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Guest post: downside of Rmb flexibility

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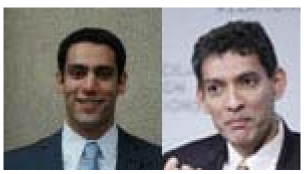

By Eswar Prasad and Karim Foda of the Brookings Institution

The renminbi has become more flexible but, in light of global financial market turmoil and concerns about China's growth, the notion that the renminbi can only go in one direction has been repudiated.

Greater flexibility of the renminbi should serve China welll, but could prove to be a mixed blessing in the short run for China's major trading partners.

In view of the economic slowdown and the upcoming leadership transition, the Chinese government is likely to do what it can to keep the renminbi's value reasonably stable relative to the dollar. 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.

The FT China currency tracker summarises the twists and turns in the renminbi's fluctuations relative to the currencies of China's major trading partners.

Over the past 12 months, the renminbi has appreciated by just 1 per cent relative to the US dollar, although the renminbi-dollar rate has fluctuated significantly in both directions over this period. The dollar's strength during a period of continued global financial turmoil has resulted in the renminbi's appreciation against the currencies of virtually all of China's major trading partners.

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

Despite the much higher inflation rates in Brazil and India compared to China, the weaknesses of the real and rupee over the past year have resulted in the renminbi's sharp appreciation relative to those currencies even in inflation-adjusted terms (19 per cent versus the rupee; 30 per cent versus the real).

More troubling for China is that the renminbi has appreciated by about 17 per cent relative to the euro over the past year. The EU is the leading market for China's exports. The eurozone's economic weakness coupled with the renminbi's appreciation relative to the euro will continue to dampen prospects for China's export growth.

Since the beginning of 2012, and especially since the widening of the floating band in April, the renminbi has shown some flexibility in both directions. On a broad trade-weighted basis, the renminbi has appreciated by about 1.6 per cent relative to the currencies of its major trading partners (0.9 per cent in inflation-adjusted terms).

Interestingly, the renminbi has depreciated by about 1 per cent relative to the US dollar, in both nominal and inflation-adjusted terms, since the beginning of this year. This probably reflects weaker capital inflows due to concerns about the Chinese economy and global economic uncertainties, as well as greater outflows as China continues to open up its capital account and reduce outflow restrictions. The renminbi has, however, continued to appreciate sharply relative to the euro.

During 2012, the renminbi has appreciated in both nominal and real terms relative to the currencies of some its major Asian trading partners such as Korea, Malaysia and Singapore. The falling Indian rupee has resulted in a sharp nominal appreciation of the renminbi relative to that currency. However, the much higher inflation rate in India relative to China implies that, in inflation-adjusted terms, the renminbi has in fact depreciated against the rupee.

The prognosis for the renminbi's value over the remainder of this year is one of stability relative to the dollar and a rollercoaster ride relative to other currencies, in tandem with the dollar's fluctuations against other major currencies.

Of course, whether concerns about the US economy or global financial turmoil will push the dollar up or down is anyone's guess.

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