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People's Bank of China Sees `Less Need' to Lift Rates, IMF Says

By Shamim Adam - Jul 29, 2010

China sees little need for an imminent increase in interest rates, standing apart from Asian counterparts that are raising borrowing costs as the region shrug offs risks from advanced economies.

People's Bank of China officials said "that with a benign inflation outlook there was less need for higher nominal interest rates at this point," the International Monetary Fund said in a statement yesterday after annual consultations with the Chinese government. "Also, they were concerned that higher interest rates could risk fueling capital inflows."

China views the yuan as "much closer to equilibrium" now than any time before, the Washington-based lender said. By contrast, IMF staff concluded the currency is "substantially" undervalued, and executive directors split on the issue in a board meeting this week.

China has left interest rates unchanged since December 2008, even as countries from Malaysia to Taiwan, South Korea and India lifted them. Trade reports from the region have indicated little sign so far that Europe's budget cuts and U.S. joblessness are damaging exports.

Real interest rates are close to zero and are creating "perverse incentives" within China, Nigel Chalk, the IMF's mission chief to the country, told reporters yesterday.

Over time "real interest rates will have to rise in combination with a number of other policies" such as financial development and an appreciation of the currency, he said.

The IMF, which provided rescue packages for countries from Ukraine to Iceland during the global crisis, released its staff review on China's economy for the first time since 2006. China had previously prevented publication of the annual report.

Policy Stance

President Hu Jintao and Premier Wen Jiabao pledged last week to maintain policy stability in the second half of 2010 after measures to rein in property prices, inflation and bank lending slowed second-quarter growth to 10.3 percent from 11.9 percent in January to March.

"At this point in the recovery, there is little evidence that the upswing in inflation is coming from either binding capacity constraints, rapid growth in broad monetary aggregates, or demand pressures," the IMF said. "Barring an unforeseen supply shock to food prices, consumer price inflation should peak in mid-year and begin falling in the second half of 2010."

Chinese policy makers are relying on administrative measures and credit controls to prevent overheating, with the central bank forcing lenders to set aside more reserves three times this year.

"Central bank officials indicated that they are fully committed to a greater use of indirect monetary policy instruments" to slow credit growth, the IMF said.

Yuan Trading

The yuan has advanced less than 1 percent against the dollar since China indicated on June 19 it would scrap the currency's two-year-old peg. It closed at 6.78 yesterday.

Asia's second-largest economy has faced pressure to allow the yuan to rise from U.S. lawmakers, who claim an undervalued currency gives its exporters an unfair advantage.

China's authorities "indicated that they are prepared to allow the exchange rate to respond more to the forces of demand and supply," the IMF report 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.

Asked by reporters about drafts of the report before it was released, Chalk declined to say whether parts of the report looking into how much the yuan is undervalued were removed before publication.

Eswar Prasad, a senior fellow at the Brookings Institution and a former head of the China division at the IMF, said that the IMF report estimates the yuan could be undervalued by 5 percent to 27 percent.

The PBOC should avoid letting movements in the yuan be determined by the strength or weakness of the U.S. dollar, because of the different cyclical conditions in the two economies, the IMF said.

Capital Flows

"As China begins to appreciate the renminbi, it will have to confront the prospect of a surge in inflows aiming to circumvent the existing capital-control regime," the fund said. "Macroeconomic and prudential policies will need to be attentive to ensuring that such capital flows do not feed rapid price increases in key asset markets or undermine the steady progress made over the past several years to improve the health of the financial system."

The pace of China's reserves accumulation and the outlook for China's current account surplus in coming years suggest to IMF staff that the yuan is still "substantially" undervalued, the report said. IMF officials expect the surplus to rise to about 8 percent of gross domestic product over the next five years, Chalk said.

Chinese officials said the increase in reserves isn't "compelling evidence" that the currency is undervalued, adding that the higher holdings were because of an "unprecedented expansion" of global liquidity. Foreign exchange reserves in China climbed to a world-record $2.45 trillion in June.

The government also said the current-account surplus will decline "modestly" in coming months and may be at about 4 percent of GDP by the end of 2010. The gap, the broadest measure of trade, amounted to 6.1 percent of GDP, down from 9.6 percent in 2008, the State Administration of Foreign Exchange said July 8.

Chalk said that the IMF staff and Chinese authorities had "a difference of view" on the currency and on the prospect of the current account. Still, he said that there's "a strong commitment to a transformation of the economic model" away from an export- and investment-led one.

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