

HIGHLIGHTS

- In late June China announced it would enhance its managed floating exchange rate regime to boost the flexibility of its currency.
- Despite the policy change, the renminbi has failed to deliver much appreciation versus the U.S. dollar, triggering renewed calls from the United States for China to allow the exchange rate to move more freely.
- The heavily regulated interest rate scheme under which Chinese banks operate represents a constraint on foreign exchange flexibility. It also creates fertile ground for asset bubbles, especially in real estate.
- However, the risk of a burst in the real estate market and its systemic consequences are contained for a number of reasons, such as the current very low levels of non-performing loans and the government's vast resources to backstop the local banking system.
- Given that transforming the banking system would require a radical departure from past policy practices, changes will continue to occur at a very slow pace.

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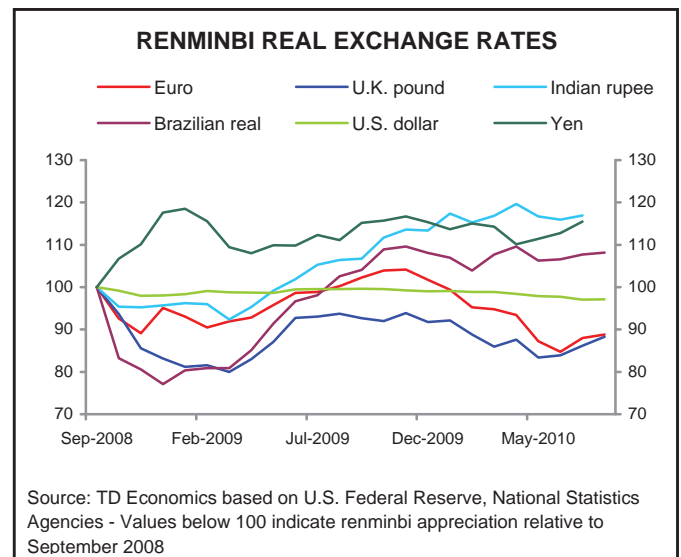
CHINA: FOREIGN EXCHANGE RIGIDITY, ASSET BUBBLES, AND THE ROLE OF CHINESE BANKS

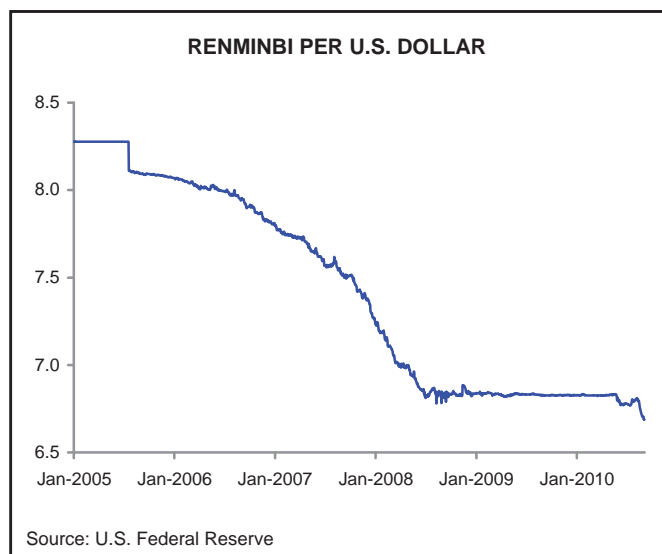
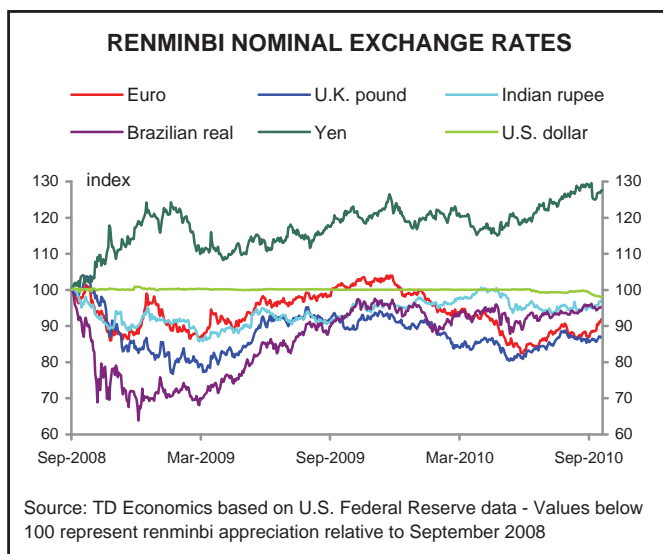
In late June China announced it would enhance its managed floating exchange rate regime seeking to introduce more flexibility on the renminbi through a scheme based on a basket of currencies. Although at the time of the announcement the People's Bank of China noted that in their view there was no basis for a large-scale appreciation of the renminbi, the policy shift generated expectations for a stronger Chinese currency. Until very recently such appreciation had not materialized, triggering renewed calls from the United States for China to allow the renminbi to move more freely. Meanwhile, international attention has also been focused on the soundness of Chinese banks and the consequences of a potential real estate bubble. A connection between the latter two issues and the rigidity of the currency may not be obvious, but they do have common ground in the asymmetry of an economy which has developed its international trade capacity far faster than progress has been made in enhancing its financial system. In particular, the heavily controlled interest rate system under which Chinese banks operate represents both a constraint on foreign exchange flexibility and a contributing factor to asset bubbles and credit misallocation. Given that transforming the

