

Free exchange | Fight or flight

China's leaders face a menu of unappealing exchange-rate options

THE past six months have been hard on the reputations of China's economic managers. Their attempts to bring troublesome stockmarkets to heel border on slapstick. The uncertain handling of the country's exchange rate, on the other hand, is no laughing matter. Unexpected wobbles in the value of China's currency roil global markets. Yet no exchange-rate policy offers a sure and safe route forward.

Some see a resemblance in China's predicament to the Asian financial crisis of the late 1990s. Then, fast-growing countries like Indonesia, South Korea and Thailand faced outflows of capital as investor sentiment flipped from bullish to bearish. Governments were forced to abandon currency pegs as their foreign-exchange reserves dwindled. Massive depreciations led to financial havoc, as asset prices tumbled and these countries' enormous debts ballooned in dollar terms. Painful recessions ensued.

The lessons of the Asian crisis were not lost on China's leaders, however. During its great boom, in the 2000s, China maintained tight capital controls, permitting foreign direct investment while eschewing "hot money". The People's Bank of China (PBOC) intervened heavily in foreign-exchange markets to keep the yuan cheap, building up \$4 trillion in reserves in the process. Where the crisis countries of the 1990s ran persistent trade deficits, China kept its current account in surplus; thus adding to, rather than draining from, its foreign-exchange reserves.

Despite these prophylactics China now faces its own financial crunch. Its reserves are down by almost \$700 billion from their peak, thanks to capital flight and sinking asset values. Determined money has long seeped out of China's stockade; signs of a bigger leak emerged in the latter half of 2015. In December alone reserves fell by more than \$100 billion. Capital slipped abroad at an annualised pace of \$1 trillion in the second half of 2015. In the third quarter, China's outward foreign-direct investment rose from \$29 billion to \$32 billion while inward investment fell sharply, from \$71 billion to \$39 billion; at \$7 billion, the net flow of inward investment was the lowest since 2000.

An anti-corruption drive, slowing growth and rising American interest rates are all partly to blame. Once begun, however, capital flight can be hard to control. Chinese citizens can move a maximum of \$50,000 abroad each year. If just 5% of the population used its quota, China's reserves would evaporate. The authorities are desperate to prevent such an outcome, and the severe tightening of domestic credit conditions it would entail, but

there is no painless way to do so.

Many economists reckon China will allow the yuan to fall. After all, the currency has appreciated by 20% against a broad range of currencies since 2012, thanks to rising wages and a peg to the strengthening dollar. Yet a sinking yuan poses threats. Roughly \$1 trillion of China's accumulated debts are denominated in dollars. That is small beer next to \$28 trillion in total Chinese debt. But because Chinese firms are so highly leveraged, even a small rise in the cost of servicing dollar-denominated debts could force some into asset sales or bankruptcy. That, in turn, would encourage more capital outflows, depressing the yuan's value still further.

The economy could expect only a modest boost to exports for its trouble. Since much of the material that goes into Chinese exports is itself imported, devaluation does not boost exports that much. It also squeezes the purchasing power of Chinese consumers and thus slows the rebalancing of its economy from investment to consumption, while irking America and encouraging competitive devaluations elsewhere.

Alternatively, China could hold the yuan's value steady. The big depreciations of the late 1990s were done out of necessity rather than by choice, after all. Investors fleeing from Thailand, for instance, converted their baht to dollars on their way out. When the government ran short of greenbacks, it had no option but to repay investors with many fewer dollars per baht. Yet China still has \$3.3 trillion of hard currency in reserve.

Stability poses its own problems, however. If China resists depreciation and capital outflows continue, the erosion of reserves could puncture the PBOC's air of invulnerability, leading to faster capital leakage. A commitment to a strong yuan could also constrain China's monetary policy. Cuts to interest rates tend to diminish a currency's value. Any attempt to maintain it under such circumstances hastens the depletion of reserves.

Why not strengthen capital controls, in that case? In 1998 Malaysia imposed controls on fleeing investors and outperformed some other crisis-hit economies, such as Indonesia. The government is cracking down on the underground financiers in Macau and banks in Hong Kong that help sneak Chinese cash past the controls. If ordinary citizens began moving savings abroad in greater numbers, China could reduce the limit on foreign transfers. Yet backtracking on planned reforms would be a huge embarrassment for China's leaders, who have laboured long and hard to raise the yuan's status internationally. It would also deter foreign investors, worsening the short-run foreign-exchange picture and long-run growth prospects.

Faith no more

Ample reserves, capital controls, a trade surplus and a determinedly interventionist state mean that China is a long way from a full-fledged crisis. Neither is all the apparent capital flight as worrying as it might appear: purchases of foreign securities by Chinese corporates may look like a stampede for the exits, but can serve to hedge firms with foreign-currency debts against depreciation. But there is good reason for nervousness, in China and elsewhere. All the countries afflicted by the Asian crisis combined accounted for a much smaller share of global output in 1998 than China does now. And China seems not to have absorbed the most important lesson of that crisis: that confidence matters. ■

