The Renminbi's Slow Move *Toward* Equilibrium

By Chi Lo

Don't hold your breath waiting for quick interest rate liberalization and capital account convertibility.

The distortion of the renminbi's valuation will remain a hotly debated issue, especially in this election year in the United States. Many politicians, however, seem to have overlooked the fact that the renminbi's undervaluation has been corrected significantly in recent years, as evident in the steady decline in China's current account surplus. But to be fair, despite China's narrowing external surplus, foreign trade evidence argues that the renminbi is still far from reaching equilibrium. In an attempt to address the economic distortion, China has recently made a move to increase the renminbi's flexibility by widening its daily trading band against the U.S. dollar. This suggests that a renminbi regime shift is underway.

Going forward, renminbi appreciation will not be a one-way bet anymore, as yuan trading volatility will rise. Such a regime shift will have profound implications for the evolution of the offshore renminbi (or CNH) market, and is a step forward towards opening up China's capital account and full renminbi convertibility. But China's daunting challenges in achieving full currency convertibility and helping rebalance its economy have just begun, as these will involve changing its die-hard monetary control model. The renminbi will only be able to find its equilibrium when interest rates are fully liberalized and the yuan becomes fully convertible.

RENMINBI EQUILIBRIUM, NOW YOU SEE IT...

In theory, an exchange rate reaches equilibrium when its underlying demand and supply forces are balanced so that there are no sustained depreciating or appreciating pressures. China's falling current account surplus is a visible sign for correcting the renminbi's undervaluation and, hence, a trend towards equilibrium. The same narrowing trend is also seen in the surplus of China's basic balance, a broader measure of the external accounts calculated by adding long-term capital inflows (approxi-

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mated by foreign direct investment in China) to the current account balance. This has led top Chinese officials to argue that the renminbi was reaching "equilibrium" and suggest that Beijing was ready for greater yuan trading flexibility.

Some analysts also argued that the renminbi's real effective exchange rate had been rising since 1994, when Beijing reformed the dual-exchange rate system by devaluing the renminbi over 33 percent against the U.S. dollar. So the distortion to the yuan exchange rate due to the massive devaluation should have been corrected and it should be approaching equilibrium in the light of falling external surpluses.

...NOW YOU DON'T

This latter argument does not make sense because 1994 was hardly the right reference point for exchange rate equilibrium when China's economy was in chaos with rampant inflation (over 20 percent) and a large trade deficit (over 3 percent of GDP). Fundamentally, China's "basic surplus" is still large, at over 4 percent of GDP. Unless narrowed further, this size of the basic surplus is hardly consistent with a stable renminbi equilibrium, despite a smaller current account surplus.

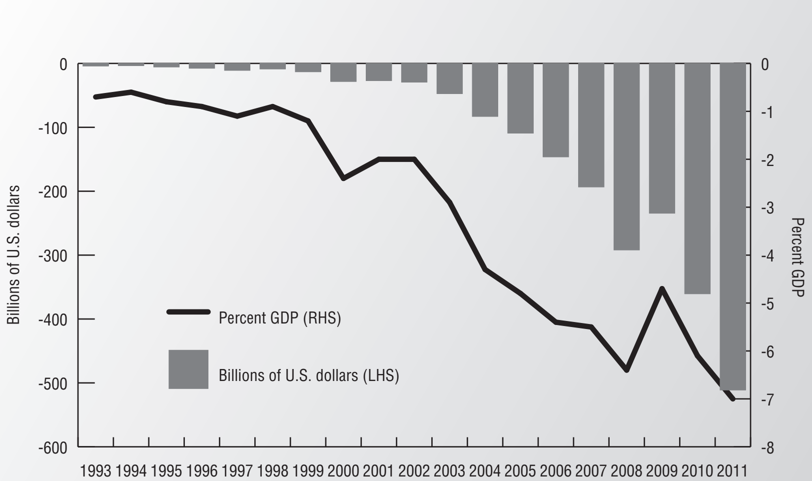
Crucially, the narrowing of China's current account surplus has not been a result of a change in the trade structure that corrects China's external imbalance. Arguably, the fall in China's current account surplus is an illusive indicator for the renminbi approaching equilibrium. Rapid industrialization has turned China from a net exporter of primary products and raw materials into a chronic net importer. Its raw material trade deficit has grown from less than 1 percent of GDP in the early 1990s to 7 percent (see figure). Excluding this deficit, China's current account surplus is still large at 9.7 percent of GDP.