banking system would require a radical departure from past policy practices, development of the financial system will take place only gradually. Thus, the Chinese banking model will remain a structural limitation to foreign exchange flexibility for years to come.

However, in the short term, the risks of a burst in the real estate market and its systemic financial consequences are contained for a number of reasons, including: high homeowner equity as a share of property values, very low levels of non-performing loans, and the government's vast resources to backstop the local banking system.

Just days ahead of the Toronto G-20 meeting, the People's Bank of China announced it was introducing further reforms on its foreign exchange regime to enhance the flexibility of the exchange rate. Despite the policy change, the renminbi barely appreciated versus the U.S. dollar in the following months, which





prompted both the U.S. legislative branch and the Obama administration to once again press on the issue. To appease those claims – although without acknowledging it – Chinese authorities have let the currency gain 1.7% versus the greenback since September 3rd.

Accusations of Chinese currency manipulation have been the norm for many years. And, there is little doubt that China has exerted a tight grip over its currency in order to favor its export-oriented industries, which have been one of the pillars of the country’s development. This has led to a general consensus that the renminbi is undervalued versus the U.S. dollar, but there is less agreement on the degree of undervaluation with estimates running from 5% to 40%.¹

However, allowing the exchange rate to be determined by market supply and demand forces does not just depend on the desire of China to transition from an industrial export-oriented economy to a service-based economy driven by domestic consumption. There are other financial structural issues that condition the flexibility of China’s exchange rate policy. Full convertibility requires two pre-requisites: first, liberalizing capital flows; and second, deep financial markets – which are critical for such a large economy highly integrated to global trade.

Regarding the latter, recently there have been small but decisive actions suggesting Chinese authorities are definitively working to promote the internationalization of the renminbi. In mid-August the People’s Bank of China announced it will allow foreign central banks and overseas financial institutions participating in the renminbi trade settlement program to access the country’s interbank bond

market. It also authorized foreign non-financial firms to issue renminbi-denominated debt outside of China. Undoubtedly, these are steps in the right direction; but the development of these markets will take a long time. Meanwhile, the restriction on capital flows remains a larger obstacle for foreign exchange flexibility.

In the past, those restrictions were used not only as a tool to control the exchange rate more effectively, but also as a shield to protect the country from the boom-and-bust crises experienced by other emerging markets. For instance, large short-term capital inflows followed by sudden outflows were a major contributing factor in both the 1994 Mexican crisis and in the 1997 Southeast Asian crisis.

Even if Chinese authorities feel confident about the country’s capability to deal with volatile short-term capital flows due to its vast US\$2.5 trillion foreign reserves, they might still not be in a position to relax capital controls because of the immediate consequences this would pose on the banking system. Liberalizing capital flows would force the removal of state-controlled interest rates on which Chinese banks operate, because it would mean they have to compete for funding and lending opportunities with external sources at market interest rates. This would, in turn, require a major alteration of the Chinese banking system business model, necessitating a drastic shift towards decision-making based on market incentives. This seems very unlikely in the short term, because the government relies heavily on its banks as instruments to enforce economic policy – as was demonstrated by last year’s credit boom discussed below. Hence, the business model of Chinese banks is a major

constraint for foreign exchange flexibility. However, this does not preclude the possibility of allowing the currency to appreciate to some degree under the existing managed foreign exchange regime.

