Toward the end of each of the past three years, a question has perennially arisen as to whether, when, and by how much China will devalue the yuan. In fact, this is the wrong question.

The right question is, whether and when will China move from a partly convertible to a fully convertible currency, and from a semi-pegged to a flexible exchange rate system? And, by the way, at what exchange rate would a flexible yuan be likely to trade?

What typically precipitates the devaluation question is a shortfall in several economic indicators behind goals previously announced by China’s leaders. In the first half of 1999, China’s exports and current account surplus decreased by about 9 percent compared to the corresponding period a year earlier. (Never mind that a smaller current account surplus, let alone a current account deficit, may in fact be quite healthy for a rapidly growing economy.) Foreign direct investment also declined by about 10 percent in this same period (at an annual rate of over $35 billion, FDI in China remains by far the largest among all developing countries). GDP growth, while having slowed a bit, has remained creditable, although it is probably one or two percentage points lower than the officially reported figures. Moreover, the economy is troubled by incipient deflation and even potential recession. Consumer prices have fallen by 1–2 percent in

*A slightly edited version was published in The Asian Wall Street Journal on October 25, 1999 under the title "Free the Yuan."*
the past year, and demand has weakened, notwithstanding substantial increases in government infrastructure spending.

Despite these and other problems, there are two reasons why the devaluation question as it is usually posed is wrong.

First, the connection between devaluation and the various indicators shortfalls which it is intended to remedy is remote. More than half of China’s exports depend on imported inputs. Devaluation would raise the yuan costs of these, as well as other imports. To the extent that the costs of such other imports as grain also rise and lead to increased labor costs, export gains from devaluation would be further reduced. Furthermore, the effects of devaluation would run counter to Beijing’s declared aim of reducing the large income disparities between the richer coastal provinces and the poorer central and western ones. The coastal regions, where exports are concentrated, would realize some gains from devaluation because of somewhat lowered yuan costs of exports, whereas the interior provinces would be adversely affected by the increased costs of imported consumer goods. Hence, the disparities between rich and poor would be aggravated.

The effect of devaluation on foreign direct investment is also ambiguous. On the one hand, devaluation would increase the exchange value of foreign funds and their ability to acquire and employ indigenous resources, thereby encouraging capital inflow. On the other hand, devaluation would equivalently reduce the exchange value of profits resulting from such investment, thereby tending to discourage FDI. Moreover, a devaluation now might engender worries that another devaluation would take place later, thereby further discouraging FDI. Devaluation would also tend to weaken China’s credit rating for commercial as well as sovereign debt, thus raising the costs of foreign borrowing.

The second, and still more important, reason why the question as usually posed is wrong is that it ignores the key issue of the yuan’s inconvertibility on capital account—a significant matter from the standpoint of China’s status as a “normal” and major player in the global economy. Both for China and the world economy, it is distinctly less important whether China has an inconvertible currency pegged, as it is currently, between 8.2 and 8.3 yuan per U.S. dollar or
pegged at a devalued rate of, say, 10.2 per U.S. dollar, than whether the yuan is fully convertible while its rate of exchange fluctuates, as does that of the dollar, yen, and euro. Hence, the devaluation question should be framed in terms of whether and when will China move from a partly convertible to a fully convertible currency, and from a semi-pegged to a flexible exchange rate system?

A convincing argument can be made that China is now, or soon will be, in a position to accomplish this major change, in the process generating significant benefits for the economy’s next development phase:

• The term structure of China’s foreign debt is favorable for convertibility: 80 percent of the debt is long-term.

• Foreign exchange reserves, estimated at $150 billion, are four or five times China’s short-term debt. Moreover, the $150 billion figure—an increase of 5 percent from a year ago—is probably underestimated. Since 1997, major exporters have been allowed to retain up to 15 percent of their foreign exchange earnings without recourse to the Central Bank, and at least some of these assets would be available to the central government if necessary.

• Convertibility of the yuan would provide a strong incentive for both direct foreign investment and long-term portfolio investment. To be sure, investors in China, as in other countries, would still face a currency risk, but one that would be more familiar, more manageable, and more hedgeable than that associated with pegged rates (as suggested by the collapse of pegged-rate systems in the 1997–1998 Asian financial crisis).

• Moving toward a convertible, flexible rate system by normalizing the status of China’s currency would enhance China’s stature in the World Trade Organization, and prospectively as a member of the G-7/8 Group.

• Finally, embracing a fully convertible, flexible rate system would be an invaluable element in furthering China’s economic liberalization efforts. At China’s relatively low interest rates (3–4 percent), convertibility would be likely to galvanize demand for capital in the entrepreneurial non-state sectors of the domestic economy, as well as boost foreign capital inflows. In the process,
China would become more open to and connected with the global economy.

It is not at all clear where a convertible and flexible yuan would actually trade against the dollar in the near-term and the longer-term future. China’s nominal (pegged) exchange rate is between 8.2 and 8.3 yuan to the dollar. Its purchasing power parity rate is at least two to three times that value: between, say, 3 and 4 yuan per dollar. It is as plausible that, with a convertible currency, the nominal exchange rate of the yuan would appreciate as that it would depreciate.

**Postaudit**

*As China continues to boost its foreign exchange reserves (by more than 40 percent since 1999, when this essay was written), the questions of whether and when it may shift to a fully-convertible yuan remain unanswered, as does the question of whether the exchange value would depreciate or appreciate.*