

China's reserve pile and credit boom

Despite action by authorities to keep liquidity in check, yuan revaluation appears inevitable at some stage

By RAMKISHEN S RAJAN

BY end-2003, China had amassed about US\$400 billion of international reserves, second only to Japan, and equivalent to about a quarter of the country's gross domestic product (GDP).

An examination of trends in the growth of China's reserves suggests that one can identify four broad sub-periods since 1990. China's reserves remained stagnant between 1990 and 1993. This was followed by a sharp upward trend after the Chinese yuan was officially devalued in January 1994. This rise continued till 1997 and was followed by a period of consolidation until 2000, a phase which spanned the East Asian financial crisis. The country's reserves have skyrocketed since then, especially in 2003. More precisely, while reserves rose by US\$120 billion in four years between October 1998 and 2002, they swelled by US\$135 billion in a single year between October 2002 and end-2003.

The surge in reserves in 2002 and 2003 is the result of a combination of the weakness of the US dollar and the desire by China to keep the yuan in a narrow trading band around 8.28 per US dollar, as well as due to a valuation effect - as a portion of reserves that were invested in non-US dollars (gold, euros, etc) has appreciated in US dollar terms.

Given that most Asian central banks are obstructing the tendency of their currencies to appreciate against the US dollar, an interesting dynamic appears to be taking hold in China and other reserve-rich economies.

Large reserves are viewed as a sign that the domestic currency has to eventually appreciate. They also tend to be taken to indicate strong 'fundamentals', hence leading to upgrading of the country's credit ratings.

This expectation of future capital gains and lower risk perceptions motivates large-scale capital inflows. This in turn adds to the country's stock of reserves as central banks mop up excess US dollars to keep the bilateral exchange rate stable in nominal terms. Thus, reserves growth in China in 2003 has primarily been due to large surpluses in the capital account as well as in the errors and omissions section of the balance of payments account.

Apart from the opportunity costs of holding reserves, there are other concerns over China's rapid reserves accumulation. In particular, the inflows of reserves are leading to sharp liquidity growth, which in turn is causing the domestic economy to overheat.

Until 2002, China appeared to be able to keep domestic credit growth under control by sterilising the monetary effects of reserves growth. This essentially implied that domestic credit had been reined in to offset the rise in monetary base due to the

reserves growth. However, this has not been the case in the last year as China's overall monetary base, particularly broad money, has shot up by over 20 per cent on an annualised basis (the highest since late 1997).

There are two reasons why the growth in reserves has not been effectively offset in recent times. One, the People's Bank of China (PBOC) may have been unable to cope with the recent sharp rise in reserves. Two, and more likely, the PBOC may have been unwilling to continue accepting the high quasi-fiscal, or financial, costs of sterilisation. These costs warrant some explanation.

The quasi-fiscal costs arise if the central bank uses open market operations to offset the growth in reserves. Therefore, the central bank is effectively selling high-yielding domestic assets for low-yielding foreign ones. One way to overcome these costs is to reduce the monetary base directly by requiring banks to hold excess reserves which may generate low returns.

By so doing, however, the quasi-fiscal costs are merely transformed into banking costs as domestic banks' profitability is reduced while bank management decisions (regarding asset allocation) are constrained. These costs of sterilisation are clearly unsustainable over time and can be counterproductive as they prevent interest rates from falling, thus prolonging capital inflows.

There is no question that the failure to effectively curb this monetary growth is leading to the overheating of the Chinese economy. One can envisage two possible scenarios for China going forward.

The benign scenario is one in which the consequent inflationary effects - which are not yet apparent with the exception of asset prices - of the domestic credit boom will erode the price competitiveness of Chinese goods, thus reducing the country's balance of payments surplus and stemming reserve inflows. In other words, while the nominal exchange rate may be rigid, the real exchange rate is self-equilibrating.

A less rosy scenario is plausible in view of the fact that the surge in domestic credit is intermediated via the banking system. Given the relatively lax supervision of banks and financial institutions, and to the extent that it is generally more difficult to discriminate between good and bad risks during a boom, resources have been inefficiently allocated to relatively unproductive investment projects, further fuelling asset price inflation.

The eventual bursting of the asset bubble, if it occurs, could be calamitous to China's already fragile financial system and may well push it back into serious deflation. (Note that while there remains an underlying deflationary trend due to overcapacity, there are also signs of inflationary pressures in some sectors. It is against this background that some observers note that China's prices are finely balanced between inflation and deflation.)

This scenario of a hard landing is causing significant unease to the Chinese authorities.

In response, the authorities are using conventional monetary instruments such as raising banks' reserve requirements (from 6 to 7 per cent) and undertaking open market bond sales to mop up excess liquidity. They have also taken aggressive, though

related, steps to curb bank lending, particularly to the real estate and construction sectors.

Overall, the Chinese authorities are appropriately speeding up and deepening financial reforms while continuing to apply the brakes on domestic monetary growth. Nonetheless, this type of intervention is unlikely to ensure that the liquidity effects are durably kept in check as long as the external dynamics motivating the reserve growth remain unaltered.

What policy option does that leave China with beyond ad hoc export taxes or import subsidies? One possibility is to further reduce capital controls in some areas. The Chinese authorities have implemented a series of measures to encourage capital outflows by further easing restrictions on overseas investments and fund raising by domestic companies; lowering ceilings and easing regulations pertaining to the extent of, and conditions under, which Chinese residents can take foreign currency abroad; and allowing Hong Kong banks to offer personal renminbi accounts. However, it would not be advisable for China to rush to liberalise capital transactions in view of the vulnerabilities of the domestic financial system.

This leaves a revaluation of the Chinese renminbi as the other obvious option, and this appears inevitable at some stage.

Revaluation can be effected in various ways: (a) a one-time revaluation with no alteration to the narrow band US dollar peg regime; (b) a widening of the trading band relative to the US dollar, essentially allowing for an appreciation of the renminbi (as was operated between January and May 1994); (c) a shift to a broader basket-pegged regime in order to stabilise the renminbi's real effective exchange rate (which would effectively imply an appreciation of the renminbi relative to the US dollar); or (d) adopting an open economy inflation-targeting regime (advocated by the International Monetary Fund for a number of countries in Asia and elsewhere).

The timing and manner in which greater exchange rate flexibility will be introduced by China is likely to be dictated as much by economics as by politics.

The writer is a visiting fellow at Singapore's Institute of Policy Studies and a visiting scholar at Claremont McKenna College in California.