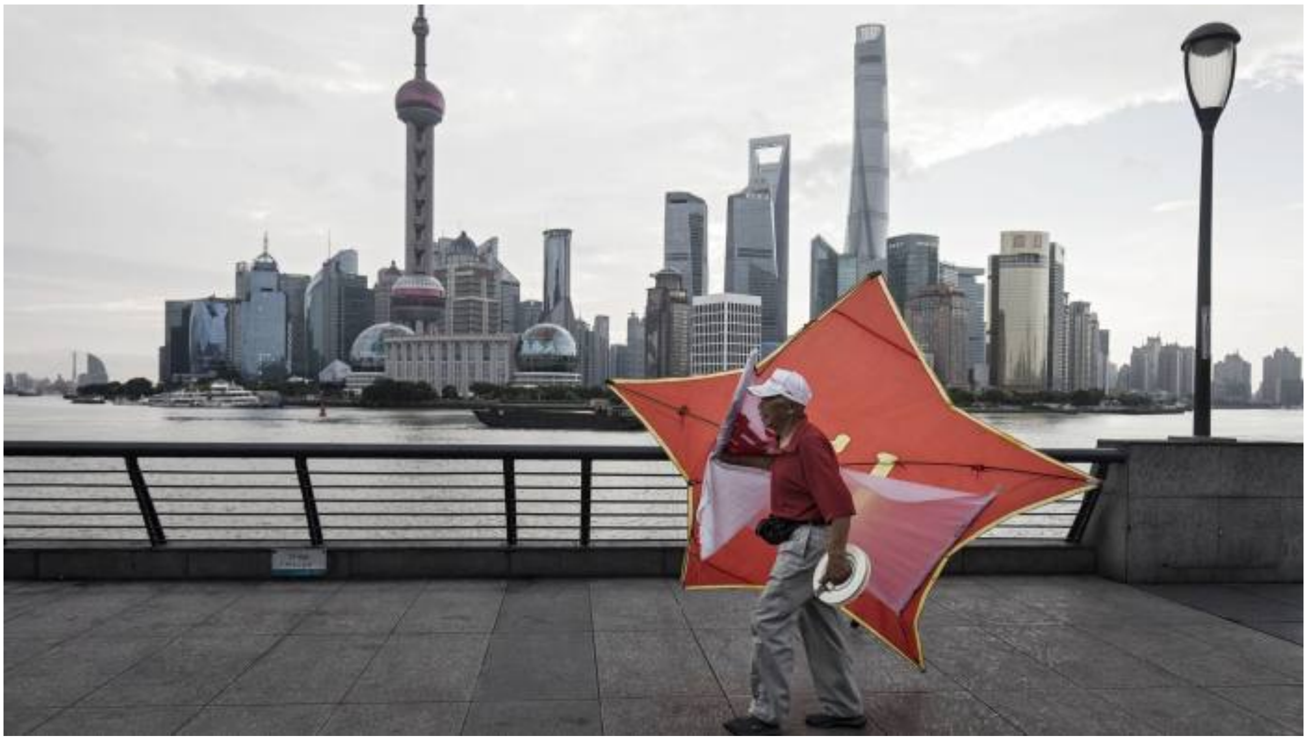
Renminbi

China needs to come clean on its exchange rate policy

The central bank must let the renminbi's value go where market forces take it

Eswar Prasad



A man carries a kite in Shanghai. A flexible and market-determined exchange rate, along with a more open capital account, would benefit the Chinese economy © Bloomberg

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Yet again, China's currency, the renminbi, is under pressure. After three years when it was fighting to keep the currency's value from depreciating too quickly relative to the dollar, the tide has shifted once more for the People's Bank of China. Now, as in the decade since it ostensibly delinked the renminbi from the dollar in 2005, the central bank is striving to limit the currency's appreciation against the dollar.

Policies governing the capital account, which influence fluctuations in the currency's value, have also come full circle. In the early years of this decade, the government gradually liberalised capital outflows. The hope was that more outflows would reduce appreciation pressures by offsetting the copious sums of money flowing in through trade surpluses and capital inflows.

Then, for the past three years, these policies were reversed as the currency faced depreciation pressures. Concerns about risks to growth and the financial system stoked a spiral of currency depreciation and capital outflows. The central bank tightened up on capital outflows. This initially led to more panic-driven outflows, but eventually the PBoC won the battle.

Now the PBoC has a golden opportunity to take some steps that would mitigate these cycles in the currency's value and increase the institution's control over monetary policy. But it must fix its approach to capital flows as well.

The opportunity has arisen since investors seem confident that China has weathered its short-term problems and can stay on its growth path. The fall in the dollar's value against other major currencies such as the euro and the Japanese yen has helped. The PBoC has been able to let the renminbi appreciate modestly against the dollar without losing competitiveness against China's other large export markets.

As evident from recent history, such windows of opportunity can slam shut in short order. So the PBoC must act rather than continue reacting to developments that are not under its control.

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Each country and each experience with changing a currency regime is special in its own way. But one common lesson from history is that exiting from a fixed or tightly managed exchange rate at a time of depreciation pressures adds to market turmoil, making the exit messier and harder to manage. Doing this from a position of strength, and combining it with policies to open up the capital account further, could stave off these pressures.

Going back and forth on capital account policies in order to handle exchange rate volatility reduces the credibility of those and other policies, making them more suspect and less effective. China recently opened up its corporate and government bond markets to foreign investors. But there was little interest, despite the attractive yields on some of these bonds, because the government was clamping down on outflows at the same time. The government's reassurances that there would be no restrictions on repatriations of earnings and investments in such bonds rang hollow to potential investors.

The PBoC simply needs to act on its stated policy of managing the renminbi's value against a basket of currencies. But with its credibility in question, the central bank will need to be candid about its exchange rate policy and show its commitment to letting the rate go where market forces take it. And it must forswear gambits such as the "countercyclical adjustment factor" that it announced some weeks ago. Such actions are seen as thinly-veiled excuses for the PBoC to continue orchestrating the currency's value, especially against the dollar, if market forces push it in a direction that it sees as undesirable.

A flexible and market-determined exchange rate, along with a more open capital account, would benefit the Chinese economy. This combination would help develop domestic financial markets through the participation of foreign investors and give Chinese investors the opportunity to benefit from international portfolio diversification. More exchange rate flexibility allows the central bank to use monetary policy and other market instruments to manage inflation and control credit. This in turn would help in reforming the banking system, improving the allocation of capital, and alleviating financial system risks.

This combination of policies is also essential for China's ambition of elevating the renminbi's prominence in global financial markets, an aspiration that has taken a beating recently. The PBoC could benefit itself and China's economy by practising what it claims, not just when convenient but as a commitment.

The writer is a professor at Cornell University and senior fellow at the Brookings Institution