

# Choices for China; Consequences for Us

*The views expressed here are those of the speakers and do not necessarily represent the views of the Federal Reserve Bank of St. Louis or of the Federal Reserve System.*



# PROGRAM

- ***Introduction and Welcome***

**Cletus C. Coughlin**, senior vice president and chief of staff to President and CEO James Bullard

- ***Presentation: Choices for China; Consequences for Us***

**Christopher J. Neely**, economist and assistant vice president in the Research division of the Federal Reserve Bank of St. Louis

- ***Panel Discussion and Audience Q&A***

Neely will be joined by fellow St. Louis Fed economists **Cletus C. Coughlin** and **YiLi Chien**

# CHOICES FOR CHINA; CONSEQUENCES FOR US

*Christopher J. Neely, Ph.D.*

**China's Forex Reserves Fall by Record \$107.9 Billion on Yuan Fears**

**Who's your debt daddy? China tops list of US foreign creditors once more**

**China's Sale of U.S. Debt – Beginning of the End?**

**U.S., WORLD STOCK MARKETS SLIDE AS PANIC IN CHINA SPREADS**

**Stalled Chinese Reforms, Stalled Chinese Economy**

**China No Longer a Bull in Treasury Shopping**

**China's Selling Tons of U.S. Debt. Americans Couldn't Care Less.**

**Asian stock markets drop as China devaluation, oil and Fed stoke fears**

**Bank regulation in China: Letting go**



# China's policy choices could affect us

*"It [2008] was a time of a financial crisis and a bear market. ... But now the root cause is basically China. ... So, a hard landing [in China] is practically unavoidable."*

– George Soros, January 21, 2016

➤ *"Think twice before declaring war on Chinese currency."*

– *People's Daily*, January 27, 2016

# China's policy choices could affect us

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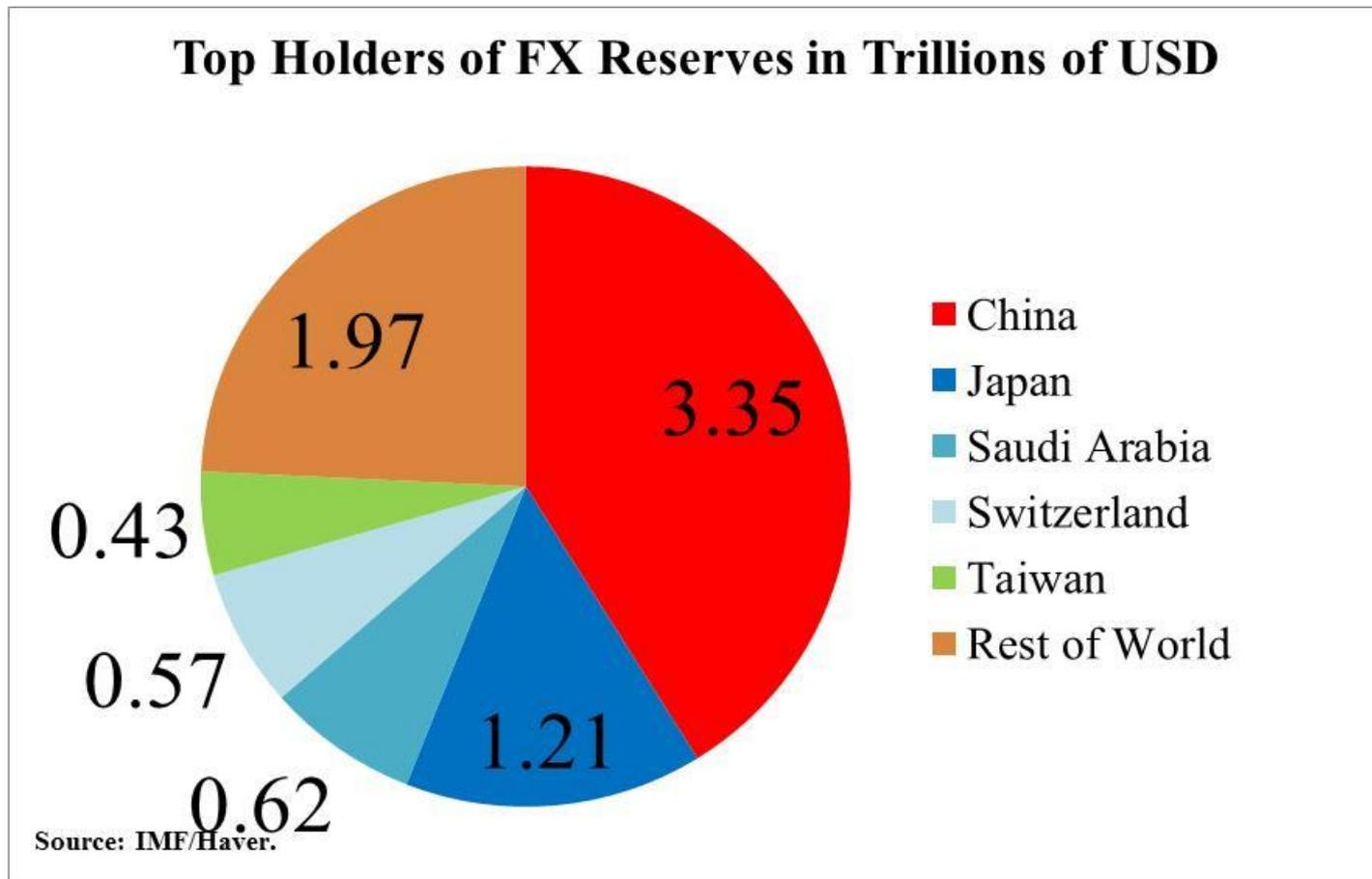
- ❑ China is the U.S.'s 2<sup>nd</sup> largest trading partner.
- ❑ China holds the most Treasury debt of any foreign entity.
- ❑ China has the largest *foreign exchange (FX) reserves* in the world.

