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The currency

A tisket, a tasket, a band not a basket

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Pressure on China to revalue the renminbi, simmering for the past two years, has intensified in 2005 as import growth slowed to 12 percent in the first quarter year on year while export growth continued full throttle at 35 percent. The Chinese government, rightly, remains strongly opposed to revaluation. A revaluation would reward speculators, slash the yuan value of central bank reserves and commercial bank dollar assets, and leave markets jittery about what was coming next.

Yet inaction is also inappropriate given the increased stress that China's rigid currency regime puts on the domestic economy and the international balance of payments. Beijing has long held that it could not move to a more flexible currency regime until it liberalised its capital account and progressed on bank reform. Contrary to conventional wisdom, China has already opened its capital account quite substantially, and this has begun to introduce significant competition into the banking sector. Even by Beijing's self-proclaimed standards, the time is ripe for a move on the renminbi.

Peg o' my heart

Regime change

Indeed, officials have signalled that a currency regime change is in the offing. One option is to switch from a US dollar peg to a peg against a trade-weighted basket of currencies, chiefly the dollar, the euro and the yen. This would have the advantage of loosening the tie to a dollar that could continue to weaken against the euro and the yen. A basket peg would have the disadvantage, however, of lacking transparency since the weights of a basket are generally not disclosed. So markets would still be left jittery about what was coming next and how government discretion would play into management of a basket peg.

The dollar peg has worked well for China precisely because of its transparency and non-discretion. A credible peg provides stability in the business climate and eliminates the costs associated with hedging risk. This is especially important in China where hedging instruments are not developed and much trade is conducted by small ventures operating on tight margins. The Chinese government has established great credibility in its peg, resisting pressure to devalue in the wake of the Asian crisis and more recently to revalue in the face of speculative pressure. That store of credibility could be exploited by sticking with a commitment to the existing peg as a target, just broadening the trading band around it. Confidence in the stability of the new regime would encourage an easing out of the speculative overhang provided speculators were convinced the modest gains allowed within the band were all they stood to get. The band should be wide enough to enable market forces to play a role in currency valuation and to motivate development of hedging instruments. Plus or minus five percent would suffice.

The institutional infrastructure for a banded float already largely exists. Officially, China characterises its exchange rate regime not as a peg but as a "market-based, unified and managed floating exchange rate system". In the initial 17 months after this system was established in January 1994, the yuan was allowed to appreciate 5 per-

cent to its current Rmb8.28. After that, however, flexibility was progressively reduced. From late 1995 to December 1997 the yuan closing price fluctuated by plus/minus 0.38 percent around a midpoint. In the wake of the Asian crisis variability was reduced sharply, to plus/minus 0.024 percent. Since January 2001 variation has been even less, 0.0066 percent. And since 12 October 2004, the daily closing price has not deviated from Rmb8.2765:US\$1. No wonder observers stood up and took notice when on 29 April the rate appreciated briefly to Rmb8.2700 – an appreciation of 0.08 percent.

This stability is achieved not by fiat but by assiduous trading by the People's Bank of China (PBoC) to clear the market at the target. Thus a slackening by PBoC traders, as on 29 April, is all that is needed to broaden the band. But in order to bring market forces into play in determining the exchange rate, the PBoC must give up its monopoly position as market maker, allowing other participants in the inter-bank market to hold discretionary balances of foreign exchange and take open dollar positions on their own accounts.

The inter-bank market – the China Foreign Exchange Trade System (CFETS) – currently comprises 354 member institutions trading on a centralised electronic order-matching platform under the supervision of the central bank. Member institutions are permitted to hold only limited foreign exchange working balances to support their retail trading activity. They must square their positions daily with CFETS to keep within these limits. Retail customers in turn must surrender foreign exchange earnings and document foreign exchange spending needs. Thus at both retail and wholesale levels, the foreign exchange market functions under compulsory supply and restricted demand.

For monopolistic pricing of foreign exchange by the PBoC to give way and a banded float to become meaningful, institutional dealer/speculators must have discretion over their foreign exchange holdings. This will necessarily cause a loss of state control over the sources and uses of foreign exchange. For this reason, capital-account liberalisation provides a foundation for broadening the trading band. Furthermore, capital account liberalisation exposes Chinese banks to competition for funds and thus requires that Chinese interest rates become responsive to international market forces. Hence China's stress on the need for capital account liberalisation and banking reform to precede exchange rate flexibility makes sense.

