Interview with Eswar Prasad

Eswar Prasad is the Tolani Senior Professor of Trade Policy in the Dyson School at Cornell University. He is also a Senior Fellow at the Brookings Institution, and a Research Associate at the National Bureau of Economic Research. He was previously chief of the Financial Studies Division in the International Monetary Fund's Research Department and, before that, was the head of the IMF's China Division. He has written extensively on exchange rate policies in emerging markets, financial regulation, capital flows, and monetary policy. He published a new book this year: *The Dollar Trap*.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: What is the role of the RMB in the global monetary system?

Eswar Prasad: The Renminbi is playing an increasingly prominent role in the global monetary system. It is already gaining significant traction as an international currency, that is to say a currency that is widely used in trade and financial transactions around the world. This owes in part to China's prowess in international trade, but also to Chinese government policies to promote the use of the RMB in international markets, including allowing trade settlements in RMB, the issuance of RMB-denominated bonds, and RMB deposits in Hong Kong, among other measures. The trajectory of this RMB "internationalization" has been impressive considering that the government essentially started from zero less than five years ago. The absolute volumes of RMB-denominated assets and other aspects of the internationalization process are still modest, but my sense is that the Renminbi is going to play an increasingly important role as an international currency.

Allison Nathan: What about as a reserve currency?

Eswar Prasad: In order for the Renminbi to become a reserve currency, it needs to satisfy some additional prerequisites beyond serving as an international currency. China would need to have a more open capital account, a flexible exchange rate and deeper and better regulated financial markets. Right now, it is still very difficult for foreign investors to acquire relatively safe and liquid RMB-denominated assets, so financial market development is crucial. But it is interesting to note that even though the Renminbi does not meet all of these prerequisites, it has already become a reserve currency in some measure. A number of central banks around the world including those of Latin American countries like Chile, African countries like Nigeria and a host of Asian economies including Malaysia, Thailand, Indonesia, Japan and Korea already hold or have indicated that they plan to hold part of their foreign exchange reserve portfolios in RMB. In my view, these countries are essentially making a low-cost bet on a currency that is almost certainly going to become more important over time, both as an international and reserve currency.

Allison Nathan: How long will it take for the Renminbi to more solidly become a reserve currency?

Eswar Prasad: If China follows through on its current plans for economic and financial market reform, I can see the Renminbi becoming a significant reserve currency, by which I mean that it could account for something between 5%-10% of global foreign exchange reserves, within the next one to two decades.

Allison Nathan: Will the Renminbi ever become a "safe haven" currency?

Eswar Prasad: In order for the Renminbi to be seen as a "safe haven" currency, China will need to not only meet the prerequisites of a reserve currency, but also institutional prerequisites including an open and transparent democratic structure, trusted public institutions such as an independent central bank, and an independent judiciary. The current Chinese leadership has clearly rejected these political, legal and institutional reforms so I do not see the RMB gaining "safe haven" status any time in the foreseeable future.

Allison Nathan: Will the Renminbi ever rival the dollar?

Eswar Prasad: The Renminbi will become a significant competitor to the US dollar in terms of certain functions of a currency--as a unit of account and as a medium of exchange. The dollar is unlikely to remain as dominant as it is today as a unit of account, or, in other words, as a currency in which trade transactions are denominated and settled. For instance, right now virtually all oil transactions are priced and settled in dollars and there is no good reason for that to persist. The Renminbi could become a settlement currency for commodities. The Renminbi is also starting to play a bigger role as a medium of exchange. China is signing bilateral currency pacts with a number of its major trading partners so those countries can trade in each other's currencies rather than having to use dollars. But even if the Renminbi becomes a significant reserve currency, I do not see it displacing the dollar. The bottom line is that if China moves forward with its economic and financial market reforms, the Renminbi will erode but not challenge the dollars' supremacy as the global reserve currency.

Allison Nathan: Given the above context, what motivated the recent shifts in Chinese policymakers' exchange rate policy?

Eswar Prasad: I believe that the People's Bank of China (PBOC) has received political support from China's top leadership to move forward with greater exchange rate flexibility in the form of a wider trading band around the Renminbi. But there have also been concerns that a wider band could lead to even more speculative activity in the currency. So my sense is that the PBOC has intervened aggressively to send a strong signal to markets that while it is interested in increasing the flexibility of the Renminbi, it is not going to tolerate speculative activity that essentially makes the currency a one-sided bet. And the PBOC has been quite effective at sending this message. They have managed to create enough uncertainty and volatility in the markets that much of the speculative activity has been taken off the table.

Allison Nathan: Some have suggested that concerns about recent weaker Chinese economic activity are at least part of the motivation behind the recent shift in stance that has led the currency to depreciate. Do you agree?

Eswar Prasad: There are certainly growing concerns about whether China's shorter-term prospects have taken a turn for the worse. But my sense is that these concerns are not the main reason behind the depreciation of the Renminbi. In my view, the PBOC's intervention might have worked better than they had anticipated by not only lessening Renminbi appreciation but also actually leading to a mild depreciation. The PBOC would have been quite happy if they had just staved off any appreciation pressures in their attempt to show that Renminbi appreciation is no longer a sure bet. A mild depreciation that gives a small boost to exports is certainly not something they are against. But I do not think that it is something they are targeting.