# China's policy choices could affect us

- ❑ But China's growth has slowed, interest rates have fallen.
- ❑ China's August 2015 currency devaluation roiled markets.
  - The S&P 500 dropped 10%.
- ❑ Reserves have declined by \$800 billion since June 2014.
  - Almost half the size of QE1.
- ❑ What are China's policy choices?
- ❑ How could those choices affect the United States?

# China's policy choices could affect us

- China holds very large FX reserves.



# EXCHANGE RATES

# What is the Chinese currency called?

- ❑ Renminbi translates as “the people’s currency.”
- ❑ Yuan is the unit of account.
- ❑ “Renminbi/yuan” compares to “sterling/pound.”
- ❑ Abbreviations:
  - CNY is the official abbreviation.
  - RMB is commonly used.
  - CNH describes CNY in offshore accounts.

Bajpai, Prableen. “Yuan vs. RMB: Understanding the Difference.” *Investopedia*, June 11, 2015.

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# How do flexible exchange rates work?

- ❑ An exchange rate is the relative prices of currencies.
  - Prices change with supply and demand.
  - An exchange rate reflects relative demand.
  - For example, greater Japanese demand for US goods and assets will tend to increase the JPY/USD rate.
- ❑ FX rates also depend on expectations.

# How do flexible exchange rates work?

## Japan / U.S. Exchange Rate



Source: Board of Governors of the Federal Reserve System (US)/FRED.

# Managed Foreign Exchange Rates

- ❑ Managed rates are more stable than flexible rates.
  - Facilitate business planning.
  - Firms want stable supply prices.
  - Firms can use derivatives to reduce uncertainty.

# Managed Foreign Exchange Rates

- ❑ About 1/3 of countries have *floating* rates.
  - A float means no commitment to an FX rate.
- ❑ About 2/3 of countries *manage* their FX rate.
- ❑ U.S. FX management ended in 1973.
- ❑ Countries with conventional pegs vs. USD in 2014:
  - Aruba, The Bahamas, Bahrain, Barbados, Belize, Curaçao and Sint Maarten, Eritrea, Jordan, Oman, Qatar, Saudi Arabia, South Sudan, Turkmenistan, United Arab Emirates and Venezuela.

# Managed Foreign Exchange Rates

- ❑ Fixed vs. flexible arrangements have tradeoffs.
- ❑ Governments must use policy to control the FX rate.
  - More on “how” later.

# How to fix a price?

- Market: Buy or sell to affect the price:
  - Agricultural price supports
  - Federal Reserve open market operations
  
- Regulatory: Outlaw and/or regulate transactions:
  - Minimum wage
  - Import quotas

# CHINESE ECONOMIC HISTORY AND POLICIES

# China manages its exchange rate

- ❑ China's government controls its FX rate with several tools:
  - Monetary policy and fiscal policy
  - Exchange and capital controls
- ❑ Both level and volatility matter.
  - The level matters for trade.
- ❑ China cares about more than the USD value.

# History of China's Exchange Rate

China / U.S. Exchange Rate



Source: Board of Governors of the Federal Reserve System (US)/FRED.