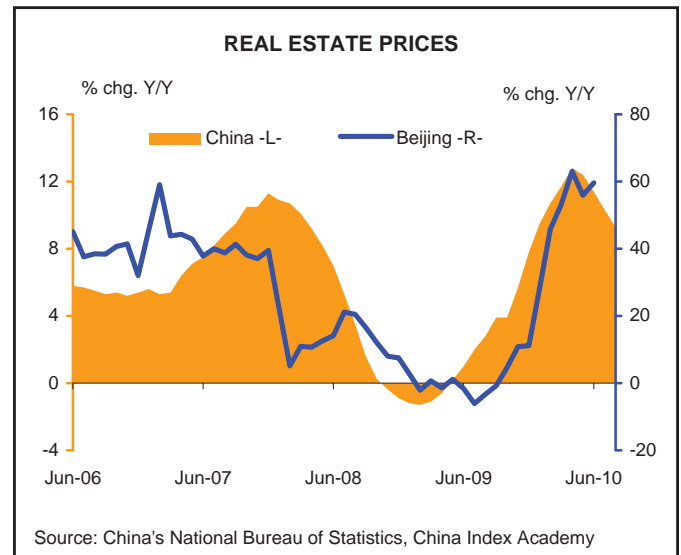
The government prompts banks to deliver an alarming credit expansion...

In the aftermath of Lehman Brothers' collapse, the Chinese government implemented its fiscal stimulus program by instructing state-controlled commercial banks to lend trillions of renminbi to households, private and state-owned firms, and regional governments. As a result, total outstanding credit last year grew by an amount equivalent to 28.7% of nominal GDP. Amid this frantic credit expansion, commercial banks increased their reliance on trust companies – a sort of special purpose vehicle – to repackage loans and take them off their balance sheets by selling them to investors. This practice allows banks to meet – somewhat artificially – their capital ratio requirements and continue extending credit without recapitalization. However, when banks sell those pooled loans, they do so under the promise to buy them back if requested to do so, which intrinsically means the credit risk remains on the banks' balance sheets. Some estimates suggest an additional 4% of GDP in new credit was created through trust companies last year.²

Amidst growing concerns this credit binge would undermine the strength of the banking system, and in light of the dubious repayment capacity of some regional governments, the regulators had to intervene to control the situation. In early August the Chinese Banking Regulatory Commission (CBRC) mandated banks to bring back to their balance sheets those pooled loans by the end of 2011, and Beijing warned regional governments to restrict the amount of credit they get from banks which are facilitated through trust companies.

...but real estate bubble is also caused by state-controlled interest rates...

The government-induced credit largesse also fueled property prices. By May 2009 the national property price index had recouped the ground it lost in the previous 10 months amid the global financial crisis and by April 2010 prices were rising at an annual pace of 12.8%. In large coastal cities such as Beijing and Shanghai, prices were up 70% from the previous year. However, the inflated real estate market was not only due to the credit boom. Interest rates played a major role. Low savings and term-deposit



interest rates – which translate in extremely low or negative real interest rates – and lack of other investment alternatives, encourage Chinese people to park their savings in real estate properties under the expectation prices will continue to rise.³ If banks had to compete for deposits in a free market, higher returns on deposits would make less liquid asset classes, such as real estate, less attractive.

...however, in the short term, there is no looming banking debacle

Fast rising property prices caused widespread discontent among the population who saw home affordability decline rapidly and also raised concern that a real estate bubble was in the making in the country's most populous cities. The government subsequently decided to impose restrictions on real estate activity through tighter credit standards. Mortgage down payments on non-owner-occupied dwellings were increased, and in some jurisdictions non-residents were banned from buying properties. These restrictions did yield some deceleration in real estate credit growth. According to the People's Bank of China, loans to property developers rose 26.1% y/y by end-June (5 percentage points lower than in March) and total outstanding household mortgage loans increased 49.6% y/y (down 3.8 percentage points from end-March). Moreover, property prices at a national level have been rising at a slower pace since June – as the accompanying chart shows. Nevertheless, the latest available data shows newly started construction was still booming in June (up 67.8% y/y) and fixed investment in real estate developments was up by 34.1% in August from a year earlier. So, while government policy tightening has prompted



some moderation in the real estate market, there have been no alarming signs of a drastic correction in prices or drop in activity. This raises the question of whether further policy tightening is required, and what might impact it might have.

