A Weaker Yuan Is *Inevitable*

By Diana Choyleva

And necessary for China if the world is to avoid a new crisis.

It sounds paradoxical, but a protracted slowdown in China is exactly what is needed to pull the global economy out of the post-crisis doldrums. Weaker growth in China, coupled with financial liberalization, can also bring about the global rebalancing that policymakers and the International Monetary Fund have long sought. But this happy outcome is not preordained. It requires the United States, Japan, and the eurozone to accept that China badly needs a much lower exchange rate to ease the pain of its economic transition. If the rest of the world balks at a cheaper yuan, the global economy could face a new crisis.

World financial markets took fright during the summer as investors finally realized that the Chinese economy was decelerating sharply. A rout in the domestic stock market and a clumsily handled mini-devaluation in August heightened fears of a hard landing, prompting the Federal Reserve in September to postpone a rise in interest rates—arguably the first time that China has decisively influenced the policy of a G-7 central bank. The markets are right about the slowdown. On our estimates, growth has more than halved on average this decade from the heady rates before the crisis. It slowed to 2.8 percent as of the third quarter of 2015, much lower than the official 6.9 percent estimate. It is difficult to see growth accelerating beyond 3–5 percent for the rest of 2015 and 2016.

China's slowdown is a catastrophe for commodity producers, as the recessions in the likes of Brazil and Russia show. It is also deflationary

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for most emerging markets, which are also suffering from capital outflows in anticipation of higher U.S. interest rates. They will need even weaker exchange rates, but nowadays an economically sluggish United States cannot accommodate currency depreciation in the same way as in the past. Hence the adjustment will also occur through domestic deflation—in other words, recessions, lower prices, and higher unemployment.

But the transfer of income globally from producers of natural resources to consumers is exactly what a world lacking genuine consumer demand needs. The slump in oil prices since mid-2014 has transferred $600 billion of real income from OPEC producers alone to the end users of that oil—mainly households in developed market economies. Consumers have largely chosen so far to hold on to money saved on cheaper gasoline and lower home-heating bills. Economic growth in Europe and the United States is subpar. But now they can see that oil prices are remaining low, consumers are starting to spend the windfall.

China's slowdown is driven by the recognition of Communist Party planners that the economic model that served the country so well since the late 1970s is no longer viable. The main driver of growth needs to shift from investment to consumption. Industry must pass the baton

The best way for China to correct the yuan's overvaluation and to help its economy and the world rebalance will be through freeing capital flows and letting the market determine its exchange rate.

to services. The Communist Party has to surrender some of its power to allocate resources and let market forces do the job. State-owned behemoths must make way for smaller, private firms. If China does manage to make the transition to consumer-driven growth, a process that could take a decade, less excessive investment would mean less crowding out of opportunities for profitable capital expenditure in advanced economies. Investment growth would follow the consumer revival.

Beijing under the leadership of **Xi Jinping** *is very different than it was under his predecessor. Since coming to power three years ago, the new leadership has resisted the temptation to repeat the massive, credit-fueled stimulus of 2008–2009, accepting that much weaker growth is the price to be paid for the reforms needed to put the economy on a sustainable path.*

Skeptics can be forgiven for doubting China's willingness to stick to the path of reform. Beijing has talked about rebalancing the economy at least since 2004, yet its investment rate went from a bloated 42 percent of GDP that year to an even more excessive peak of 47 percent in 2011. But Beijing under the leadership of Xi Jinping is very different than it was under his predecessor Hu Jintao (2002–2012). Since coming to power three years ago, the new leadership has resisted the temptation to repeat the massive, credit-fueled stimulus of 2008–2009, accepting that much weaker growth is the price to be paid for the reforms needed to put the economy on a sustainable path.

The job market could challenge this resolve. China's slump has so far dented corporate balance sheets and decimated profits. But it has left the labor market largely unscathed, partly due to demographic trends that are actually favorable for the rebalancing of growth. A leap in unemployment, with the potential for social discontent, would be the real litmus test of Beijing's commitment to a new model of growth. But for now, action speaks louder than words. Given the enormity of the task, the Party's progress so far has been swift by past standards.