- Pre-2005
  - Concerns about undervaluation
- Post 2005
  - Controlled CNY revaluation
- Post 2013
  - CNY depreciation

# China has Capital Controls

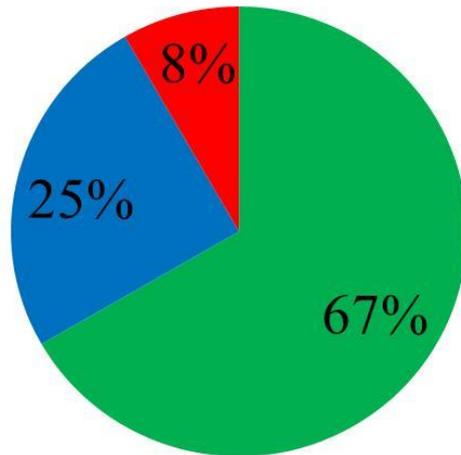
- ❑ Capital controls restrict international asset sales.
- ❑ FX transactions must go through certain banks.
- ❑ Chinese residents can buy FX.
- ❑ Controls prevent “destabilizing” asset transactions.
  - Prevent “volatile” inflows.
  - Prevent speculation against the currency.

# How did China accumulate reserves?

- ❑ Chinese firm sells goods abroad for USD.
- ❑ Firm sells the USD to an FX bank for CNY.
- ❑ People's Bank of China (PBC) buys USD from banks.
  - This expands the domestic money supply (MS).
  - PBC reverses the domestic MS expansion.
- ❑ PBC buys assets from US with USD.

# China's FX reserves

Estimated Makeup of China FX reserves

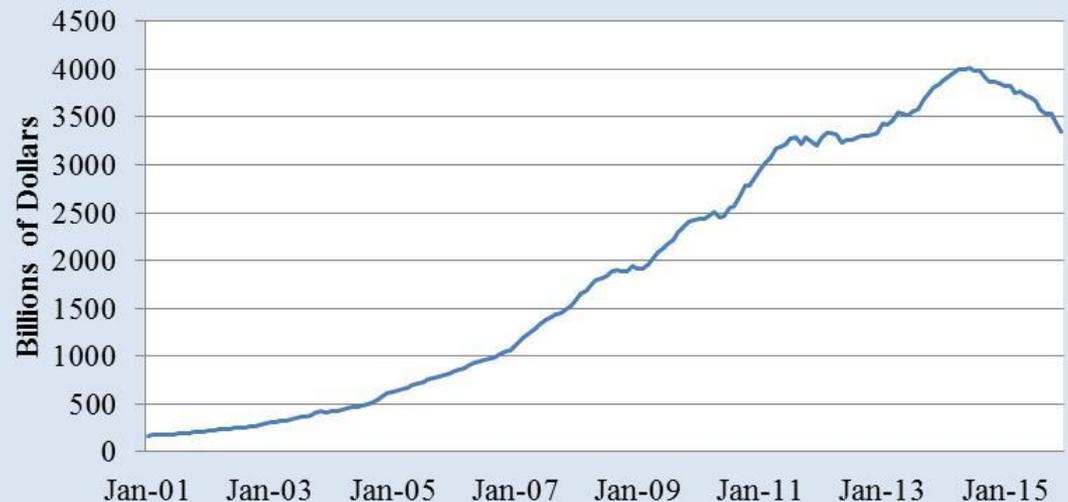


Source: Financial Times.