Even if a sharp decline in property prices did occur, there are several factors that would temper its impact on the banking system. First, homeowners are required to make a downpayment in the range of 30% to 50% of the value of the property, thereby reducing the likelihood of strategic defaults if homebuyers were confronted with significant price declines. Second, mortgage lending to households combined with loans to real estate developers account for less than 20% of total banking lending. This implies that even if non-performing loans (NPLs) in this sector were to increase in very significant amounts, the overall impact on total NPLs would be much smaller. Another risk mitigating factor is the current very low level of bad loans: the NPL ratio was 1.3% by end-June, with a coverage provision ratio of 186%. This, combined with very strong net profits so far this year, gives banks enough shoulder to absorb an increase in bad loans in the event of a deterioration in economic conditions. And last but not least, the government's vast financial resources also represent a significant backstop for the banking system. Indeed, there is little doubt that Chinese policy makers would respond aggressively to counteract the economic fallout of a real estate correction, and the experience in 2009 shows that when fiscal stimulus is injected in China, the impact is felt rapidly. Thus, the odds of an economic downturn or a banking crisis from a correction in real estate are much lower than one might expect.

Final Remarks

This note has linked three issues regarding China which have recently grabbed international attention. We argue that the Chinese banking model characterized by government influence over bank managers and regulated interest rates

poses a major constraint to foreign exchange flexibility and have contributed to excesses in China's real estate market. However, in the short term, very low NPL ratios, strong profits, and plenty of financial resources at the government's disposal significantly reduce the chances of financial instability in the Asian country, despite last year's massive increase in credit and surge in property prices. Therefore, the recent slowdown in the real estate market that Chinese authorities have engineered will only exert a very moderate drag on economic activity this year, and the government could pull a number of levers if its actions were to deliver a sharper-than-intended cool down. In all, this remains very much in line with our recently released [quarterly forecast](#), which sees China's economy growing 10.2% in 2010, and decelerating to a still high 9.3% growth rate in 2011.

Regarding the Chinese currency, there is no doubt that a free-floating exchange rate would greatly improve market incentives for the proper allocation of resources, facilitating China's transition from an export-oriented economy to one with a larger service sector in which growth is driven by domestic consumption. But even if China decides to abandon its export-oriented growth model – which would very much eliminate the *raison d'être* for its managed foreign exchange regime – the country would still have to embark on the daunting enterprise of reforming its banking system, because Chinese banks would not be able to operate with their current business model under free capital flows. These reforms require a good amount of political wrestling, so one should not expect significant changes to materialize in the short term. Rather one should expect the issue of an undervalued renminbi to continue fueling international discussions for some time to come. Indeed, we see the Chinese currency hovering around 6.7 renminbi per U.S. dollar throughout the remainder of 2010, and to post only a modest appreciation in the range of 2% to 5% in 2011.

**Endnotes:**

- 1 If we look at the real exchange rate (i.e. the nominal exchange rate adjusted by the inflation differential between the two countries), the chart on the first page shows that since the aftermath of Lehman Brothers' fall – when Chinese authorities implemented a very tight crawling peg to the U.S. dollar – the Chinese currency has depreciated vis-à-vis the Indian rupee, the Brazilian real, and the Japanese yen. On the other hand, the renminbi has appreciated very slightly versus the U.S. dollar, and more significantly versus the U.K. pound and the euro. This certainly weakens the case made by those calling for more renminbi appreciation.
- 2 The close relationship of Chinese banks with regional governments and state-owned enterprises is nothing new: it was also at the root of the surge in Chinese non-performing loans (NPLs) in the aftermath of the 1997 East Asian economic crisis, when the Chinese government prompted state-owned banks to support state-owned firms with easy credit. By end 1999, NPLs ratios had risen to 30%, forcing the government to intervene to save its banks.
- 3 Those expectations are fueled by another structural cause: the short supply of low-cost housing, especially in coastal or urban regions. These regions have continuously attracted rural population due to the ever rising inequality between urban and rural per capita disposable income – the former is less than a third of the latter – a demographic trend that is set to last. During 1996-2009 the rural population declined at an average 1.3% annual rate, while its urban counterpart was climbing by 4.1% annually. This demographic trends support housing price increase expectations, fueling housing demand.

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