New renminbi regime looks like deft political move

By Geoff Dyer in Beijing

Published: June 20 2010 09:37 | Last updated: June 20 2010 20:33

China's **announcement** at the weekend that it will introduce more flexibility into its exchange rate is a deft political move amid rising international criticism of Beijing but the economic implications are much less certain.

Although Chinese officials said on Saturday the decision was taken for domestic reasons, the announcement comes a week ahead of a **G20 summit** in Canada that was shaping to be something of a **showdown over the level of the Chinese currency**.

By indicating that the peg between the renminbi and the US dollar is now likely to be broken, Beijing has "stolen the thunder" from the US and other governments which hoped to use the summit to put pressure on China, said Eswar Prasad, a former IMF China economist now at Cornell University.

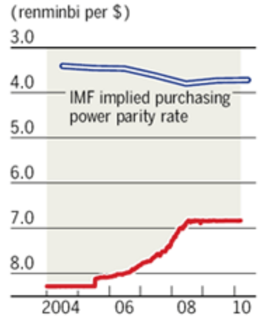
"They have taken the issue right off the table for the G20 and can refocus attention on what they see as the real problem for global financial stability - rising government debt in the advanced economies, especially the US," he said.

This is not the first time that Beijing has used carefully timed announcements to deflect attention from its policies. In the run-up to the first G20 summit in April last year, international debate about the global financial crisis was beginning to focus on China's large current account surplus.

However, 10 days beforehand, Zhou Xiaochuan, head of the central bank, released a paper calling for the eventual replacement of the US dollar as the global reserve currency. That proposal has been little discussed since, but it did have the desired political effect of shifting the focus back to the US economy.

Renminbi against the dollar

(renminbi per $)



Source: Thomson Reuters Datastream

And in recent weeks, as US criticism of China's undervalued currency intensifies, Beijing has again argued that the US economy is the real problem. "They themselves issue the major international reserve currency. What they are doing with their own currency will affect the global economy much more than anything else," one senior government official said last week.

What the weekend statement actually means for the day-to-day practice of China's exchange rate is more difficult to predict. The central bank's announcement ruled out the two things that had been expected in any significant change of policy – a sizeable one-off appreciation and a widening of the bands between which the currency trades.

The implication, therefore, is that Beijing will return to a pre-crisis policy of a crawling peg against the US dollar, possibly starting on Monday.

Yet economists believe there are plenty of reasons to expect only a very slow strengthening of the renminbi against the dollar in the near future. China's exchange rate against the euro has already appreciated 15 per cent in recent months, raising worries about slowing exports to China's biggest market. **Inflation in China is now higher** than most of its trading partners, meaning that China's real exchange rate is also rising.

Moreover, Chinese officials point to the sharp drop in the country's current account surplus as evidence that substantial rebalancing of the economy is already taking place – even though the surplus could yet balloon in the second half of the year as investment-related imports slow.

Andy Rothman, an economist at CLSA in Shanghai, says he expects appreciation against the US dollar in the short-term of 0.2 per cent a month – well short of the likely level needed to appease critics in the US and elsewhere.

Indeed, the greater "flexibility" that the central bank announced could potentially also include occasional periods of depreciation against the dollar. The Chinese authorities are aware of the risk of setting up a "one-way bet" on the currency that ends up attracting capital inflows into the economy.

By stressing that the renminbi will be managed against a basket of currencies, authorities have an excuse to weaken the currency against the dollar and punish speculators if the euro continues to depreciate. "The greater two-way volatility between the renminbi and the dollar will help mitigate hot money inflows," said Jun Ma, an economist at Deutsche Bank.

Managing the float

- By saying that it will introduce a more flexible exchange rate policy, China's central bank appears to be reverting to the foreign exchange system it introduced in July 2005, when it abandoned an explicit dollar peg.
- The managed float system links the renminbi to a basket of currencies of its main trading partners. In practice, economists say, the currency has mainly tracked the US dollar.
- Every day the central bank sets a reference rate for the renminbi against the dollar. The renminbi is then allowed to rise or fall 0.5 per cent around that mid-point, although daily fluctuations have tended to be much smaller.
- The renminbi rose about 21 per cent against the dollar from 2005 to mid-2008 and the start of the financial crisis, but since then it has remained stable.

Just as before Saturday's announcement, therefore, China's currency policy will depend heavily on what happens in Europe over the coming months. The central bank, which has been battling to strengthen the renminbi for some time to cool the economy and give it more control over monetary policy, has won a tactical victory over pro-export lobbies.

If the situation in Europe stabilises, the central bank could yet secure the political backing to resume a more decisive path of appreciation against the dollar. But until then, analysts say, its hands are likely to remain tied, despite the powerful political punch of its weekend announcement.