2/3 of Chinese FX reserves in USD assets

- dollars
- euros
- yen and pounds

Total Reserves Excluding Gold for China

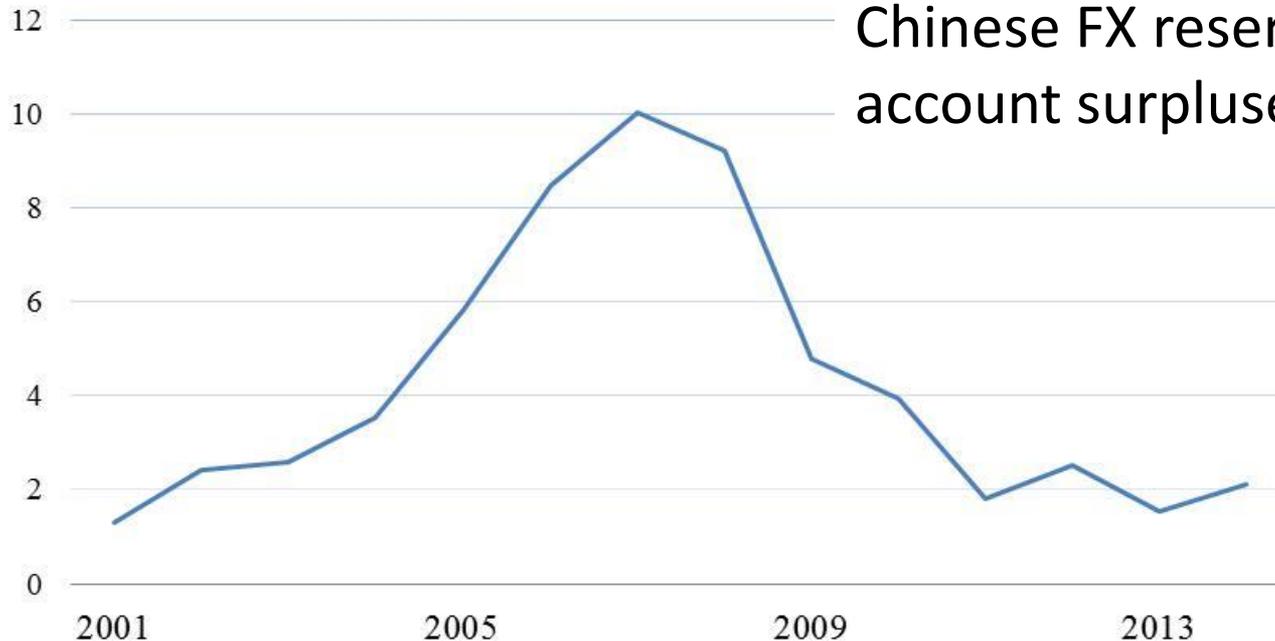


Source: International Monetary Fund/FRED.

# China's FX reserves

## China: Current Account Balance

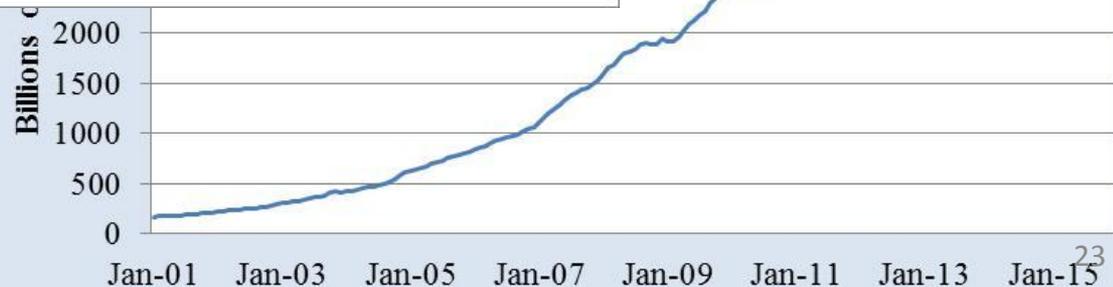
Percent of GDP



Source: IMF/OECD/Haver,

Chinese FX reserves grow as current account surpluses accumulate.

## China's Gold Reserves



Source: International Monetary Fund/FRED.

# Why does China keep reserves?

- ❑ To consume later: China is aging rapidly.
  - Why not domestic investment?
- ❑ For insurance: precautionary savings
  - Natural disasters
  - Concerns about the banking system
  - Financial flexibility and credibility
  - Asian currency crisis of 1997 was a lesson.

# Why has China been selling reserves?

## ❑ Net capital outflows?

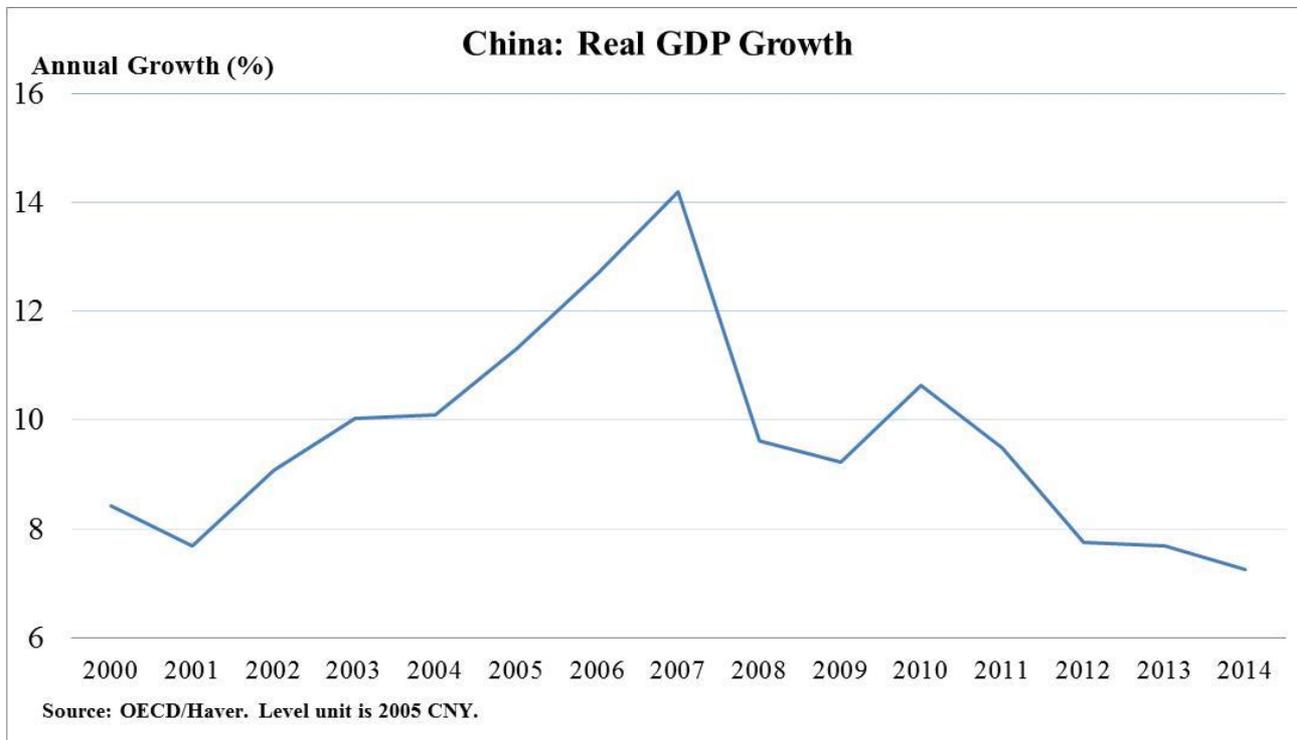
- No.
- It is difficult for foreigners to “short” Chinese assets.