Progress on financial reform has been particularly remarkable, in part to meet the IMF's conditions for admitting the yuan to the Special Drawing Right, the Fund's basket of reserve currencies. True, Beijing's heavy-handed intervention to prop up the stock market was a mistake that dented confidence in Chinese policymakers. The fact, though, is that the challenges they face are so huge that it is unrealistic to expect them not to make blunders along the way. More significant is that the Communist Party has relaxed its grip on two of the most important levers in any economy—the exchange rate and the interest rate.

The 1.9 percent depreciation of the yuan on August 11 was accompanied by a shift in the management of the currency to make it more responsive to market forces. The People's Bank of China has since intervened in the foreign

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exchange markets to cushion the yuan from massive capital outflows, but the central bank will find it very hard to put the genie back in the bottle. On interest rates, the People's Bank of China took the momentous decision in October to remove the remaining restrictions on how much interest banks may pay depositors. China's state-owned banks will not risk the wrath of the People's Bank of China and start an immediate no-holds-barred battle for deposits, but, as with the exchange rate, the direction of travel is clear.

Even if the authorities perform a U-turn, put reforms on ice, and opt for renewed stimulus, the channel will have to be the exchange rate rather than another burst of lending from the country's banks, which are already groaning under the weight of bad loans—some recognized, many others not. Those who argue that China is unlikely to allow its exchange rate to depreciate because it wants to promote stability in the region, as it did during the 1997/98 Asian financial crisis, forget that at that time the yuan was significantly undervalued. Today, by our estimates, the yuan is around 15 percent overvalued on a real trade-weighted basis. Together with the wasteful allocation of a mountain of capital, the overvalued yuan has precipitated the sharp structural slowdown. China desperately needs a more competitive exchange rate.

The best way for China to correct the yuan's overvaluation and to help its economy and the world rebalance will be through freeing capital flows and letting the market determine its exchange rate. China's potential capital outflows are huge. The U.S. Treasury estimated that $500 billion left China in the first eight months of 2015, despite the country's capital controls. China's national savings were around $5 trillion in 2014. When Beijing allows freer movement of capital, more of this huge tide of money will unfurl over the global economy. China's current account surplus will only partly offset the outflows, so the currency will fall and domestic interest rates will rise. Higher interest rates will transfer income from firms to households as savers get rewarded properly. Chinese firms are large cash holders, too, so higher deposit rates will cushion the blow from increased borrowing costs. Household wealth will be boosted as well, while portfolio diversification abroad would bring more security. This is the fastest way for China to lower its exorbitant savings rate.

The alternative to market-driven depreciation is to abandon financial reforms and go down the route of old-style devaluation. Either way, a weaker yuan is likely. But the outcome for global markets and growth will depend on the policy response in the rest of the world. Other major economies, namely the United States, Japan, and the euro area, need to accommodate China's economic transformation for the benefit of all.

America must welcome China into the world financial system, allowing it to take its rightful place in global monetary institutions. The IMF's decision to include the yuan into the SDR basket is encouraging. But China's adjustment will involve a stronger U.S. dollar. Congress and the candidates in next year's presidential election must not revert to "China bashing" if the yuan depreciates as a result of a more freely moving exchange rate, a policy choice America has encouraged Beijing to make.

Japan's stance is also critical. Prime Minister Shinzo Abe's efforts to boost the economy are turning into a policy disaster. Abenomics has done little to stimulate domestic demand, while the yen's depreciation has exacerbated Japan's main structural deficiency—too much income flowing to businesses and not consumers. Yet the Bank of Japan is under pressure to expand its quantitative easing program, which would push the yen even lower. Of the big economies with surplus savings, only China has an overvalued currency. Yet so far, only China has resisted joining the currency wars started by the Bank of Japan. If Japan does debase the yen further, China's currency restraint could become untenable. The European Central Bank has also dropped a strong hint that it will ease monetary policy again in December. If it does and the euro—already not expensive—takes another leg down, it will be one more reason for China to reconsider whether it should act as a responsible global citizen.

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If China were to trigger a new round in the currency wars by letting the yuan fall sharply, exporting deflation in the process, the world economy could tumble into a new recession and possible financial crisis. Alternatively, if Beijing sticks to the reform path and controls the yuan's depreciation, there is a chance—after a few years of economic and financial distress in China—that it can reinvigorate the global economy. By moving away from the yuan-dollar peg and opening its capital account, China is addressing the most important causes of the financial imbalances dogging the global economy. Other countries thus have a huge stake in China pulling off its economic transition. For that reason they should embrace China's adjustment and its consequences. ◆