Commentary on the February 2018 BCI

Professor Li Wei

In February, the CKGSB Business Conditions Index (BCI) rose to 59.5 from last month’s 55.5. This month’s indices show that business conditions have improved overall. Not only sales and profit forecasts, but also the indices for financing and inventory have also risen to varying degrees. Moreover, total costs have come down somewhat, marking a clear contrast with last month’s weak indices across the board. For comprehensive figures, please refer to this month’s accompanying data report.

Regarding this month’s data, there are two points of note:

First, beginning in Q4 2016, the consumer product prices index broke away from the record low trend in place since 2013, rising to a mark of around 60. From the end of 2017 until now, it has again begun rising and is now at 67.8. Producer prices have seen a decline, registering 51.8 this month. Both forward-looking indices, they reflect the expectation of sample companies that prices will change in a certain direction over the next six months. Seen like this, inflationary pressure still exists in consumer product prices. The trend for producer products is not yet clear, as the index dropped below 50 for a long period in the past few years and only rebounded above 50 in December 2016. Since then, while the trend has turned, it cannot yet be considered stable.

This January’s CPI growth rate was 1.5% YoY, which is not high, but 0.6% quarterly growth nevertheless, the second highest since last January. At the start of this year, the PPI growth rate was 4.3% YoY, a quarterly increase of just 0.3%, indicating the start of a downward spiral. Official figures have some similarities with our data.

We believe the risk of further inflation should not be underestimated. Further relaxation of China’s monetary policy would not seem to be a good idea. Maintaining a balanced and stable economy is likely to be far more conducive to business operations and economic development.

Second, while it is still uncertain what impact recent leadership changes at the US Federal Reserve will have on future monetary policy, judging from the current situation, interest rate hikes will continue. Although this upward trend is gradual and in line with market expectations, the rate of return on US dollar assets will rise as the federal rates rise. If China's macroeconomic policies allow the relative return on RMB assets to fall, China's capital outflow pressure will grow.

To limit this kind of pressure on capital outflow, China has three options. First, raising interest rates in line with the pace set by the US, keeping domestic and foreign interest spreads stable and raising the yield on RMB assets. This is equivalent to tightening the monetary policy alongside the Federal Reserve. Of course, the Federal Reserve is tightening its monetary policy because its decision-makers believe that the US economy will maintain a steady growth rate. While tightening monetary policy would work for China's economy at present, its cycle is unlikely to keep pace with that of the US in the long run. It makes sense that monetary policies consciously de-couple over time.

The second is reform of the RMB exchange rate mechanism to enable market forces to play a greater role. If China retains its current interest rate and at the same time lets the market become the protagonist of RMB exchange, the flood of capital outflow will lead to a rapid fall in the RMB exchange rate. For capital that wish to join the exodus but has not yet done so, a fall in the RMB exchange rate will increase outflow costs as well as risk, and the relative return on US dollar assets will fall. Moreover there is a possibility of overshooting after the RMB exchange rate falls. In such circumstances, it may not be a good choice to convert the RMB into foreign currency. From this perspective, a market-oriented RMB exchange rate can become a "pressure relief valve" for cross-border capital flows.

Third, strengthen capital controls. If China wants to neither raise interest rates nor devalue its exchange rate, its only recourse is to strengthen capital controls. While China has long implemented capital controls, these have been one-way only, that is, welcoming in new capital, but restricting its exit. In the context of RMB appreciation, this in effect creates an arbitrage space for funds flowing in from outside. In the case of capital outflow and the pressure of devaluation on the RMB exchange rate, this has not yet been seriously impeded. However, once the situation is reversed and the RMB is under pressure to revalue, the problems of the past will be repeated. Moreover, these funds have flowed into China for the purpose of arbitrage, and this will only increase going forward. The invisible space has expanded the scale of domestic and overseas capital flows and damaged the stability of China's economic environment. In view of past experience and lessons, we believe that if China should choose to strengthen the capital control policy to cope with foreign interest rate increases, then the best way is to implement two-sided control, managed entry and exit, and strictly applied.

In actual fact, China's three policy options revolve around the Mundellian Trilemma. This shows that an economic system can only chose two out of three policy goals, namely autonomous monetary policy, fixed exchange rate and free capital flow, and cannot achieve all three goals at the same time. To give up autonomy means giving up the chance to use monetary policy to carry out countercyclical macroeconomic maneuvers. If the economy overheats, it may not be able to raise interest rates and cool down the economy. In the case of a recession, it may not be able to cut interest rates to stimulate economic growth. China is the second-largest economy in the world, and is chiefly powered by domestic demand. Policy objectives such as economic growth, inflation and employment stimulation all need to be adjusted using monetary policies. Therefore, both from the theoretical and practical perspective, giving up an autonomous monetary policy would be unwise. China has indeed maintained its own monetary policy to date, at least in part, and the Chinese government is now mainly formulating its own monetary policy in the light of the domestic economic situation.

In terms of the exchange rate, China is nominally practicing a managed floating exchange rate, but practically speaking, the RMB is more managed, less floating, and close to a fixed exchange rate.

As for free flow of capital, as mentioned above, China has long implemented unilateral control.

Although the Chinese government has tried to defend its autonomous monetary policy, due to the influence of exchange rate and capital control policies, it is inevitably affected by other economies, especially the US, so its monetary policy can be said to be an not entirely “autonomous” currency policy.

In principle, we can use capital controls to solve this problem. However, international experience shows that there is a diminishing effect on the efficiency of capital controls. And capital controls have increased the cost of economic operations, at not insignificant cost, proving unsuitable long-term.

From the perspective of economic principles and historical experience, China's best policy choice is to retain its own monetary policy and free flow of capital so that the market can decide on the RMB exchange rate. However, the real situation is rather complicated. On August 11, 2015, the People’s Bank of China announced that the central parity quotation system for adjusting the exchange rate of RMB against the US dollar will play a greater role in the RMB exchange rate mechanism. Due to the devaluation pressure of the RMB on the market at the time, the move led to a significant depreciation of RMB against the US dollar. Subsequently, in order to maintain exchange rate stability, the People’s Bank of China had to sell US dollars and buy RMB. This led to a rapid decline in China’s foreign exchange reserves. In order to avoid a rapid depletion of foreign exchange reserves, the People’s Bank of China had to re-strengthen capital controls. This exchange rate reform is generally considered a lesson in what needs to be avoided, since the central bank is now very cautious. So, although a market-based RMB exchange rate mechanism is an optimal choice, in the short term there is likely to be limited progress in this regard.

Although the market-based exchange rate adjustments approach may not be feasible in the short term, the author believes that with US Federal interest rate increases, China may in future follow a policy mix that entails on the one hand maintaining capital controls, and on the other hand allowing domestic interest rates to rise. This may not a good option, but in the moment it may be the most realistic and harmless one.

CKGSB Professor Li Wei, February 26, 2018