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OPINION | COMMENTARY

How China Copes With Capital Flight

As growth slows and tariffs threaten, the central bank now strives to prevent a sharp slide in the yuan.

By John Greenwood and Steve H. Hanke

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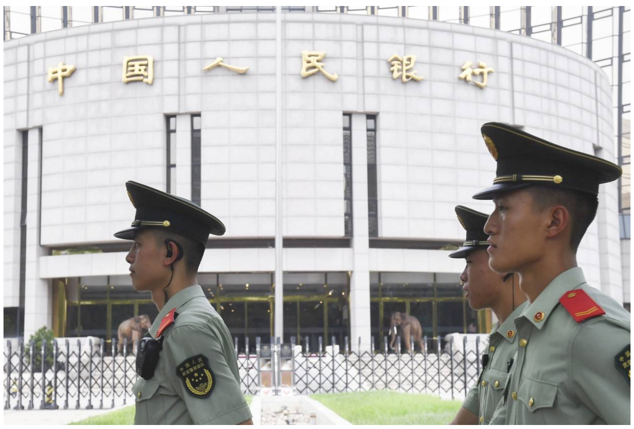

The People's Bank of China in Beijing, Aug. 1. **PHOTO:** KYODO NEWS VIA GETTY IMAGES

Watchers of China's currency in the past few years have risked a serious case of whiplash. After tamping down the yuan's appreciation for the better part of two decades, Beijing has begun to lend support to the sagging currency. Last month China used roughly $32 billion of its foreign-exchange reserves to bolster its currency. The yuan is dropping largely because China's growth is slowing and capital has begun to flee the country.

For most of its recent history, China had little reason to worry about capital outflows of foreign money. From 1994 to 2014 the Chinese enjoyed a surplus in their overall balance of payments, which consists of the current-account balance plus private capital flows. This surplus generated foreign-exchange earnings. The People's Bank of China, Beijing's central bank, purchased incoming foreign currency at the going rate and amassed a mountain of foreign-exchange reserves. These peaked at just over $4 trillion in June 2014.

While a growing pile of reserves might seem like a gift, it presented the Chinese authorities with a series of challenges. As the foreign currency rolled in, the PBOC purchased it from commercial banks by crediting them in yuan. This drove down interest rates in the interbank market, which in turn increased domestic lending and the money supply. To control these increases, the PBOC began issuing bonds to the banks in 2002, absorbing excess yuan. Known as sterilization, operations of this kind were pioneered in Japan in the 1960s and have been common across East Asia since the 1980s.

Yet the PBOC's bond issues came at a cost. With the increased bond issuance associated with sterilization, the central bank had to pay ever-higher yields to entice banks to buy bonds. To stem the growing cost, the PBOC slowed down its sterilization operations. Instead, it aimed to control the money supply by raising the reserve-requirement ratio (RRR) on bank deposits, which mandates that banks place a certain percentage of their cash in a central-bank reserve. By June 2011 the RRR had reached 21.5%, freezing more than a fifth of Chinese bank deposits that otherwise would have been lent out to private borrowers.

In parallel with the sterilization of capital inflows, the PBOC began in 2005 to allow appreciation in the yuan-dollar exchange rate. The yuan rose 35% against the U.S. dollar from 2005-15. Over the same period, China's thriving economy meant wages also increased by 14.6% a year. The combination of the stronger yuan and the wage surge meant Chinese wages in U.S.-dollar terms effectively quadrupled, boosting the local standard of living but hurting China's international competitiveness.

Fast forward to August 2015. That's when the yuan experienced a nasty wobble, declining 4% in two days as capital flows reversed. Since then, regulators have imposed new exchange controls and other restrictions on certain types of capital outflows. Yet the trend of net outflows from China has continued sporadically.

So the PBOC's challenge today is the opposite of what it faced in the previous two decades. The central bank must ensure adequate growth in the money supply while capital flows out and the current-account surplus rapidly dries up. More broadly, China must reverse the sterilization process without destabilizing the economy.

The PBOC's strategy so far has been to increase domestic credit, compensating for shrinking foreign-exchange reserves. By today, those reserves have decreased by the equivalent of about $1 trillion, which the PBOC has counterbalanced with about $1.2 trillion of domestic credit.

The major difference from the surplus era of the early 2000s is that China's annual growth rate has dropped from roughly 10% to 6%. To meet its inflation target of 2%, the central bank has reduced the rate of growth in the money supply from 15% a year in 2013 to just 8% today.

Wages have leveled off as China's economy cools and inflation has stayed low. But the question remains whether things are stabilizing, as President Xi Jinping desires, or if capital will continue to flee as a result of the U.S.-China trade war.

Trade disruptions seem unlikely to upend China's economy entirely, as exports account for only about 18% of Chinese gross domestic product, and only 3.6% of GDP comes from exports to the U.S.

So where is China headed? The most likely course is the one taken by Japan after its trade spat with the U.S. over textiles and steel in the 1980s. Back then, Japan shifted rapidly to higher value-added industries like automobiles and robotics. China already has begun to shift away from industries that add less value like garments and toys, allowing jobs to migrate to Vietnam and Bangladesh. If U.S. tariff pressures intensify, China surely will accelerate the upgrade of its automobile, electronics and artificial-intelligence capabilities.

Though China is going through a rough patch as it deleverages and slows its credit growth, central-bank policy looks set to maintain stability on the domestic front. Steady growth in the money supply will ensure an increase in domestic consumption and investment, which form the bulk of China's GDP. Stability isn't everything. But—as Mr. Xi and the PBOC know well—everything is nothing without it.

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