept. 24, 2013. Credit: AFP

Taking the brunt

Gary Hufbauer, nonresident senior fellow at the Peterson Institute for International Economics in Washington, said President Xi Jinping seems more likely to accept a lower value for the yuan.

The currency will be in for a drubbing due to U.S. President Donald Trump's threat to raise tariffs in any case, unless a trade agreement with China is reached soon.

"I think Chinese leaders have decided to let the yuan take the brunt of Trump's trade offensive," Hufbauer said by email.

"So, if Trump imposes the 25-percent tariff rate on Jan. 1 (up from 10 percent), the yuan could drop another 5 percent to 8 percent," he said.

"Xi wants to preserve China's hoard of dollars … and not spend it defending the yuan," Hufbauer said.

Prospects for a trade deal dimmed last week as U.S. Vice President Mike Pence delivered a tough speech at the Asia-Pacific Economic Cooperation (APEC) summit in Papua New Guinea, an event also addressed by China's President Xi.

While Xi implicitly criticized U.S. tariffs as "short-sighted, Pence said that Washington "could more than double" the U.S. $250 billion in penalties that have already been placed on imports from China.

"The United States … will not change its course until China changes its ways," Pence said in his speech Saturday.

Clashes with China over the wording of a draft text criticizing "unfair trade practices" prevented an agreement on a joint statement from APEC for the first time in the group's history, news agencies reported.

Speaking at the White House on Friday, President Trump acknowledged that China had sent a list of concessions in response to U.S. demands on trade and other policy differences, but he dismissed the offers as insufficient.

"It's not acceptable to me yet," Trump said, according to *The Times*.

By widening the trading band for the yuan, China will be able to argue that it is opening up further to the market while it is reaping the benefits of cheapening exports and reducing the impact of tariffs.

Such a choice could keep China's powder dry in terms of forex reserves, but concerns over capital flight may imply even tighter capital controls.

China's declining economic growth rates and rising U.S. interest rates have been pushing the yuan in the same direction. A change in exchange rate policy may only determine how far and how fast.

The property market factor

An alternative reading is that a "reform" of exchange rates may be little more than a cover story for the same benefits that would otherwise be achieved by currency manipulation.

But internal considerations in China are likely to be a greater force in driving policy changes.

The *China Daily* article made repeated references to the bursting of "asset bubbles," citing the risk that a defense of the yuan would require more credit tightening and risks for the property market.

Years of property investment and appreciation have been met with periodic waves of local buying restrictions, driven in part by Xi's dictum that houses are "for living in, not for speculation."

But the buying curbs have done little to keep property prices from rising or prevent apartments from becoming stores of wealth.

Cooling of the sales frenzy has led some developers to offer discounts on unsold units, sparking protests from investors who bought at higher prices.

Reactions to recent demonstrations over housing quality complaints at a Beijing complex built by leading developer Vanke are symptomatic of a downturn in the market, the *South China Morning Post* reported last month.

Softening property prices are likely to prompt government concerns not only about economic growth but also social stability, giving rise to thinly-veiled terms like “asset bubbles.”

Defending the yuan may imply a tightening of liquidity, but confidence in domestic property investment as a store of wealth may also be hurt if the yuan continues to drop.

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