Half-open door policy

It is sometimes glibly stated that China has a “closed capital account”, but this is not really true. China has gradually opened its capital account over the past 20 years, under two principles: relax inflows before outflows (to minimise the risk of capital flight) and relax long-term illiquid forms of investment before short-term liquid ones (to minimise volatile speculative flows). As a result, according to PBoC governor Zhou Xiaochuan, 50 percent of capital account items are now open (see “How closed is ‘closed?’” on p. 40).

This increasing openness is dramatically evident in the 150 percent upsurge in two-way capital flows between 2002 and 2004 (see Table I on next page). The vast majority of this increase stemmed from the “other investment” category, which more than tripled over the two-year period, from US\$150bn to US\$486bn. Most of this represents loans, principally short-term. Rapid growth in inflows from borrowing quickly generates rapid growth in outflows, as borrowers repay their loans.

Currency pairs traded on CFETS

Yuan rates

US\$

Euro

Yen

HK\$

Cross rates

(traded since 18 May 2005)

Euro / US\$

Euro / Yen

Aus\$ / US\$

Sterling / US\$

US\$ / Yen

US\$ / HK\$

US\$ / Can\$

US\$ / Swiss franc

Source: PBoC

Opening the account

Table 1
China's balance of payments, 2002-04, US\$bn

	2002		2004		Change 2002-04
	2-Way	Balance	2-Way	Balance	
Current account	739.6	35.4	1332.7	68.7	33.2
Goods	607.1	44.2	1127.8	59.0	14.8
Services	86.3	-6.8	134.6	-9.7	-2.9
Income	31.6	-14.9	44.6	-3.5	11.4
Current transfers	14.6	13.0	25.8	22.9	9.9
Capital & financial account	224.4	32.3	576.0	110.7	78.4
Direct investment	59.4	46.8	68.7	53.1	6.3
<i>Outbound</i>	3.2	-2.5	2.4	-1.8	0.7
<i>Inbound</i>	56.2	49.3	66.3	54.9	5.6
Portfolio investment	14.9	-10.3	20.8	19.7	30.0
<i>Assets</i>	12.1	-12.1	6.6	6.5	18.6
<i>Liabilities</i>	2.8	1.8	14.2	13.2	11.5
Other investment	150.0	-4.1	486.5	37.9	42.0
<i>Assets</i>	30.6	-3.1	100.5	2.0	5.1
<i>Liabilities</i>	119.4	-1.0	386.0	35.9	37.0
Increase in official reserves		75.5		206.4	130.9
Net errors & omissions		7.8		27.0	19.3

Source: SAFE

Table 2
Components of increases in net inflows, 2002-04

	Amount US\$bn	Comments
Goods & services trade	11.9	Overall trade grew rapidly but trade surplus did not.
Other current account items	21.3	Outward income payments down by US\$11bn; net inward transfers rose by US\$10bn. This may mask speculative activity.
Direct investment	6.3	Modest increase in inflows, partially offset by higher outflows. Outflows represent both Chinese FDI abroad and disposal of foreign-owned investments in China.
Portfolio investment	30.0	Combination of Chinese shifting from net acquisition to net disposal of foreign assets and foreigners increasing their net acquisition of Chinese assets.
Other investment	42.0	Overwhelmingly loans, mostly short-term borrowing betting on a revaluation
Net errors and omissions	19.0	Shifted to a net inflow in 2002 after years of net outflows representing capital flight. Captures marking to market of yen and euro assets in light of their appreciation vs the US dollar – perhaps US\$25bn in 2003 and US\$15bn in 2004

Understanding China's international imbalances

Surpluses in China's current and capital accounts led to an increase in official foreign reserve assets of US\$206.4bn in 2004, exceeding the increase for 2002 by US\$130.9bn (see Table 1). Foreign exchange inflows from trade and direct investment saw scant increase (though in Q1 2005, not covered by this table, the trade surplus rose sharply). The big increases came from portfolio and loan capital flows, non-trade elements of the current account, and errors and omissions, all of which reflect speculative activity to some extent. An analysis of the sources of the US\$130.9bn increment in foreign currency inflows is given in Table 2.

One capital-account opening measure that has paved the way for great expansion in flows was the granting of the right to foreign-invested enterprises (FIEs) to borrow in foreign currency for conversion to yuan and then back again for loan repayment. Domestic firms can also take out forex loans with proper approval. Expectations of yuan appreciation have prompted a switch from borrowing in yuan to support domestic expenditures to borrowing in foreign currency and converting, since payback of the loans stands to become cheaper in yuan terms if there is an appreciation.

