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IMF Urges Stronger Yuan to Protect World From ‘Shocks’ in China’s Growth

By Sandrine Rastello and Scott Lanman - Jul 21, 2011

The International Monetary Fund said China should let the yuan gain to boost demand and global economic stability, citing the risk that any growth shocks in the country will hurt the world.

Currency appreciation combined with reforms to rebalance the Chinese economy “would yield substantial benefits,” the fund said in a statement late yesterday in Washington. A “major disruption in China’s so-far steady growth would have material adverse consequences,” IMF directors said.

The IMF’s stance marks a shift from last year, when directors of the 187-nation fund split over their economists’ view that the yuan was undervalued. China disputed yesterday’s assessment, while the currency rose to a 17-year high today, the sixth anniversary of the scrapping of a peg to the dollar.

“There is a growing consensus that China’s currency policy is not serving the global economy well,” Eswar Prasad, a senior fellow at the Brookings Institution and a former head of the China division at the IMF, said in an e-mail. “It complicates China’s own battle against inflation and raises the risk of an eventual hard landing there.”

The yuan touched 6.4509 per dollar today in Shanghai before trading at 6.4513 as of 1:27 p.m.

Manufacturing Contraction

China’s manufacturing may contract this month for the first time in a year, according to preliminary purchasing managers’ data released by HSBC Holdings Plc. today.

The main near-term risks are inflation, the threat of a property bubble, and bad loans after stimulus spending, IMF staff said in a report completed June 27. The economy remains on a “solid footing,” the organization’s directors said.

China disputed the IMF staff assessment that the currency is “substantially below the level consistent with medium-term fundamentals,” citing reasons including faulty current-account projections. He Jianxiong and Zhang Zhengxin, representatives at the fund’s board, also said that China’s plan to rebalance demand, including boosting wages to spur consumption, is “the most comprehensive and elaborate" put forward by any Group of 20 nation.

The IMF's 24 directors "generally agreed that, over the medium term, a stronger renminbi would be an important component in rebalancing the economy toward domestic demand," the fund said in a statement using another term for the yuan.

Calculating Value

The currency remains undervalued by 3 percent to 23 percent, depending on methodology, and fell against the currencies of trading partners in the past year in inflation- adjusted terms, the organization's economists said.

China kept the yuan stable at about 6.83 per dollar from July 2008 to June 2010, after allowing it to gain 21 percent in the previous three years. The IMF didn't give a breakdown of how individual directors viewed China's currency.

On dangers for the banking system, including lending to local-government financing vehicles, the IMF staff said that a full assessment is hampered by "serious data gaps" and a lack of access to confidential data. They saw potential for "significant contingent liabilities."

In a "spillover" report on China's effects on the world, staff said rebalancing the economy including by reducing household and corporate savings rates is crucial.

China increasingly has the potential to cause global "shocks" as the first or second-biggest trading partner of 78 countries with 55 percent of global gross domestic product, the report said.

Under Pressure

Premier Wen Jiabao faces pressure to let the yuan rise from U.S. lawmakers, who claim an undervalued currency gives Chinese exporters an unfair advantage. The U.S. administration declined in May to brand the nation a currency manipulator, while describing appreciation as "insufficient."

Yesterday's report estimates that China's current- account surplus, the broadest measure of trade, will widen to 6 percent of gross domestic product next year, from a forecast 5.5 percent this year and 5.2 percent last year.

The economy may expand 9.6 percent this year and 9.5 percent in 2012, the IMF said. Inflation should slow to an average 3.3 percent next year compared with 4.7 percent in 2011, it said.

Financial Risks

In addition to calling for yuan appreciation to support economic growth, the IMF staff report said such a policy would reduce risks in the financial system and let other improvements in interest-rate management, regulation and bond and stock markets “safely” proceed.

Without a coordinated plan, changes may be dictated by markets, which “would create liquidity stress, growing cross-border capital flows and both asset price and macroeconomic volatility,” the report said. “Given the increasing complexity of China’s financial system, an ad-hoc or poorly configured approach would be especially risky, for both China and the global economy.”

Allowing the yuan to strengthen would slow the buildup of foreign reserves and reduce the need to “use higher and higher reserve requirements” for lenders and central bank intervention to absorb liquidity, the IMF said. China’s foreign-exchange reserves rose by $153 billion to $3.2 trillion in the second quarter.

The IMF recommended changes to regulation including stress-testing of banks, tighter oversight for companies critical to the financial system and improved data quality and collection. Eventually, China should loosen restrictions on investment flows, the fund said.

China’s government responded that while it was in “broad agreement with the scope of the reforms” outlined by the IMF, setting a definitive sequence for the changes “would be difficult,” and they would be “preconditioned on a stable and supportive macroeconomic environment,” the report said.

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