## ❑ A transfer from PBC to residents?

- Chinese citizens’ desire to hold foreign assets.
  - This limits the impact on the U.S.
- But the loss of reserves can’t go on forever.

# Why do Chinese want foreign assets?

- ❑ Growth has slowed; interest rates are lower.
- ❑ Fear of banking crisis and/or devaluation
  - A CNY devaluation raises foreign asset values.

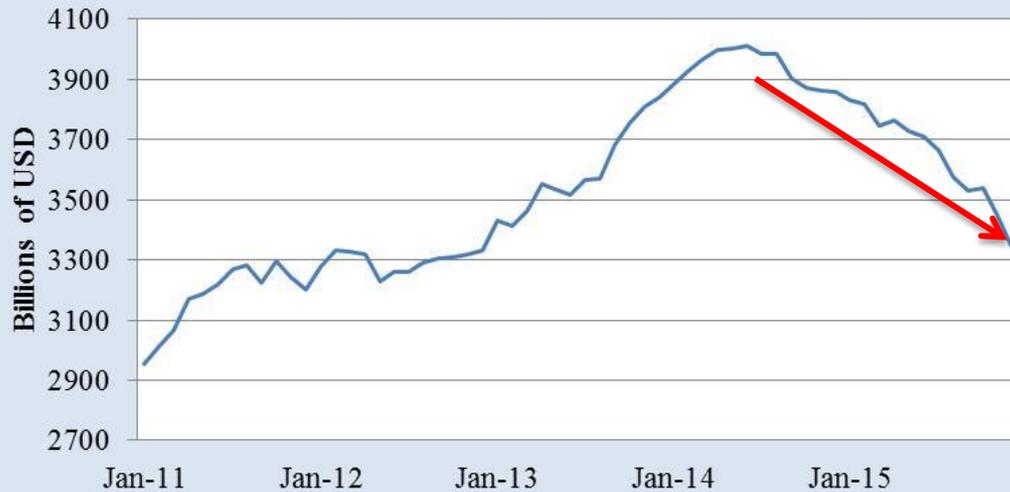


# How do reserves become private assets?

- ❑ Chinese citizens buy FX from FX banks.
  - Tuition, assets, travel.
- ❑ FX banks demand FX from PBC to replenish inventory.
- ❑ PBC sells foreign assets to get USD (or other FX).
- ❑ PBC sells USD to FX banks to replenish inventory.
  - This contracts the domestic money supply.
  - PBC reverses the domestic money supply contraction.

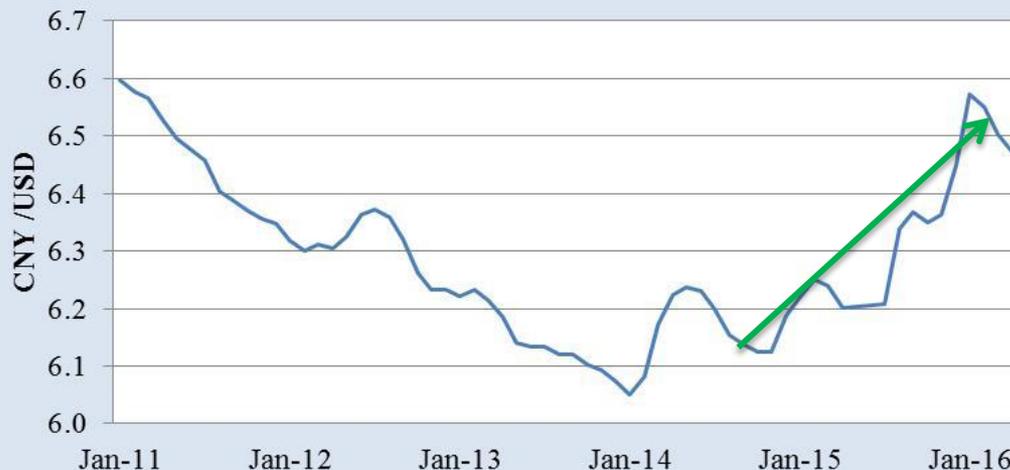
# History of China's Exchange Rate

## Total Reserves Excluding Gold for China



Source: International Monetary Fund/FRED.

