China's Currency: About to Crack?

MUCH as the government swears blind that it will not devalue the currency , not all local and foreign holders of the yuan believe it. So in recent days China has issued regulations meant to check what the official press calls "black-market activities" and what others call capital flight. A measure of its desperation, perhaps, but not, as many think, a despairing final throw of the dice.

Determining the amount of money leaking out of China has always been tricky. Even as foreign investment has flooded into the country during the 1990s, Chinese capital has fled the other way. Much of it has been the ill-gotten gains from stripping state assets, or the proceeds from the rampant smuggling of tobacco, cars, oil and so on, led by the People's Liberation Army (which oddly includes the navy). And a lot of the money finds its way back disguised, for instance, as foreign investment with preferential tax treatment.

Net capital flight seems to have been roughly $20 billion last year and will be a lot higher this year. By means both fair and foul Chinese companies, fearing a devaluation, have been buying dollars with local currency in order to pay back dollar loans. Others have been converting spare yuan in the belief that, even if it is not devalued, the yuan is hardly likely to appreciate.

There are two big clues as to how much money is fleeing the country. The first is that the yuan is fetching a lot less on black markets. At one such, in Shanghai, its value is 7% below the official rate of 8.7 yuan to the dollar. The second is that, in the first eight months of the year, China recorded a trade surplus of $31.3 billion and foreign investment of $27.4 billion-but its stated foreign-exchange reserves, at $140 billion, have barely budged. This discrepancy, a reasonable proxy for capital flight, shows up as "errors and omissions" on the capital account. Curiously, the government has hesitated over publishing recent numbers.

All of which explains, in part, why the government, in the form of the State Administration of Foreign Exchange (SAFE), is now cracking down. Since last month it has been tightening the screws on Chinese companies paying off dollar loans. And it has vowed to get tough with illegal money-changers. A week ago it "severely dealt with" five domestic bank branches in Guangdong province (which shares a border with Hong Kong) that had apparently broken hard- currency regulations.

Most controversial are a number of new regulations just issued by SAFE that impose tough restrictions on taking out of China hard currency that is needed for import-export purposes. The government claims that the restrictions will hit smuggling and corruption and not harm companies involved in legitimate foreign trade. Yet foreign firms say they are suffering: their local customers are having trouble finding hard currency to pay for imports, and without their cash foreign companies do not themselves have the wherewithal.

Are the new rules a sign of panic? Perhaps not. They more likely reflect the government's desire to stamp out corruption as much as fear of capital flight. With an officially closed capital account, its will still counts for something. And there are good reasons why it might not want to devalue now. For a start, the export picture is not entirely bleak. Although exports to the rest of Asia have collapsed, those to America and Europe have stayed remarkably buoyant. China's main problem is flagging domestic demand. At home, government economists say, devaluation would exacerbate capital flight and knock still further the confidence of foreign investors. Abroad, it would squander political capital that China has so carefully built up.

Nor, unless America cuts first, is the government likely to do what analysts expect: reduce interest rates. The two most recent cuts have done nothing to prod domestic demand and have probably exacerbated capital flight: interest rates on one-year yuan deposits are already below those on equivalent dollar deposits. Instead, the government will continue to pin its faith on massive fiscal reflation and an infrastructure binge. Only if – when, some say – that fails is it likely to consider the ultimate humiliation of devaluing.