The point is that China's shrinking current account (and trade) surplus in recent years has more to do with the rise in commodity prices, which has created a negative terms-of-trade shock on its external accounts, than with a genuine change in the trade structure that rebalances Chinese demand towards more domestic consumption (imports). This can be seen in China's trade surpluses with its two largest trading partners, Europe and the United States, which have continued to rise despite a drop in its overall trade surplus since 2008. In other words, the renminbi's steady appreciation over the years has not been a force for reorienting China's growth drivers from exports to domestic demand. So the sharp decline in the current account (and trade) surplus since 2007 is not really indicative of the yuan approaching equilibrium.

A REGIME SHIFT AND IMPACT ON THE CNH MARKET

Under such circumstances, the renminbi will continue to experience mild appreciation pressure for a while longer

China's raw material* trade balance



*Approximated by crude materials, fuel, lubricants, and raw materials.

Sources: CEIC, HFT (HK).

There is no imminent need for China to speed up the pace of deep-rooted financial reforms.

than many have predicted. Sustained depreciation of the yuan is unlikely yet, but its trading will become more volatile due to fluctuations in capital flows and the narrowing of the current account balances. We may finally be seeing a foreign exchange regime shift, as Beijing moves to allow more renminbi fluctuation in the coming years. This is necessary step for China to move towards a floating foreign exchange regime.

After two years of experiment, Beijing has allowed all Chinese importers and exporters to use the renminbi for international trade settlement. This will help increase renminbi two-way trading as Beijing becomes more comfortable with greater foreign exchange fluctuation when international renminbi transaction is more prevalent. Meanwhile, the development of the CNH (offshore renminbi spot) market has augmented the renminbi's non-deliverable forward market in providing market signals for the Chinese system. A two-way market driven by market forces is instrumental for pushing China's capital account convertibility and renminbi internationalization, which ultimately affect Chinese asset prices.

More yuan trading flexibility may lead to bigger speculation risk and arbitrage opportunities in the offshore market. Since offshore renminbi trading is market-driven, CNH volatility will be much higher than the onshore foreign exchange rate. Until recently, foreign investors have been accepting the low-yield renminbi because of its low volatility and the expectation of steady currency appreciation. But this incentive has gone with fading yuan appreciation expectation and the expected rise in renminbi volatility. The lack of hedging tools for the renminbi has aggravated the decline in the demand for renminbi products in the offshore market. Going forward, CNH investors will likely demand a higher risk premium on renminbi products.

Yuan issuers offshore have also been enjoying the twin benefits of low cost and high demand for renminbi products—until recently, that is. With fading expectations on renminbi appreciation and rising volatility, they will likely face higher costs going forward. In other words, both demand and supply forces suggest a higher risk premium structure in the CNH market until China develops better hedging tools for the renminbi.

UPROOTING THE OLD MODEL

Despite the olive branch that Beijing has extended to increase the renminbi/U.S. dollar trading flexibility, the challenges for achieving full renminbi convertibility—for the exchange rate to find its equilibrium via market forces—remain daunting. This is because the profound changes that China will have to make will involve uprooting its entire monetary management model that has been driving policy for over two decades.

Chinese monetary management and financial system development have been based on a closed economic system. This has allowed Beijing to keep interest rates low and stable without needing to worry about external arbitrage and the resultant capital flow volatility; to adopt discretionary economic stimulus without having to worry about the underlying banking system asset quality; and to prop up banks without concern about damaging capital flows and exchange rate volatility. All of these "benefits" can only be accrued when the capital account is closed so that foreign funds cannot affect local asset prices and local funds have nowhere to go but stay home.

So it may be in China's theoretical interest to move to a market-driven system over time, as many pundits have argued, but there is no imminent need for China to speed up the pace of deep-rooted financial reforms, notably the interest rate liberalization that lies at the heart of full renminbi convertibility. The incentive to go slow on deep reforms is even stronger in the short term because the economy is overextended with credit (as a result of the 2009 stimulus package), so that Chinese banks are facing a wave of bad loans.

The potential impact of deeper financial reforms on the Chinese banking system will also make the authorities hesitant to do them quickly. Given financial suppression especially on the deposit side, full interest rate liberalization will lead to a sharp rise in deposit rates relative to lending rates, thus hurting banks' subsidized net margins. Opening up the capital markets will bid deposits away from banks, and the resultant deposit outflow will lead to higher deposit rates and systemic instability for the banks. Finally, opening up the capital account will just give Chinese savings one more avenue for leaving the banking system.

Hence, we cannot expect Beijing to go too fast on full interest rate liberalization and capital account convertibility. Before these two conditions are accomplished, a shrinking current account surplus is not sufficient for the renminbi to find its equilibrium in the foreign exchange market. ◆