

### The Yuan's Exchange Rate

During his US election campaign, candidate Donald Trump had claimed that the Chinese are “*devaluing their currency . . . they’re using our country as a piggy bank to rebuild China.*” His post-election statements and actions do not suggest that his views have changed: the threat of imposing 45% duty on imports from China remains.

The reality is that, instead of the US being China’s ‘piggy bank’, it has for long been the largest financier of US fiscal/trade deficits given its holdings of treasury bonds: last week, it became the second largest (next to Japan), as a result of interventions in the currency market to stem the yuan’s fall. After appreciating by almost 40% since 2005, the yuan has depreciated about 15% in the last three years against the dollar. But this seems to be more a reflection of the dollar’s global appreciation: against a basket of currencies of its trading partners, China’s currency has continued to appreciate. The IMF believes it is now fairly valued.

The downward pressure on the currency, despite a large trade surplus, stems from continued capital outflows, and despite significant intervention by the central bank: China’s reserves of foreign exchange have come down from \$4 trillion to close to \$ 3 trillion. It has recently tightened capital controls in order to stem capital outflows.

Chinese exchange rate policies are attracting some odd comments even from sources more knowledgeable than Mr Trump. Last week (December 15<sup>th</sup>), the Financial Times editorially commented that “*The government could address the decline with a big one-off devaluation — or embracing a free float of the currency,.... This would....stem outflows because investors would no longer expect further devaluation. The currency would then stabilise without draining foreign exchange reserves further.....So long as it is kept artificially strong (or weak) the pressures on China’s capital account will persist.*”

To this student of the currency markets, it is news that “a free float would stabilize the exchange rate” – or that the pressures on China’s capital account are because the currency is kept artificially strong. The only theoretical criterion for what is a reasonable exchange rate for a currency is the good old purchasing power parity theory: despite the continued, and managed, appreciation of the yuan, the currency still seems undervalued as evidenced by the large trade surplus.

And, it is not so much the prospect of yuan weakness that is driving Chinese capital abroad, as the other way round. The decades of double digit GDP growth have ended, and the rate has slowed to between 6 and 7%: to be sure, in absolute numbers, China’s contribution to global growth is likely to remain by far the largest for the next several years. With few investment opportunities in the domestic market, private Chinese companies are sitting on cash surpluses estimated at \$ 1 trillion. They are therefore rushing to invest money abroad either in takeover of companies, or in greenfield investments, particularly in the infrastructure sector. Most of these are supported by the government or state-owned banks and are spreading from east Asia to west Asia, to Africa, even to Latin America – and Europe. China is building a nuclear power plant in the UK; has created a \$ 10 bn fund for investments in central and eastern Europe; it is financing Russia’s energy sector – and making large investments in sophisticated engineering and technology industries in Germany. I am often reminded of what Japan did in the 1980s, taking over all kinds of businesses, particularly in the US.

Domestically, the surplus savings are getting invested in property development, despite the huge over-supply in the market. Corporate debt, both private and public sector companies, is 170% of GDP. And, property loans could become a major problem for the banking system. Meanwhile, in order to ease access to the domestic stock market for foreign portfolio investors, recently a link (StockConnect) has been established between the Hong Kong and Shenzhen stock markets, similar to the one between Hong Kong and Shanghai.

Coming back to Mr. Trump's threat to impose duties on Chinese imports, this may well lead to some reduction of imports from China, but not necessarily in total US imports; the sourcing may change and add to inflationary pressures.

### **Demonetization**

Many commentators have criticized the way the decision was implemented in India. They should read/see the current media reports about the demonetization in Venezuela, a much smaller economy and country: the chaos, the street riots, the near collapse of the economy. Our implementers seem to have done much better!

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