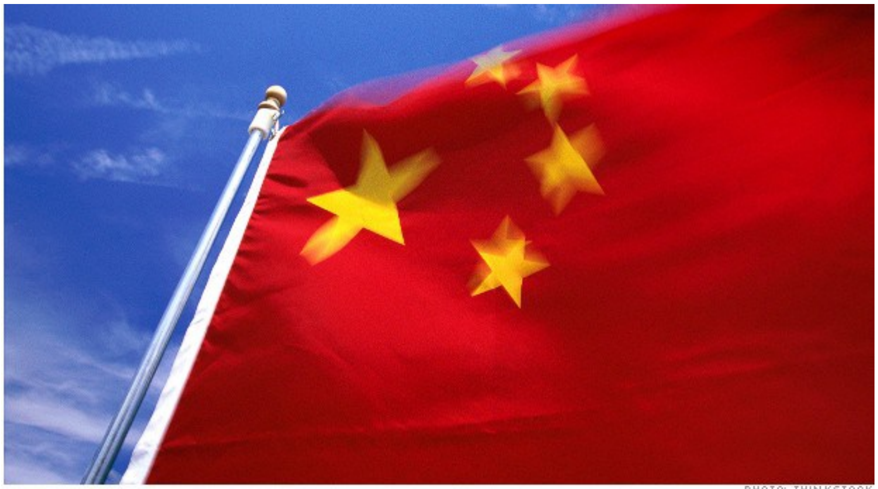
China's lofty currency plans are just getting started

By Christopher Matthews March 24, 2014: 1:23 PM ET

Last week's coordinated depression of the yuan is a sign that the world's second-largest economy is looking to secure a much larger role in the global economy.



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FORTUNE -- For years, investors around the world knew that China's currency was going just one way: up.

After the People's Bank of China (PBOC) announced last week that it would allow its currency to trade in a wider daily band of 2% rather than 1%, analysts expected this to simply mark another step in the direction of allowing the currency to appreciate to a value more in line with the relative strength of the Chinese economy. But when trading began last week, the renminbi actually fell steadily, to its lowest level in nearly a year.

The conventional wisdom is that China's central bank engineered this move, first by aggressively selling renminbi itself and then in coordination with state-owned Chinese banks and Chinese exporters. **Here's a *Financial Times*** report from last Thursday:

> The **renminbi's decline** began one month ago with sustained intervention by the People's Bank of China, but most companies and banks remained on the sidelines in the onshore market, anticipating that depreciation would be shortlived.
>
> However, traders said important market players -- from state-owned oil companies to private sector exporters -- had capitulated in recent days and were now positioning themselves for a weaker renminbi for longer.

So it would appear that the Chinese central bank, state-owned companies, and the private sector are engaged in a full-court press to drive down the value of the yuan. The appeal of this strategy is clear for exporters, as a weaker yuan means fatter revenues for China's export-dominated economy. But the reason for this maneuvering goes beyond helping exporters get through a period **when the Chinese economy appears to be weakening**.

According to Eswar Prasad, an economist at Cornell University and author of ***The Dollar Trap: How the U.S. Dollar Tightened Its Grip on Global Finance***, the move is part of a complicated dance in which the Chinese government is attempting to slowly liberalize its financial markets and allow the renminbi to take on a more prominent role in the global economy. "The widening of the trade band and the decline of the yuan are part of the same story," Prasad says. "In terms of getting domestic political support for this move, I feel the PBOC was under pressure to show that this would not immediately lead to a jump in the renminbi's value."

So the PBOC had to coordinate the depreciation of the renminbi in order to satisfy politically powerful exporters, but it was also a move to give the central bank and reformers inside the Chinese government wiggle room to further liberalize its economic policy. As Qu Hongbin, co-head of Asian Economic Research and Chief Economist at HSBC **has written**:

> China has a three-pronged approach to renminbi internationalisation: expand the currency's role in foreign trade settlement -- it has already overtaken the euro to become the second to the dollar -- encourage its use in cross-border investment, and develop offshore renminbi centres.

In other words, China is trying to help its currency ascend to the status of a reserve currency. Being an international reserve currency has many benefits, including increased geopolitical power, as well as the ability to borrow cheaply in international markets. But to get there, China is going to have to give up its control of the value of the remninbi, as well as loosen its capital controls. That means allowing foreigners to invest more heavily in Chinese companies and permitting Chinese citizens to invest money abroad. All of these moves are going to effect the value of the renminbi. Chinese investing money abroad will push the value of the renminbi down, allowing more outside investment in China will push it up. And the PBOC allowing more volatility in the remninbi will relieve some of the pressure that all this new economic activity will have on the Chinese economy.

We're used to seeing China work to keep the value of its currency down to help its export-driven economy. But last week's coordinated depression of the yuan is a sign that the world's second-largest economy is moving away from a concerted effort to undervalue its currency and toward policies that will lead to it ultimately appreciating and taking on a larger role in the global economy.