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Guest post: soaring reserves put renminbi back in the spotlight

Apr 15, 2013 2:00am by beyondbrics

By Eswar Prasad and Karim Foda

Last year was a calm one for the renminbi. China's trade and current account surpluses fell below 3 per cent of GDP in 2012, suggesting that the economy was on its way to resolving its protracted external imbalances. Capital inflows eased off and capital outflows rose as the government liberalised controls on outflows. Net accumulation of foreign exchange reserves was just over $130bn, compared to $330bn in 2011 and an average of nearly $450bn per year in the four years preceding that.

But the surge in reserves in the first quarter of 2013 has put the renminbi is back in the spotlight. Rising capital inflows have led to a surge in accumulation of reserves as China's central bank has attempted to fend off pressures for the renminbi to appreciate.

Back in 2012, the pressures on the renminbi appeared to have become more balanced. In fact, for most of the year, the offshore non-deliverable forwards (NDF) market indicated expectations of mild renminbi depreciation relative to the US dollar. In April 2012, the government increased the flexibility of the exchange rate, allowing the renminbi to rise or fall by 1 per cent each day relative to the midpoint of the trading range determined by the People's Bank of China (PBC). Soon after that, the renminbi briefly retreated in value against the dollar before returning to a slow pace of appreciation.

This year could prove to be a more interesting year on the currency front. Capital inflows into China seem to have picked up due to a mix of pull and push factors. The economy's short-term growth prospects seem solid, although Chinese equity markets have not performed well. The major advanced economies are likely to maintain protracted low interest rate and easy money policies, pushing capital out to China and other emerging markets.

The economy seems to have settled down to a pace of 7-8 per cent GDP growth. Inflation appears under control, leaving room for a strong policy response to counter any slowdown in growth. There are many risks to this relatively benign scenario, including concerns about local government debt, the housing market, and financial system weaknesses.

Still, capital flows to China are likely to increase, particularly since the government has been easing restrictions on inflows. This will maintain appreciation pressures on the currency barring any major global financial turmoil – for instance from a flare-up of the eurozone debt crisis – that could pull capital back from emerging markets to the traditional safe haven currencies.

China currency tracker: interactive on FT.com

On a trade-weighted basis, the renminbi's nominal effective exchange rate relative to its major trading partners has appreciated by 3 per cent over the past twelve months. The inflation-adjusted real effective exchange rate has appreciated by 5 per cent over this period – although China has maintained moderate inflation, many of its advanced economy trading partners have even lower inflation rates.

Over the past twelve months (March 2012 to March 2013), the renminbi has appreciated relative to the currencies of virtually all of its major trading partners. In inflation-adjusted terms, the renminbi's value has risen sharply against the yen – by nearly 18 per cent. By this measure, the renminbi has also appreciated by 5.9 per cent relative to the euro and 1.5 per cent relative to the US dollar. Measured relative to its recent low against the dollar in August 2012, the renminbi is now up by about 3 per cent against the dollar.

The renminbi's modest appreciation relative to the dollar suggests that the exchange rate is still being tightly managed by the PBC through its intervention in foreign exchange markets. Indeed, in the first quarter of 2013, China added $128bn to its stockpile of reserves, pushing them to a level of $3.44tn.

With the US bilateral trade deficit with China hitting a new high of $314bn in 2012 and US job growth still at dismal levels, China's currency policy could once again become a source of tension between the two countries. This would not bode well for the bilateral economic relationship and could also raise global trade tensions, particularly as China and other emerging markets continue to feel victimised by aggressive monetary easing in the major advanced economies.

Continued liberalisation of capital outflows will help take some of the pressure off from any increase in inflows. Still, there is a strong case for allowing more flexibility in China's exchange rate. This would have many other domestic benefits as well. As China continues to open up its capital account, greater exchange rate flexibility will be important to make the process smoother and to facilitate the move towards free convertibility of the renminbi. It will also boost monetary and financial sector reforms.

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