The Not-So-Mighty Yuan?

By Chi Lo

Maybe Washington should hold off on its demand that China float its currency.

China saw net capital outflow in October 2011 for the first time in four years. The offshore RMB (or so called CNH) exchange rate, which is market-driven, also reflects waning demand for the RMB. That goes against the rhetoric of excess demand for the RMB due to its rising popularity. A hypothetical analysis shows that there might even be massive RMB outflow if the capital account were fully opened today! This may reflect the risk of resident Chinese losing confidence in their home currency. Indeed, there are structural reasons for the capital outflow incentive. So do not expect full capital account convertibility by Beijing soon. The yuan may be entering a normal two-way trading paradigm in the near term, which will be instrumental for RMB internationalization and development of the offshore CNH market. But for those who are pushing for RMB revaluation, the argument of RMB undervaluation may lose support as the economic dynamics for the RMB may be turning from appreciation (undervaluation) to depreciation (overvaluation).

CAPITAL OUTFLOW

China's foreign exchange reserves fell by US$3.91 billion in October 2011. That was the first monthly drop in foreign reserves since 2007, and reflected net capital outflow. In fact, capital flows to China outside of the trade channel have been slowing since late 2011 due to fears of a Chinese economic hard landing and global investors repatriating funds to meet the liquidity squeeze back home.

The market is also starting to doubt a sustained rise in the yuan exchange rate as China's current account has been halved from a peak of over 10 percent of GDP in 2007 to 5 percent. This weakens the argument

---

Chi Lo is CEO of HFT Investment Management (HK) Ltd., and author of Thinking the Inevitable: China's Economic Superpower Inspiration in the New Paradigm *(forthcoming, 2012). Opinions expressed here are the author's and may not represent HFT's official views.*

THE INTERNATIONAL ECONOMY

THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY

888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

for an undervalued RMB exchange rate. The concern about the bursting of China's property bubble pulling the rug from under its financial system and rising awareness of Chinese credit risk have also hurt RMB sentiment and cooled expectations of continuous RMB appreciation.

However, the fact that China runs a persistent, though recently smaller, current account surplus suggests that the culprit for the net capital outflow might be hot money. Indeed, China's hot money outflows between August and October 2011 were the biggest for the past ten years. Meanwhile, RMB sentiment in the offshore market in Hong Kong has also turned sour due to investors' risk aversion amid the European debt crisis and financial scandals of Chinese-listed companies in the United States since late 2010. Reduced demand for the RMB has driven the offshore (CNH) RMB/dollar exchange rate below the onshore (CNY) rate since September 2011. This is the first time such a persistent CNH discount to CNY has arisen.

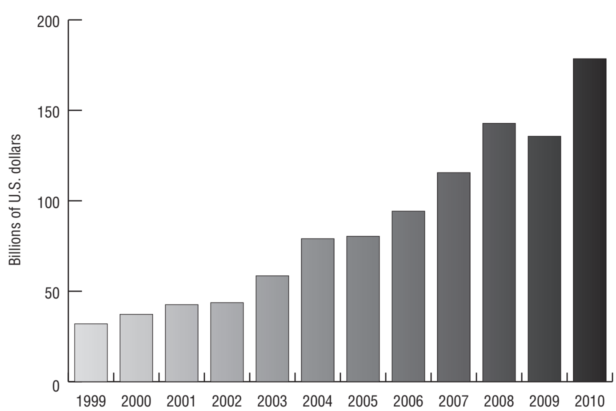
Persistent capital outflows may prompt the Chinese authorities to loosen policy because capital flight will put downward pressure on the RMB (as reflected by the CNH rates which are market-driven). Under Beijing's stable exchange rate preference, the People's Bank of China will reduce RMB supply to offset the depreciation force, thus creating a liquidity squeeze in the local system. The sterilization process used to keep the RMB from rising before capital flight will have to be reversed to protect growth.

However, hot money flows are volatile, and this is not the first time that China has seen hot money leave. It will return as market sentiment and the economy cycle again toward positive. Likewise, the CNH discount to CNY will disappear when the poor RMB sentiment in the CNH market changes. A temporary fall in the yuan is not uncommon. Given the still-strong macro fundamentals, a sustained RMB depreciation is unlikely at this stage.

Together with a shrinking current account surplus, which may even turn into a deficit in the post-subprime world, depreciation of the RMB may emerge in the not-too-distant future.

Passing Capital Overseas: The Over-Invoicing of Chinese Imports

Value of Chinese imports from European Union and United States minus value of EU and U.S. exports to China



Source: CEIC, HFT (HK).

PLAYING DEVIL'S ADVOCATE

What is crucial to note is that both capital outflow from China and the CNH discounted to CNY are market-driven phenomena, suggesting that players were questioning the fundamentals behind the RMB. So let us play devil's advocate and ask: What would happen to capital flows if China's capital account were to become fully convertible today? The worsening of China's over-invoicing problem may be indicative of an ever-increasing incentive for capital to leave the country if the floodgate were opened.

In over-invoicing, a Chinese firm will inflate the import bill by charging an import price much higher than the actual cost of some commodity. This allows the passing of capital overseas, as the foreign (exporting) entity credits the amount of the excess payment into its Chinese counterpart's bank account outside of China. One imperfect estimate for over-invoicing is the difference between China's import values and the export values of its corresponding trading partners. In principle, after allowing for the small foreign exchange rate differences used in the different official reporting systems, they should be the same. But the data show that China's inflated imports bills seemed to be getting larger over the years (see figure), suggesting a rising incentive for capital outflow.

