FINANCIAL TIMES

Guest post: Rmb flexibility, not price, should be the west's concern

May 2, 2012 5:55 am by beyondbrics

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The political pressure for China to allow for more currency appreciation remains strong even as the economic pressure on China's currency to appreciate in value has temporarily dissipated. Liberalising China's currency regime is now less about correcting external imbalances than it is about helping to deal with domestic imbalances and promoting the currency's international use.

Popular discussion about the renminbi tends to focus on its nominal value relative to the US dollar, which has been managed tightly on a day-to-day basis by China's central bank. Extensive intervention by the central bank to prevent China's currency from appreciating too rapidly has resulted in an eye-popping $3.3tn in foreign exchange reserves.

Despite this extensive intervention, on a cumulative basis the renminbi has in fact appreciated considerably against the dollar in recent years, especially when adjusted for inflation in China versus the US. The renminbi has also appreciated against the currencies of most of its major trading partners.

The real exchange rate is a better measure of a country's external competitiveness as it accounts for domestic inflation relative to foreign inflation. The real effective exchange rate (REER), a composite measure that weights bilateral real exchange rates against each of China's major trading partners by their shares in China's total trade, provides a broader view of the country's external competitiveness.

An interactive graphic on the FT website shows how the renminbi's real effective exchange rate and also real exchange rates versus the currencies of China's main trading partners have fluctuated over time.

Since 2000, just prior to China's WTO accession, its REER has appreciated by about 20 per cent. China experienced a bout of deflation around 2002-03 and its REER actually depreciated from 2003 through 2005. The REER has appreciated by 30 per cent since June 2005, when China de-pegged its currency from the dollar. Over the past year, the REER has appreciated by 5 per cent.

Since 2000, the renminbi's real exchange rate has appreciated significantly versus Japan, the UK and the US, appreciated modestly relative to Germany, and stayed almost unchanged relative to the euro. One would expect eurozone countries to be a lot more critical than the US about China's currency regime! The renminbi has depreciated significantly relative to the Australian dollar, Indian rupee and Brazilian real, mostly because of higher inflation in those countries.

Over the past year, the renminbi has appreciated in both nominal and real terms relative to all of its trading partners. The real appreciation ranges from 15 per cent versus the Brazilian real, 12 per cent versus the euro, 5 per cent versus the US dollar to 2 per cent versus the Singapore dollar.

This renminbi appreciation says nothing about whether or not the renminbi is at its "equilibrium" market-determined value. The following data should make it harder to support the case that Chinese intervention in the foreign exchange market is perpetuating undervaluation of the renminbi in the short run:

- The current account surplus has declined steadily from a surplus of 10.1 per cent of GDP in 2007 to 2.8 per cent in 2011.
- The trade surplus fell from its peak of 7.5 per cent of GDP in 2007 to 2.1 per cent in 2011, and was essentially zero in January-February 2012.
- Capital inflows have slowed down while capital outflows have picked up as controls on outflows continue to be liberalised.
- There was no net accumulation of reserves in the last half of 2011, a sharp fall from accumulation of $150-200bn per quarter in the preceding four quarters.

It is an open question how much of the decline in China's trade and current account surpluses is purely cyclical, reflecting global financial turmoil and strong growth in China while its major advanced economy markets remain weak. Indeed, as world financial markets stabilised in the first quarter of 2012, reserve accumulation bounced back to $124bn.

Over the long term, the renminbi is likely to appreciate further. Long-term exchange rate movements tend to be driven by productivity differentials and China is expected to continue delivering higher productivity growth relative to its trading partners, especially the advanced economies.

China's central bank recently announced a significant step in the road towards greater exchange rate flexibility - a widening of the trading band for the renminbi relative to the dollar. The benefits of currency flexibility are well recognised: It would help China develop a more independent monetary policy; its central bank could set interest rates to meet domestic objectives, rather than being driven by concerns over inflows or outflows of foreign capital due to differences between domestic and foreign interest rates. This would help promote financial sector reforms by allowing the central bank to use interest rates to guide credit allocation. In turn, the reforms would help rebalance growth by boosting domestic consumption.

If China is serious about making the renminbi a powerhouse global currency, liberalising its currency regime is a prerequisite. A more flexible currency is an important step on the path to an open capital account, as well as broader and stronger financial markets.

Focusing on flexibility of the currency rather than a "desirable" level of the renminbi is a more productive approach for the US and the international community to engage with China on the currency issue. And one that Chinese policymakers ought to take to heart as being in their own interest.

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