Agenda setting financial insight **December 28, 2016**

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China's currency faces big 2017 test

By William R. Rhodes

William Rhodes, a former senior vice chairman of Citigroup, is president and chief executive officer of William R. Rhodes Global Advisors and author of "Banker to the World: Leadership Lessons from the Front Lines of Global Finance."

As the Federal Reserve pursues a course of gradual interest rate increases, so the U.S. dollar is set to rise further and, quite possibly, continue gaining strength relative to all other major currencies in 2017. This may fortify export growth from the Eurozone, United Kingdom, Japan and China. However, the Chinese authorities will rightly see the trend as a net negative for their economy and, in particular, their increasingly fragile financial system.

The outlook for the renminbi, "the people's currency," which is key to the prospects for the world's second-largest economy, will be influenced by the Fed's actions and by President-elect Donald Trump's trade approach to China, and, most importantly, by Chinese domestic political developments.

Today's uncertainty surrounding the Chinese currency's exchange rate with the dollar will add to volatility in international financial markets – perhaps through most of 2017 until after the important 19th National Congress of the Chinese Communist Party late in the year.

The Chinese have been struggling to stabilize the exchange rate and depleted their foreign exchange reserves by over $1 trillion in the last year (down to a current total just above $3 trillion) for this purpose. All the same, the renminbi, also known as the yuan, is falling and set to go above 7 yuan to the dollar.

This approach to supporting the yuan is expensive, while the current use of both formal and informal capital controls is fundamentally unsustainable. These measures will do nothing to arrest the rise in the nation's balance sheet – its debt-to-GDP ratio has soared from around 150 percent of GDP in 2008 to as much as 282 percent today, McKinsey estimates. This factor has been a cause for diminished confidence in the currency, which has prompted major capital outflows.

The high level of debt reflects a financial system that has gone full throttle for economic growth and hurled prudent risk management aside. The mounting financial problems are due to out-of-control borrowing by state-owned enterprises in steel, coal, shipbuilding and other sectors, by municipal authorities, by real estate developers who are adding to an existing housing bubble, and by many corporations that have secured exceptionally large lines of credit from the major banks and from the shadow banking sector.

It was clear to me from my most recent visit to Beijing that the authorities are well aware of the situation, but that they might take only stop-gap measures now to secure some temporary relief. They are toying with debt-for-securities swaps as part of the solution. They may be allowing some banks to book loans as investments, rather than cleaning up their balance sheets and dealing with problem loans when they see them. Tougher and more comprehensive actions are needed and the more they are postponed, so the greater will be the eventual cost to economic growth.

President Xi Jinping, however, appears to be on course to consolidate his power. So he will not risk any slowing of the economy until after next autumn's 19th Congress, which will see the replacement of the majority of the members of the Politburo Standing Committee.

The authorities need to take a series of complementary actions as soon as possible that include: writing-off non-performing debts at banks and ensuring the recapitalization of some banks; bringing under rigid control the liquidity tap used by major public sector borrowers; closing zombie enterprises; and introducing legislation to regulate the expanding shadow banking sector that Moody's estimates at around 80 percent of GDP.

In addition to these financial measures, the authorities should take steps to encourage inward foreign direct investment. Potential foreign investors, however, are likely to remain on the sidelines irrespective of Chinese incentives so long as there is a lack of clarity about the ways in which the new Trump Administration will reshape U.S.-China trade relations.

American efforts to curb Chinese imports and impose high tariffs could add to the already mounting difficulties the Chinese leadership faces in striving to secure 2017 economic growth at what I believe is an increasingly optimistic goal of over 6.5 percent. Indeed, further pressures on the currency and delays in addressing fundamental domestic financial problems will have consequences for growth not only in China, but worldwide.

The author is a Reuters Breakingviews guest columnist. The opinions expressed are his own.

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