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More Important Than the Yuan: Opening China's Capital Account

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The entire global economy would benefit if the dollar–yuan exchange rate were driven by market demand. It would contribute to a U.S.–China economic relationship that is more balanced, more sustainable, and more beneficial to people in both countries in a way that a government-ordered revaluation would not.

The Communist Party appears to believe that Chinese workers and companies cannot be competitive with a market-oriented exchange rate. In fact, the responsiveness of bilateral trade to the exchange rate is exaggerated in both the U.S. and the People's Republic of China (PRC). However, there is a genuine financial risk in allowing the yuan to move freely. China's dollar holdings now exceed $2 trillion, so a 25 percent gain by the yuan against the dollar would reduce their yuan value by $500 billion. The PRC is finally addressing this issue by resuming balance-of-payments reform, including actions taken in the past few months. If extended, they would enable China to internationalize the yuan and reduce its extreme dependence on the dollar. To this point, though, Beijing has avoided the crucial steps.

The U.S. can help alleviate Chinese concerns and spur financial reform in the PRC. It would require American assistance—and insistence—on a schedule for capital account liberalization.

Too Many Dollars. The PRC holds more dollar assets than is commonly believed. The U.S. Treasury's series on major foreign holders of Treasury bonds puts the PRC's total at $896 billion at the end of November 2010. This obscures hundreds of billions in Chinese purchases made via Britain and Hong Kong. It also excludes hundreds of billions in agency debt from Fannie Mae and Freddie Mac.

A better (but dated) estimate from Treasury is $1.46 trillion in June 2009, which includes agency debt.[1] However, this still treats offshore sites as if they were independent rather than tools of national investors. Moreover, Chinese dollar holdings have climbed since June 2009, but there are currently no more recent U.S. government figures.

Oddly, Chinese data are better. By the end of 2010, official reserves were $2.85 trillion. Foreign exchange purchases indicate that state banks held about $550 billion more.[2] Other investors push total foreign currency to about $3.45 trillion. The highest estimate of the dollar share of this amount is the dollar share of China's own debt—72 percent—while the lowest estimate for the dollar share is about 58 percent.[3]

The range for dollar holdings is thus $2.0 trillion to $2.5 trillion, probably closer to the high end. If the yuan moved freely against the dollar, the yuan value of China's dollar holdings might conceivably decline by over $1 trillion.

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Why so many dollars? The 2010 balance-of-payments surplus was a staggering $471 billion. This is net of purchases of oil, iron ore, and so on, including stockpiles. Proposals involving gold are fanciful—that market is comparatively small.

China's outward investment outside of bonds is $55 billion to $60 billion annually, but this has left $300 billion or more to allocate in recent years. Rapid expansion of non-bond investment faces established opposition. There is no unified European bond market, and Japan is closed to large Chinese purchases. The only market large enough to absorb such huge surpluses is American bonds.[4]

Attempts at Change. Chinese reserves, representing the "blood, sweat, and tears of the Chinese people," have been largely sent to the U.S. The central reason is that the country's own balance-of-payments rules prevent foreign money from being used at home.[5]

Three features of the balance of payments drive this inability: (1) Inward investment using RMB is restricted, (2) individuals and most firms cannot send foreign money overseas, and (3) the state controls currency trading. Because they cannot invest, Chinese individuals and firms do not hold foreign money; it remains within the utterly state-dominated financial system.

After the shock of the financial crisis, initial measures have finally been introduced to liberalize the balance of payments. One set increased use of the yuan in trade. In 2009, this primarily involved currency swaps and various bilateral agreements not to use the dollar in trade. It culminated in late 2010 with clearance to use the yuan in effect in all trade settlement. China is now capable of moving away from use of the dollar in trade, a small but necessary step toward an independent currency.

For capital movement, the Bank of China grabbed attention with an office to buy and sell yuan in New York. Some Chinese firms recently received permission to pay for their growing foreign acquisitions in yuan. Most important was an invitation to certain foreign institutions to participate in the PRC's bond market, if in limited fashion.[6] This action is indispensable to the yuan becoming an international currency.