## China / U.S. Exchange Rate



Source: Board of Governors of the Federal Reserve System (US)/FRED.

China still holds very substantial FX reserves.

Sales have slowed considerably since January 2016.

*"If something cannot go on forever, it will stop."*  
-- Herb Stein

# CHINESE POLICY CHOICES AND CONSEQUENCES

# China's Policy Choices

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1. Restrict asset purchases by Chinese residents.
2. Use monetary or fiscal policy to boost the CNY.
3. Devalue CNY substantially.
4. Defer a choice and continue to sell reserves.

# Stricter Capital Controls

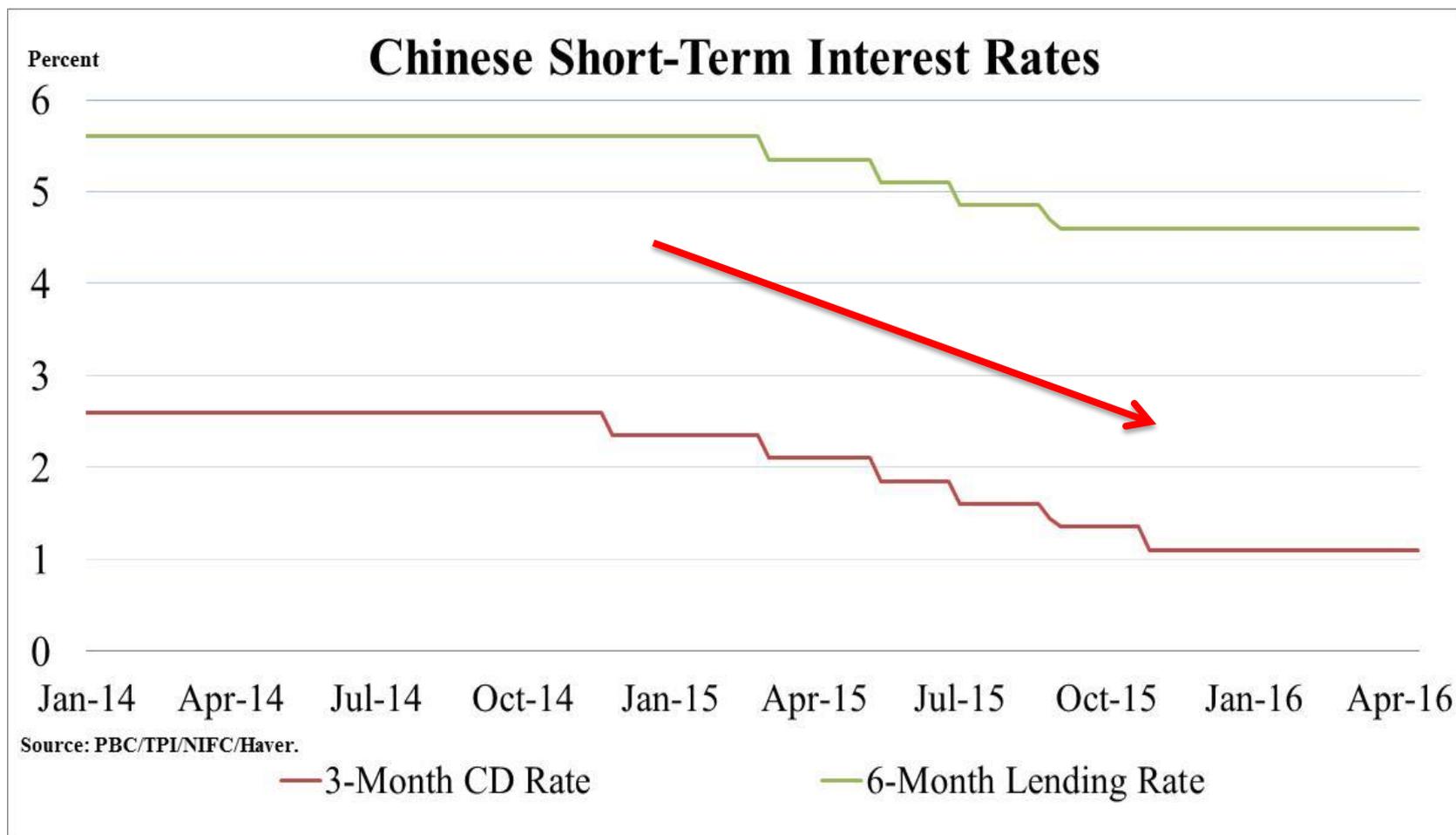
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- ❑ Have no particular implications for the U.S.
- ❑ Might require draconian enforcement.
- ❑ Would conflict with stated Chinese government goals.
- ❑ Interfere with efficient investment.

