Trump's imaginary enemy

By Zhang Jun
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Last month, China commemorated the 20th anniversary of the death of Deng Xiaoping, the chief architect of the economic reform and opening up that catapulted the country to the top rungs of the global economic ladder. The anniversary comes at a time when economic openness is under threat, as the United States is now being led by a president who believes that the way to "make America great again" is to close it off from the world.

In particular, Donald Trump's administration is posturing for a stricter approach to China, which he claims has been "raping" the US with its trade policies, including by keeping the renminbi's value artificially low. Whatever concrete steps Trump takes, it seems clear that US policy will be economically tougher on China in the coming years, potentially even triggering a trade war. But, as a closer look at China's financial policy stance shows, China is not America's foe.

Just a few months ago, China was confronted with the urgent challenge of preventing the continued depreciation of the renminbi and cooling down an overheating real-estate market. This would be no easy feat, not least because the authorities' efforts to stem the renminbi's decline were rapidly shrinking China's foreign-exchange reserves.

The situation was so grim that some international investors and economists suggested that the government would have to give up on managing housing prices and focus, instead, on propping up the exchange rate, as Japan, Russia, and South Asian economies had done. China, they argued, could not allow its hard-earned foreign-exchange reserves to slip away.

But, after partly decoupling the renminbi from the dollar in August 2015, the People's Bank of China (PBOC) tried hard not to intervene to boost the renminbi's value. As China's economic growth continued to decline and America's continued to recover, the renminbi's exchange rate continued to fall.

Some observers might have wondered whether the PBOC purposely allowed the depreciation to boost China's trade competitiveness in advance of a potential victory by Trump in the US election – a result that many assumed would weaken the US dollar. Perhaps it did. But it did not actively devalue the renminbi.

When Trump's election as US president defied expectations and made the already-strong dollar rise further, depreciation pressure on the renminbi intensified. By the end of last year, the renminbi had depreciated by around 15% against the dollar from the summer of 2015, and rapidly rising expectations of further depreciation were driving more investors to take their capital out of China.

The PBOC had to take stronger action to contain the renminbi's decline. To stabilize exchange-rate expectations, it imposed tighter restrictions on short-term capital outflows. At the same time, it took its previous efforts to decouple the renminbi from the dollar – a shift from a fixed median-price system to a market-based exchange-rate package – a step further, adding 11 currencies to the renminbi's reference currency basket. With that, China's exchange-rate storm subsided, and a two-way fluctuation range for the renminbi-dollar exchange rate was established, an important step toward a market-based exchange rate regime.

The PBOC took these steps before Trump's January inauguration. Given Trump's accusations of currency manipulation by China, that was good timing, regardless of the fact that

the PBOC's intervention was aimed at *strengthening*, not weakening, the renminbi. Enduring restrictions on short-term capital outflows, however, could still become a target, though such criticism, too, would be unwarranted.

China's regulation of cross-border capital flows has long been a contentious subject. A few years ago, most economists recommended that China liberalize the capital account, thereby eliminating a key institutional barrier to the establishment of Shanghai as an international financial center and of the renminbi as an international reserve currency.

But, according to respected economists like Justin Yifu Lin and Yu Yongding, the full liberalization of China's capital account would be highly risky for China. They also point out that there is little evidence backing claims that free cross-border capital flows are necessary for continued economic development.

As recent experience shows, China's use of adjustable quotas for qualified foreign and domestic institutional investors to manage short-term cross-border capital flows remains a valuable tactic for protecting its exchange rate and foreign-exchange reserves. As a country with considerable savings and an underdeveloped financial market, China knows that it must be careful.

To be sure, when China's economic situation has called for it, the authorities have taken steps to reduce restrictions on capital flows. Some 20 years ago, China began to allow – even encourage – current-account liberalization, in order to attract inflows of foreign direct investment into its manufacturing sector and boost exports and economic growth. But it was not until 2008 that Chinese policymakers – seeking to offset the upward pressure that high capital inflows were placing on the renminbi – allowed local enterprises to invest abroad. And even then, such investments could be made only in specific circumstances.

Similarly, in 2013, China established a pilot free-trade zone in Shanghai, to explore approaches to facilitating short-term capital flows and to quiet demands for financial liberalization from the US and the International Monetary Fund. But, in order to mitigate possible financial risks, China continued to develop its regulatory framework for capital-account convertibility.

China also initiated in 2013 its "one belt, one road" initiative, a massive undertaking that will establish the physical and institutional structure for closer trade and investment relations with countries in the Asia-Pacific region and beyond, thereby accelerating the internationalization of the renminbi. At that time, overseas investments and acquisitions by Chinese enterprises were being strongly encouraged, in order to provide an outlet – something like the US Marshall Plan for the reconstruction of post-war Europe – for the excess capital and production capacity that had emerged following the 2008 global financial crisis.

Deng used to tell Chinese officials that, when faced with new challenges, one should "stay calm, hold one's ground, and respond." So far, that is what China has done, pursuing cautious financial liberalization according to its own needs and logic. Whatever Trump says, that does not make China an enemy of America.

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