But the difficult part remains. For foreign holders to treat the yuan as a legitimate currency, they must

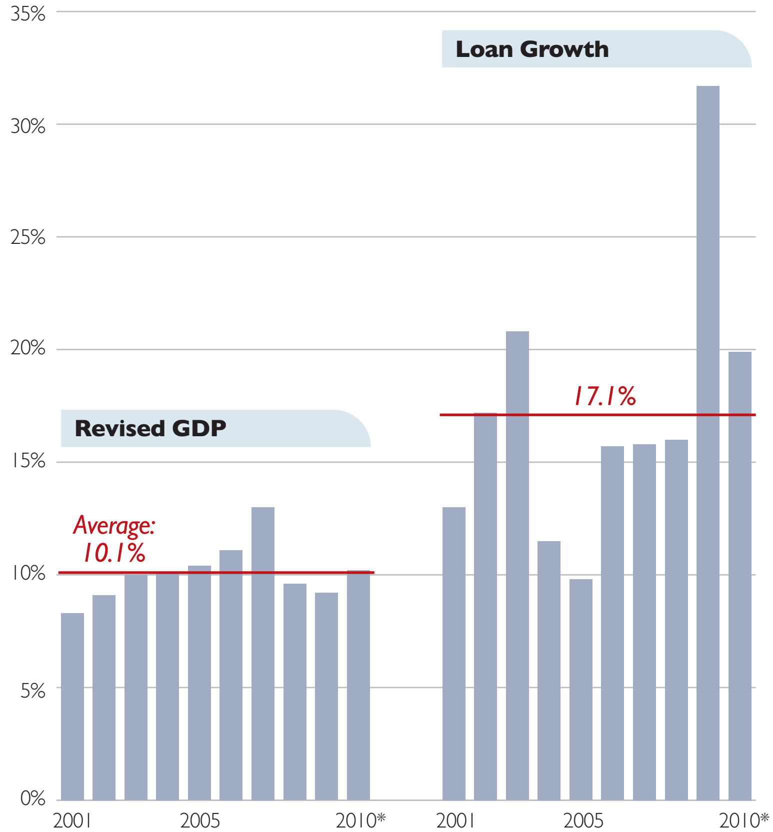
1. U.S. Department of the Treasury, Federal Reserve Bank of New York, and Board of Governors of the Federal Reserve System, *Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2009*, April 2010, at *http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/shl2009r.pdf* (February 7, 2011).
2. Li Jia, "China's Foreign Exchange Reserves Top 2.8 Trillion USD in 2010," *People's Daily Online*, January 12, 2011, at *http://english.peopledaily.com.cn/90001/90778/7258242.html* (February 7, 2011); People's Bank of China, "Financial Statistics, November 2010," December 30, 2010, at *http://www.pbc.gov.cn/publish/english/955/2010/20101228160720355427287/20101228160720355427287_.html* (February 7, 2011).
3. Andrew Batson, "China's Reserves Already Diverse, Citi Says," *China Real Time Report*, September 9, 2010, at *http://blogs.wsj.com/chinarealtime/2010/09/09/chinas-reserves-already-diverse-citi-says* (February 7, 2011); Xinhua, "China's External Debt Reaches 546.4 Bln U.S. Dollars by Last Sept.," January 19, 2011, at *http://news.xinhuanet.com/english2010/china/2011-01/19/c_13698193.htm* (February 7, 2011).
4. Derek Scissors, "China's Investment Overseas in 2010," Heritage Foundation *WebMemo* No. 3133, February 3, 2011, at *http://www.heritage.org/Research/Reports/2011/02/Chinas-Investment-Overseas-in-2010*; Derek Scissors, "China Is a Banker Over a Barrel," Heritage Foundation *Commentary*, March 16, 2009, at *http://www.heritage.org/Research/Commentary/2009/03/China-is-a-banker-over-a-barrel* (February 7, 2011).
5. Andrew Batson, "Beijing Reveals Small Parts of Big Stimulus," *The Wall Street Journal*, November 15, 2008, at *http://online.wsj.com/article/SB122670803014529937.html* (February 8, 2011).
6. Xinhua, "China Expands Yuan Trade Settlement Trial," December 7, 2010, at *http://www.china.org.cn/business/2010-12/07/content_21491360.htm* (February 7, 2011); Xinhua, "HKMA Welcomes Overseas Yuan Fund Investment," August 18, 2010, at *http://www.chinadaily.com.cn/business/2010-08/18/content_11170066.htm* (February 7, 2011); Gertrude Chavez-Dreyfuss and Saikat Chatterjee, "Bank of China Allows US Customers to Trade Yuan," Reuters, January 12, 2011, at *http://us.mobile.reuters.com/article/topNews/idUSTRE70B11S20110112?feedType=RSS&feedName=topNews* (February 7, 2011); Xinhua, "China Starts Pilot Scheme for Settlement of Oversea Direct Investments in Yuan," January 13, 2011, at *http://news.xinhuanet.com/english2010/china/2011-01/13/c_13689615.htm* (February 7, 2011).