# Monetary / Fiscal Policy to Boost CNY

- ❑ Tighter monetary policy will slow the economy.
  - The PBC has been easing policy.
  - More easing is expected.
- ❑ Expansive fiscal policy is a blunt instrument.

# Monetary / fiscal policy to boost CNY

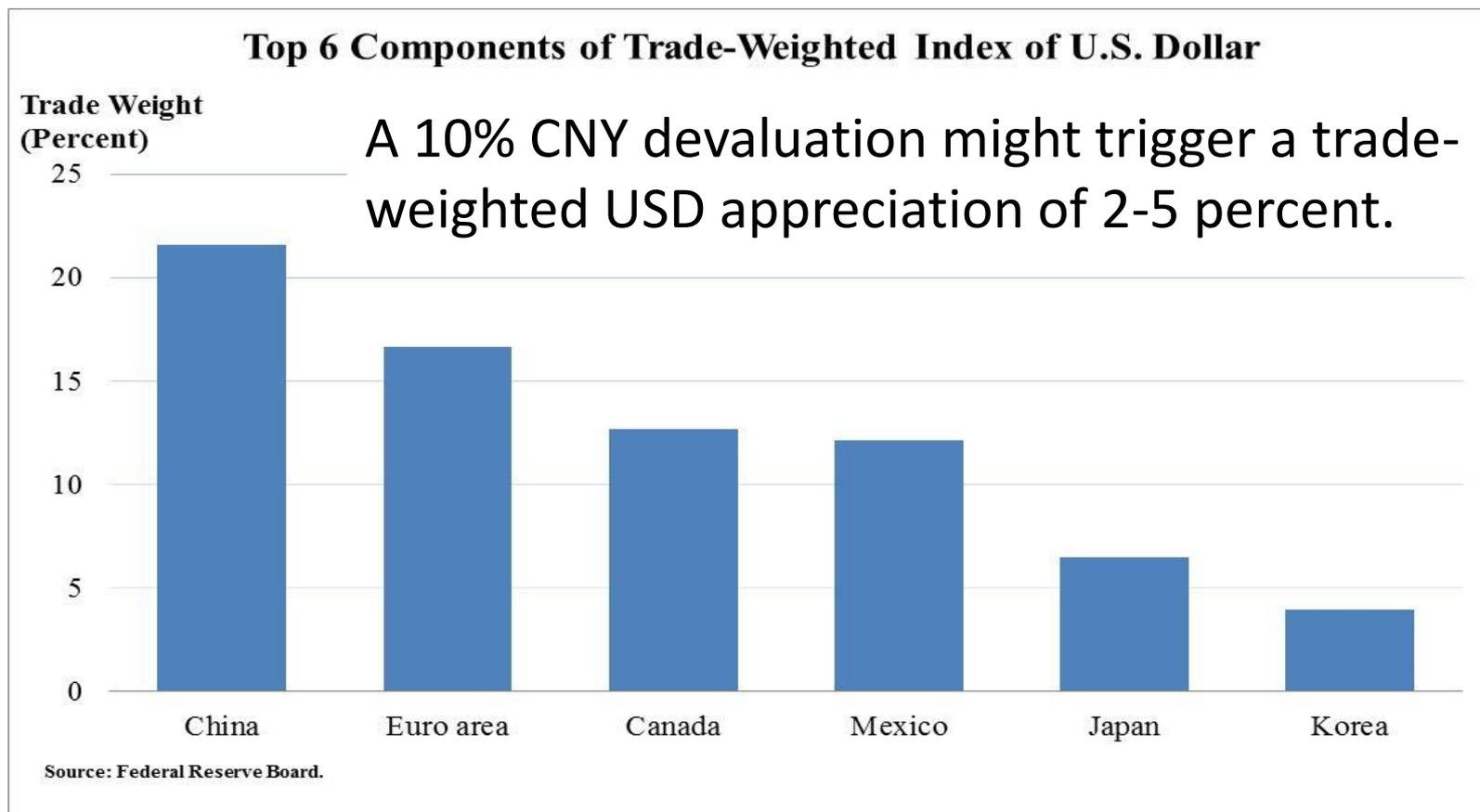


# Devaluation of the CNY

- ❑ Can reduce fear of future devaluation.
- ❑ Must be substantial.
- ❑ Will increase USD value on FX markets.
- ❑ Will increase Chinese exports at expense of others.
- ❑ Will be stimulatory for China.
- ❑ Could provoke inflation.
- ❑ Might be better to float the CNY.

