FINANCIAL TIMES

August 12, 2015 6:02 am

IMF gives cautious approval to China's new currency regime

Shawn Donnan in Washington

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The International Monetary Fund has offered a cautious endorsement of China's move to let the market play a greater role in setting the value of its currency, signalling the step could help Beijing's bid to win much-prized reserve currency status for the renminbi alongside the dollar, euro, yen and sterling.

In a statement issued as Beijing on Wednesday lowered the value of the renminbi by the second-largest amount in two decades, following Tuesday's 1.9 per cent devaluation, the IMF said China's new pricing regime was "a welcome step as it should allow market forces to have a greater role in determining the exchange rate". It cautioned, however, that the "exact impact will depend on how the new mechanism is implemented in practice".

China's move on Tuesday to change the way it has set the daily trading band for the renminbi since it first loosened its peg to the dollar in 2005 caught markets by surprise and prompted accusations that Beijing had decided to devalue to prop up a faltering economy and was thus launching a new round of the so-called "currency wars".

While China's timing may well have been linked to recent data pointing to a fall in exports and slowing economic growth, its move was also seen by many as bolstering its case for inclusion of the renminbi in the elite basket of currencies used to set the value of the IMF's own de-facto currency, its "special drawing rights".

The IMF's board is due to decide later this year whether to include the renminbi in that basket as part of a five-yearly review. Such a move, which would amount to an endorsement of the Chinese "redback" as one of the world's reserve currencies, had until recently been seen by many as largely a fait accompli until the IMF's staff last week offered a slightly sceptical assessment of China's case and whether or not its currency was sufficiently "freely usable" for inclusion.

One of the areas of concern for the fund has been whether China is prepared to let the market play a bigger role in determining the value of the renminbi and resist the temptation to continue to tightly manage its trading band.

But the People's Bank of China on Tuesday said it would now set the daily midpoint for the renminbi's trading band in line with where the currency closed the previous day, thereby handing the market greater influence than it had before. That amounted to a response to IMF doubts and again bolstered Beijing's bid, said Eswar Prasad, a former head of the IMF's China department who now teaches at Cornell University in the US.

"The PBoC has effectively defanged potential critics such as the US and the IMF by offering just what has been asked of it — more currency flexibility," he said.

The fund made clear in its statement that it wanted Beijing to be more ambitious still. "We believe that China can, and should, aim to achieve an effectively floating exchange-rate system within two to three years," it said.

The IMF also insisted that the changes announced by Beijing had "no direct implications" for the criteria it would use to determine whether to include the renminbi in the SDR basket. It conceded, however, that "nevertheless, a more market-determined exchange rate would facilitate SDR operations in case the renminbi were included in the currency basket going forward".

Tuesday's reform is far from the last China will have to undertake if it wants to see the renminbi embraced by the IMF. It also faces other potential obstacles.

Among those are US politics and a lingering scepticism in Washington about Beijing's intentions. The US is the IMF's largest shareholder and wields veto power over most of its decisions.

US Treasury officials have all but embraced China's bid to have the renminbi included in the IMF basket, arguing that if Beijing enacted the necessary reforms to achieve that it would be positive for the global economy. They stuck with that line on Tuesday, cautiously welcoming the PBoC's move.

But others in Washington remain suspicious.

We believe that

Adam Posen, head of the Peterson Institute for International Economics, a think-tank that has long campaigned against currency manipulation, said he was concerned China was launching what could turn out to be a prolonged devaluation campaign amid an "air of interventionist panic" in Beijing.

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>
> \- IMF statement

In Congress critics of China also immediately seized on the PBoC's move. Charles Schumer, a New York Democrat who has long pushed for the US to be tougher on Beijing's currency policies, called for the IMF to be barred from including the renminbi in its reserve basket.

"Given China's history of devaluing its currency to gain an unfair export advantage, [Tuesday's] actions by the Chinese government raise serious concerns," said Sander Levin, the top Democrat on the influential House Ways and Means committee. "There is reason to be sceptical . . . that the largest devaluation of the Chinese currency in over two decades is merely about moving to a market-based exchange rate."

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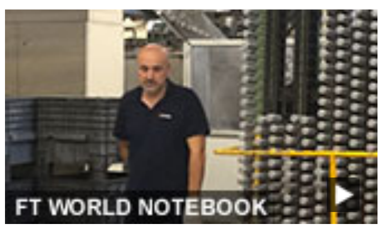

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