Allison Nathan: China is taking steps to liberalize capital outflows at the same time that it is pursuing greater exchange rate flexibility. How concerned are you about capital flight?

Eswar Prasad: Given the somewhat weak state of the Chinese domestic financial system, throwing open the door to capital outflows in a completely unrestricted manner would create significant risks. So the Chinese government's strategy of opening up to both inflows and outflows in a calibrated and controlled manner makes a lot of sense. But I certainly think that the Chinese government is doing the right thing by liberalizing outflows. It is a matter of interpretation whether more capital outflows would be a sign of panic or deep concern about the domestic financial system. My interpretation is that it is actually a positive sign of a maturing economy with maturing financial markets; because most Chinese institutions and middle income Chinese households still hold most of their financial wealth within China, it makes perfect sense for Chinese corporations, financial institutions and households to diversify their portfolios through foreign investments.

Allison Nathan: Will the long-held appreciation trend, which has recently been broken, resume?

Eswar Prasad: Over the next five to ten years, I strongly suspect that the Renminbi will appreciate. Unless Chinese growth stumbles very badly, the differential between China's productivity growth and the productivity growth of its trading partners means that the Renminbi will tend to appreciate over the long term. But over the next two to three years, this dynamic could be overtaken by what happens to capital flows. If there is a normalization of the interest rate cycle in the advanced economies, particularly the US, and if China's growth slows more, capital inflows and related appreciation pressures on the Renminbi could decline. And any further steps by the Chinese government to liberalize outflows will reinforce this dynamic. In fact, if capital outflows were to surge, that alone could lead to more downward pressure on the currency. So over the next one to two years the value of the Renminbi is going to largely be driven by these capital flow swings that in turn are going to be determined by macro fundamentals and by how aggressively China continues to move forward with capital account opening. It is not obvious whether the net result will be appreciation or depreciation in the short term.

Allison Nathan: How close is the Renminbi to fair value today?

Eswar Prasad: There are various models to estimate the fair value of a currency but they are not very reliable. It is hard to make statements at a particular time about what the suitable level of a currency is because it depends so much on capital flow dynamics, business cycle conditions and global factors. But right now pressures on the Renminbi seem fairly balanced. The non-deliverable forwards market that is one reflection of the supply and demand for RMB is actually predicting a very slight depreciation of the Renminbi over the next year. And China's trade surplus is likely to remain modest--in the range of 2% to 3% of GDP this year. I therefore do not see strong pressures in either direction.

Allison Nathan: What should the PBOC have done differently in recent years in terms of its exchange rate policy?

Eswar Prasad: I would have preferred them to move a little more aggressively on widening the trading band around the Renminbi. But they are subject to a lot of economic and political constraints, and within those constraints I think they are doing a reasonable job. The latest move suggests that the PBOC has a fair amount of support from the top leadership to move forward with exchange rate and financial market reforms, which I see as positive steps. But China has its own way of undertaking reforms; I think they are eager to demonstrate after each reform that it does not create forces that spin out of their control. So every time they loosen up a touch, they then pull back on the reins a little bit, to make sure that they still have enough control of the process.

Allison Nathan: If you were in the PBOC right now, what would you do?

Eswar Prasad: I would move forward more aggressively with currency flexibility through additional widening of the band as conditions seem propitious for more action – pressures on the Renminbi are fairly evenly balanced, inflation is well contained and the economy has slowed but still seems to have a reasonable amount of momentum. Given that the PBOC ultimately wants enough exchange rate flexibility to gain more control over monetary policy and use it to attain domestic objectives, the timing seems right to move even further towards this goal.

Allison Nathan: How important is exchange rate reform to China's broader reform process?

Eswar Prasad: In and of itself it may not be hugely important. But as a part of the broader reform process it is quite important in order to facilitate other reforms that are in China's long-term interest such as a more open capital account, better financial markets and better regulatory frameworks.

Allison Nathan: How important is exchange rate reform to China's growth outlook?

Eswar Prasad: If China wants to secure a good rate of medium-term growth, especially given unfavorable demographics and other headwinds, it is going to need better productivity growth. In turn, to achieve better productivity growth, it will need a better allocation of resources, especially financial resources. And for that China needs a better financial system. Because of the importance of exchange rate flexibility for the broader financial reform agenda, I think it has significant implications for sustainable long term growth.

Allison Nathan: What are the most important economic and asset implications of a more volatile Chinese currency?

Eswar Prasad: Given China's importance in the global trading system, more volatility is going to increase demand for hedging instruments for currency trades denominated in RMB. This raises the question of whether there is going to be enough depth in the derivatives market for RMB-denominated trades to be effectively hedged. Right now there is not yet enough volatility in the Renminbi for that to be a major concern. It is going to be interesting to watch whether the availability, depth and liquidity of hedging instruments is going to keep pace with the demand for those derivatives as Renminbi volatility rises.