# Devalue the CNY Substantially

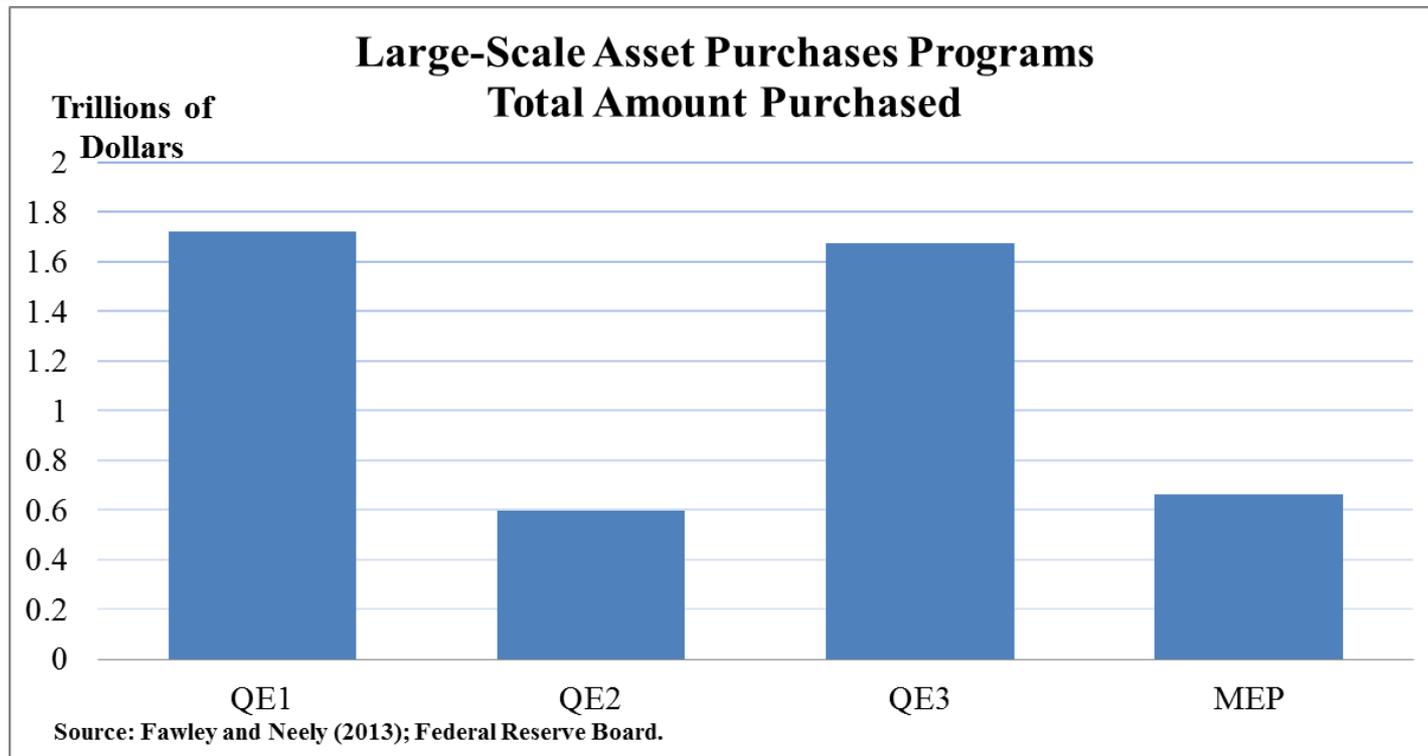
The *trade-weighted* USD exchange rate is the USD's value against a "basket" of currencies whose weights are determined by their shares of US trade.



# Defer Choice; Continue to Sell Reserves

- ❑ Potentially problematic.
- ❑ \$3 trillion of reserves is a *lot*.
- ❑ QE research (naively) suggests 50-100 bp higher US yields, across the whole curve.
- ❑ Several factors mitigate against this impact:
  - Sales reflect transfer to Chinese residents.
  - No “signal” about future US monetary policy.

# Size of Fed QE Purchases



- The QE total was \$4 trillion.
- \$3 trillion is a substantial amount of assets.
- Even the non-U.S. assets are highly substitutable for U.S. assets.

# Summary

- ❑ Chinese residents have been buying a lot of the PRC government's foreign bonds.
- ❑ Policy alternatives:
  - Tighten capital controls.
  - Tighten monetary policy.
  - Devalue the CNY.
  - Play for time.
- ❑ These might affect the U.S. economy.

# Q & A

# Acknowledgements

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