This seems to run contrary to the perception of rising hot money flowing into China until

China's hot money outflows between August and October 2011 were the biggest for the past ten years.

recently. But in fact, the two sets of data do not necessarily contradict each other because they correspond to two different incentives (or two disjoint sets, technically). One is local capital wanting to get out of China (the over-invoicing problem), and the other is foreign capital wanting to come into China (the hot money inflow issue). Further, the over-invoicing problem shows a persistent rising trend, but the hot money inflow is volatile from year to year without a steady trend.

Such a potential risk of massive capital outflows argues against full capital account convertibility anytime soon. In the medium term, China will likely keep its asymmetric stringent capital controls, which allow capital to come into the country much more easily than to go out. This practice basically rules out the possibility of massive capital flight that could destabilize China's financial system.

BEHIND THE CAPITAL FLIGHT

If economic growth is supposed to enhance living standards and make people happier, why is there such a large incentive for capital flight? This speaks volumes about the unhappiness of the mainland Chinese regarding the eroding fundamentals behind the RMB. Criticism from the public of the government has been exploding, despite fierce censorship. Local academic and media polls in 2011 showed that an average of 40 percent of Chinese were unhappy about their lives, 70 percent of the farmers were very unhappy because of land seizures, and 60 percent of the rich were emigrating or wanted to do so.

Until recently, most Chinese had faith in their national leaders and accepted the post-1989 social contract in which the Party provided rising living standards in return for citizens not questioning its monopoly on power. The Party survived over 180,000 protests in 2010, many of which were large-scale. But this is changing.

First, income and wealth inequality has become more severe as the country grows richer. This has raised awareness among the bottom strata of society that it is policy made at higher levels, not just the corruption and incompetence of local officials, which bars the poor from sharing the benefits of growth. Second, the wealthy and the intellectuals are taking more interest in politics and the reform process in order to protect their interests, or even to take part in the rent-seeking activity that has emerged, unfortunately, as a byproduct of economic reform.

The first trend is creating a critical mass of social grievances. The second is developing into a catalyst for change. The Party's hold on power since 1989 has hinged on its ability to co-opt the educated minority both by offering them material benefits and by arguing that democracy would lead to the uneducated masses destroying their privileges. That strategy worked well until recently. But disillusionment with this deal has driven an increase in political activism. The educated class is realizing that upward mobility is capped and any advancement gained by hard work can be taken away by the elite group for no reason because the elites can do and get what they want at will. The misbehavior of the Party elites is also responsible for their trouble. People were angered, for example, by the government's concealment of air pollution levels while the leaders in Zhongnanhai installed air purifiers to protect their health.

With this unfair distribution of power and wealth, expanded educational opportunities backfire on the government. Since the universities expanded enrollments in the early 2000s, many families have borrowed heavily to pay the tuition for their children. But graduates without political connections have been stranded at the bottom level of society and live in slums. Meanwhile, the media is full of stories about the children of Party and business elites street-racing their Ferraris without fear of arrest. The lack of accountability of government officials, as seen in the continuous flow of financial scandals, food poisoning (notably infant formula) incidents, and serious man-made accidents only increases social discontent.

Meanwhile, macroeconomic policy still discriminates against the private sector and households. The persistent low deposit interest rates and large interest margins for the banks have deprived households of consumption power and fattened bank profits. To fight inflation, the central bank has tightened credit. But state companies have continued to get bank loans while private firms have been starved of credit and gone belly-up. The property sector has suffered from serious distortion, creating a significant division between the "haves" (referring to those who own property) and the "have nots." This, in turn, has brewed social discontent.

No wonder capital wants to leave the country. This capital flight incentive likely reflects the views of many Chinese that fair opportunities to invest at home are scarce, and they are beginning to lose confidence in the system.

Continued on page 80

Continued from page 70

Some may also worry about potential political upheaval and are trying to diversify their savings.

IMPLICATIONS

All this is not to say that China will blow up soon. The macroeconomic backdrop is still strong and will help contain such a risk. The point is that the rising incentives for domestic capital outflow from this hypothetical analysis have structural underpinnings. It is not unimaginable that depreciation pressure on the RMB could arise in the not-too-distant future. The potential for capital flight explains why we should not expect full capital account convertibility in China too soon. From a market perspective, the underlying forces argue that the RMB might be entering a normal two-way trading paradigm. Hot money outflow is the first test for its downside risk. Two-way trading is in fact what Beijing is aiming for in its foreign exchange reform.

This brings us to the need to develop tools for hedging RMB foreign exchange risk, which now are almost nonexistent. One of the key reasons for limiting RMB demand outside of trade transaction needs, which then limits the internationalization process, is a lack of hedging tools. So using the CNH market (currently only in Hong Kong) to develop a derivative market for such purposes will go a long way toward promoting RMB internationalization. Finally, capital outflow will increase the circulation of RMB offshore, which is directly linked to the internationalization process. This should give Hong Kong a golden opportunity to create more RMB investment and hedging products and deepen the CNH market in order to facilitate RMB internationalization.

All this also suggests that the argument for pushing for more RMB appreciation might lose support, as capital flight from China will turn the RMB's underlying appreciation pressure to depreciation. Together with a shrinking current account surplus, which may even turn into a deficit in the post-subprime world, depreciation of the RMB may emerge in the not-too-distant future. This should serve as food for thought for America's economic policy in dealing with China. ◆