The genie's out of the bottle

More generally, oversight of foreign exchange transactions for FIEs has slackened since July 2002 when the State Administration of Foreign Exchange (SAFE) relinquished its role in approving conversion of funds held in FIE deposit accounts, delegating this function to the banks providing the accounts. Meanwhile, the financial services market has become more competitive, with foreign banks doing a wider range of business. In this environment, it has become easy for FIEs to borrow in foreign currency to support investment in local assets or even to meet working capital needs. In effect, the yuan has become near fully convertible under the FIE umbrella.

The officials who engineered these reforms were probably surprised by how readily they allowed a surge in capital inflows as speculative sentiment took off. Liberalisation tends to take on a life of its own. Boundaries are porous, monies are fungible and leakages become harder to contain the larger the uncontrolled domain. This is especially true in a big country such as China where regulatory oversight must be decentralised and lower-level interests do not necessarily coincide with central policies.

In any case, reforms have achieved two things: first, substantial capital-account liberalisation; and second, the exposure of domestic banks to significant foreign competition, since foreign banks are very active in making foreign currency loans to FIEs.

This competition will heat up at the end of 2006 when majority foreign-owned banks are permitted to take deposits and make loans in renminbi. Financial market development is thus high on the agenda, and this process would be aided by a modest innovation in the foreign exchange market.

How it would work

If Beijing does move to a banded float, managing market psychology is crucial. The goal is to keep the currency trading within the band, close to the target (rather than immediately shooting to one end of the band) with minimal intervention by the PBoC. Provided the central bank's commitment to the peg is credible – and China has an excellent track record in this regard – institutional dealers can carry most of the load in making the market. Faith that trading will return the exchange rate to the target will deter potential buyers from paying much more and potential sellers from taking much less. Dealers will have an incentive to buy actively when the market moves below the target and sell when it moves toward the upper limit. PBoC intervention will thus be confined to offsetting fundamental imbalances in international payments.

Fundamental payments imbalances can be headed off through a variety of supportive policy measures outside the forex market. These include eliminating import barriers, encouraging the payment of licensing and royalty fees for foreign intellectual property, reducing or repealing export tax rebates, and liberalising capital outflows. Beijing has shown some willingness to employ all of these measures.

Speculative surge

In short, China is ready to move to a broader trading band and a more market-based exchange rate mechanism. The reasons to take the leap soon are: 1) to relieve speculative pressure; 2) to relieve international political pressure; 3) to encourage financial market development; and 4) to create the capacity for market-based, rather than administrative, responses to future balance of payments shocks and the pressure to appreciate that results from China's rapid productivity growth.

Table 3

Openness of key items in China's capital account**Direct investment**

Outbound Subject to approval, managed in part through province-level quotas totalling US\$2.5bn in 2004.

Inbound Open except excluded industries.

Portfolio investment

Assets Chinese financial institutions permitted to invest in foreign securities and Chinese insurance companies in foreign bonds.

In planning, a programme of Qualified Domestic Institutional Investors (QDII) through which Chinese residents would gain access to foreign securities markets.

Prohibited for non-residents to issue yuan-denominated securities on Chinese markets, although permission has been granted for selected multilateral organisations to sell yuan bonds beginning in 2005.

Liabilities Foreign-currency-denominated B-share market open to both residents and non-residents.

Yuan-denominated A-shares and bonds available to non-residents only through the Qualified Foreign Institutional Investor (QFII) programme, now at 26 institutions and US\$3.75bn, expanding per market demand.

Chinese companies allowed to list on foreign stock markets and retain funds.

Chinese government agencies and banks permitted to issue foreign-currency bonds.

Other investment

Assets Lending to non-residents permitted for authorised financial institutions. Recent crackdown on lending of funds obtained through deferred payment for imports or advance collection of export receipts; but ceiling on retention of export receipts raised to 100%.

Liabilities Borrowing in foreign currency permitted for resident financial institutions, FIEs, and, subject to approval, domestic firms.

Prohibited to purchase foreign exchange for advance repayment of loans.

Source: IMF, author research. For additional details, see IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions, 2004*.

How closed is "closed"?

About half the items in China's capital account are open, according to a statement made by PBoC governor Zhou Xiaochuan in November 2004. Tallying up what is "open" and what is not is a complicated exercise though because registration or approval is often required from various agencies (SAFE, PBoC, National Development and Reform Commission, the China Securities Regulatory Commission, etc.). Conditions may apply and aggregate quantitative limits may be in force, for example under the State External Debt Plan. But the overall easing trend is clearly shown by the huge recent increase in two-way capital flows in Table 1.