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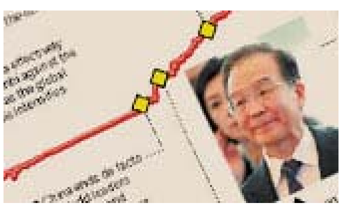
Renminbi slide raises stakes for Beijing

By Robert Cookson in Hong Kong

For more than a decade, investors could depend on one thing no matter how dire the state of global financial markets: the renminbi would not fall against the US dollar.

For sure, it wobbled. But the renminbi's dips were always small, brief interruptions to its upward trajectory. Even when Lehman Brothers collapsed in 2008, Beijing in effect pegged the renminbi to the dollar rather than let it fall.



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Not any more. The Chinese currency has weakened 1 per cent against the dollar so far this year – a modest move by the standards of most currencies but a big fall for the renminbi, which had appreciated more than 30 per cent since 2005 under tight control by Beijing.

"It's a very big deal that we're seeing a clear depreciation," says Dariusz Kowalczyk, economist at Crédit Agricole in Hong Kong. "There was a paradigm in financial markets for a very long time that the renminbi can only appreciate."

With the Chinese economy slowing sharply, traders are now betting the renminbi will fall further in the coming months; a decline that would have repercussions in China and beyond.

The renminbi/dollar exchange rate is the key financial metric that connects China to the world. The country uses the dollar to settle more than 70 per cent of its import and export transactions and also holds the bulk of its $3.2tn of foreign exchange reserves in the US currency.

The exchange rate is also a source of conflict with Washington. US politicians, gearing up for a presidential election in November, have long accused Beijing of holding the renminbi at an artificially low level to give its exporters an edge.

Renminbi weakness, if sustained, could hinder Beijing's plan to internationalise its currency, since people tend not to accept a currency they fear will lose value. One of the main reasons investors piled into renminbi-denominated assets such as "dim sum bonds" in recent years was the expectation of currency appreciation.

With so much at stake, the question is whether the renminbi will fall further against the dollar and if so, how far and how fast?

Much depends on how the dollar fares against other major currencies such as the euro and the yen.

On a trade-weighted basis, the renminbi has appreciated by about 8 per cent over the past year in both nominal and inflation-adjusted terms relative to a broad group of China's major trading partners.

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That has made Chinese exporters less competitive – and prompted the China Securities Journal, an influential state newspaper, to argue last week that the renminbi needed to depreciate.

Eswar Prasad, a senior fellow at the Brookings Institution in Washington, reckons Beijing will do what it can to keep the renminbi's value "reasonably stable" relative to the dollar.

He says: "An appreciation would hurt export growth, which is already weak, while a significant depreciation could suggest a loss of economic control and sharpen concerns about China's growth prospects."

Inflows of foreign money into China have slowed this year and there are signs that Chinese investors are increasingly evading the country's strict capital controls to send money offshore.

In expectation of renminbi depreciation, Chinese companies have been accumulating dollars at a record pace this year and total foreign currency deposits have increased $137bn, or 50 per cent, since January.

All that has put pressure on the domestic exchange rate, which is allowed to fluctuate up to 1 per cent either side of a midpoint set each day by the People's Bank of China.

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On several occasions this year, most recently in July, the renminbi has fallen to the bottom of its trading band and traders suspect the PBoC was forced to support the currency.

While most economists expect the renminbi will stay flat or rise slightly over the next year, financial markets tell a different story.

In the non-deliverable forward market, where traders place bets on the future exchange rate, the renminbi is priced to fall 1.3 per cent against the dollar over the next 12 months.

Some experts say the decline will be much more substantial. Jim Walker, an economist who predicted the 1997 Asian financial crisis, forecasts a 5 per cent depreciation over the next year because "corporate financials in China are deteriorating dramatically".

If the renminbi were a free-floating currency, it could well fall much more than 5 per cent, he says. But Beijing would not allow the renminbi to go into free fall, he adds, since that would enrage US Congress and risk retaliation.