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Renminbi marks new trading regime with fall to 11-month low

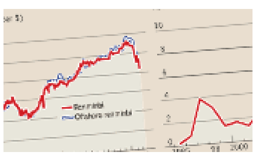
By Delphine Strauss in London and Josh Noble in Hong Kong

China's central bank underlined its intention to give the market a bigger role in determining the value of its currency when it announced a doubling of the renminbi's trading band on Saturday. But investors stung by its recent clampdown on speculators will be cautious in testing its tolerance of greater volatility.

In the short term, many appear to be betting that the authorities will countenance – or engineer – a mild depreciation. The renminbi marked the first day of its new trading regime with a 0.5 per cent fall, taking it to an 11-month low of 6.1784 against the dollar in the onshore market. Offshore, it hit its lowest level since May before recovering to trade 0.1 per cent down at 6.1630 to the dollar.

Although the People's Bank of China had set its daily fixing rate slightly stronger than on Friday, preventing a bigger fall, analysts think that policy makers may still want to drive out hot money, underlining their message that speculators should not rely on one-way appreciation in the renminbi.

Renminbi



Dollar exchange rate and China's current account balance

"We don't think that the government's short squeeze is over yet," say analysts at Credit Suisse, who add that until China's huge current account surplus is much smaller, or capital outflows much larger, volatility is likely to be mainly a function of the PBoC's fixings and its interventions in foreign exchange markets.

Mounting evidence of a slowdown in China's economy is also weighing on the currency. "As the economy may weaken further in coming months and the cost of capital may drift lower, the renminbi exchange rate could be mostly driven by short-term capital flows, which are likely outbound," say analysts at Citigroup.

The real question, though, is when the central bank will feel able to scale back its interventions and end its practice of daily fixings to control the currency.

Eswar Prasad, a senior fellow at the Brookings Institute and a former head of the IMF's China division, thinks the band-widening move – together with the PBoC's recent proposal to liberalise bank deposit rates within two years – are "important signals of the government's commitment to financial market liberalisation at a fairly aggressive pace."

China may never entirely cede control of its currency, he says, but policy makers at the central bank view a more flexible exchange rate as an essential part of its drive to open China's capital markets and make the domestic financial sector more competitive.

"Higher volatility [in the exchange rate] will enable the PBoC to set interest rates higher to curb credit growth in the economy," say analysts at Commerzbank, who think the next steps before the central bank can end its daily fix will be to introduce a banking deposit guarantee and deregulate deposit rates.

Since the PBoC must overcome other institutions' doubts about this drive to liberalise, some speculate that it might prefer a weaker currency in the short term – to show that a freer exchange rate need not hurt the economy.

"It is much more in their interest for the currency to go down," says Diana Choyleva, an economist at Lombard Street Research, who thinks the renminbi is in any case heavily overvalued.

"One key challenge for Beijing is to properly sequence the interest rate and exchange rate reforms," says Stephen Jen, head of the currency hedge fund SLJ Macro Partners.

However, the big change from previous rounds of currency liberalisation is that there is no longer a clear consensus on which way a free-floating renminbi would move.

Economists' forecasts for the currency are at present as much about second-guessing policy makers as they are about calculating the renminbi's fair value; and the latest move by the PBoC has prompted analysts to both raise and lower their estimates for its movement over the next year.

But Citi's analysts think the fall in China's current account surplus over the past five years, from 10 per cent of gross domestic product in 2007 to 2.1 per cent last year, leaves the renminbi near its equilibrium.

Mr Jen notes that it has strengthened some 35-40 per cent against the dollar since 2005, once inflation has been taken into account, and says: "I don't think Beijing or anyone else knows exactly where the equilibrium levels of the Rmb is, but my guess is that it is not too far from here."

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