have a place to invest. This will require far greater access to the Chinese bond market, which would introduce foreign influence over monetary conditions and curb state control of interest rates. On the outflow side, the ability of ordinary citizens to send money out of the country is paramount. Without this ability, there is little reason for ordinary people to hold dollars. Here, unfortunately, a pilot program to permit Wenzhou residents to be the first to invest directly overseas was almost immediately called into question.[7]

Financial Weakness. Decisive Chinese liberalization is impeded by weak domestic financial markets. The bond market is immature due to state control. Bill sales by the central bank can dictate monetary conditions, and bill purchases are compulsory, so interest rates are artificial. State institutions utterly dominate both the bond market and banking (the foreign share of bank assets is below 2 percent). Private entities cannot set interest rates for their few transactions. Extensive foreign participation in bonds would be a transformative event, and Beijing does not like transformative events.

China's Unsustainable Growth

Annual Percentage Change



* Preliminary estimates.

Source: National Bureau of Statistics, *China Monthly Statistics*, Beijing, Vol. 1, 2001–Vol. 12, 2010.

Chart 1 • WM 3140 heritage.org

Broader financial participation would also promote true competition, revealing a major weakness in banking. Permitting firms and citizens to freely invest overseas is essentially competition between internal and external financial systems. Beijing's refusal to act makes clear that it believes the Chinese financial system would lose this contest.

From 1998 to 2007, China spent over $400 billion to bail out just its four largest banks. The amount spent in 1998 alone would be equivalent, in GDP terms, to a $2.5 trillion post-Lehman bailout in the U.S. Yet when the crisis reached the PRC, banks were again ordered to lend massively, despite much of the money just being used to pay firms' bills.[8] Conditions were the worst since the Asian crisis, which previously pushed Beijing away from opening the capital account.

The Party believes counter-cyclical lending must be used to limit downturns, and global praise for forced lending during the crisis reinforced that. To ensure the ability to make these bad loans, savings cannot be allowed to go freely overseas. But unless money can leave, foreign currency is not usable at

7. Ma Yuan, "Wenzhou's Overseas Investment Trial Halted," *Caixin Online*, January 24, 2011, at *http://english.caing.com/2011-01-24/100220616.html* (February 7, 2011).

home, dollar assets continue to soar, and China remains stuck.

Getting Out of the Trap. Foreign exchange reserves are 10 times the level of eight years ago, and the need for reform is now squared against possibly gigantic financial flows. The PRC fears reform due to imbalances of its own making, but it cannot curb imbalances without reform.

The U.S. can help break the impasse. The American bond market is by far the world's most developed, and the U.S. Treasury can provide technical assistance to remove one of Beijing's concerns about opening its bond market.

More important, the U.S. can offer cooperation with China in countering sudden, large capital flight from the PRC. Flight would be first and foremost to the U.S., and clear indications of American support in case of instability would start to address Beijing's biggest worry. The U.S. should also wield a stick, demanding a schedule for capital account liberalization as the highest economic priority in the Strategic and Economic Dialogue.

China will not break the yuan's peg to the dollar until it can resolve the matter of soaring dollar holdings, and that can be done only through financial reform.

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8. Chi Lo, "How Much Time Does China Have?" *The China Business Review Online*, March–April 2004, at *http://www.chinabusinessreview.com/public/0403/chilo.html* (February 7, 2011); Xinhua, "Profits of Chinese State-Owned Enterprises Up 9.8 Pct in 2009," January 20, 2010, at *http://www.gov.cn/english/2010-01/20/content_1515283.htm* (February 7, 2011); Wang Lan, "China Checking on Leap in Bill Financing—Report," Reuters, February 16, 2009, at *http://in.reuters.com/article/2009/02/16/china-economy-loans-idINPEK10431120090216* (February 7, 2011).

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