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Right time for China to liberalise renminbi

By Eswar Prasad

The Obama administration has raised the stakes in its increasingly tense stand-off with Beijing on trade and currency issues. It has set up a new agency to investigate China's trade practices and, along with Japan and the European Union, recently initiated a process through the World Trade Organisation to challenge the restrictions that China places on exports of rare earth minerals.

Despite the improving employment picture in the US, the economic and political arguments for taking a tougher line against China in an election year are overriding longer-term strategic considerations. With China in the throes of its own leadership transition, the situation is ripe for an escalating trade conflict that could damage the global trade system and wreck the fragile world economic recovery.

There is a simple solution for Beijing to disarm its critics, make progress on its own domestic reforms and show the kind of leadership that would help cement its role as a global economic power.

This is a perfect time for China to move towards a more flexible currency regime by announcing a wider trading band for the renminbi. The benefits of currency flexibility are well recognised, including by its central bank.

The shift in currency regime would help China develop a more independent monetary policy. Its central bank could set interest rates to meet domestic objectives, rather than being constrained by fears it might be swamped by flows of foreign capital responding to differences in 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.

China has been hesitant about widening the renminbi's trading band because of the worries over surges of speculative inflows, which would result in severe appreciation pressures on the renminbi. Such forces could be offset by intervening in the foreign exchange market, but it would be at the cost of further complicating domestic monetary policy and adding to its large stockpile of reserves.

But in recent months, pressures for renminbi appreciation have eased, creating an opportunity to make headway on currency policy. China's strong economy has kept import growth high, yet export growth has slowed as a result of weaknesses in the major advanced economies. Over the past two months, China recorded a small trade deficit, a reversal from the large surpluses of recent years.

As in other emerging markets, the flight to safety as the eurozone debt crisis drags on has diminished capital inflows, resulting in virtually no net accumulation of reserves in the second half of last year.

All signs suggest that markets anticipate little or no appreciation of the renminbi over the next year, an expectation that is unlikely to be drastically altered by a shift to a more flexible currency regime.

These favourable conditions for a shift in policy may not last long. China needs to grab this opportunity before resurgent trade surpluses or capital inflows again induce the renminbi to resume its appreciation.

However, selling the move domestically will be tricky because it could be seen as yielding to external forces. During a time of leadership transition, it will be even more difficult. How can China's leaders present this change in policy to a very sceptical audience?

There's a simple answer, one that even the People's Bank of China recently endorsed in a paper by one of its staffers. A more flexible currency is an important step on the path to an open capital account, as well as stronger and broader financial markets. In other words, this shift would serve China well in the process of making its currency more widely accepted internationally.

The notion of making the renminbi a powerhouse global currency ought to resonate well with nationalistic sentiments and help blunt domestic opposition to currency reform.

Timing is everything in global finance and politics. China has a perfect opportunity to sharpen its macroeconomic policy tools, promote its own balanced economic development, elevate the global stature of its currency and help avert a trade war that nobody wants.

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