Box 4

THE REFORM OF THE RENMINBI EXCHANGE RATE REGIME

Against a background of large and growing global financial imbalances and concerns about the associated risks for global financial stability, international pressure mounted on the Chinese authorities to adopt a more flexible exchange rate regime in order to help curb growing global current account imbalances and to alleviate upward pressure on more flexible international currencies. Many analysts also expected that any revaluation of the Chinese currency would trigger greater exchange rate flexibility in other Asian countries. On 21 July 2005, the renminbi was revalued by 2% against the US dollar, from 8.2765 to 8.11, and the Chinese authorities announced that they had moved to a "managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies". However, since the reforms, the renminbi has continued to be tightly managed against the US dollar, so that little impact on the scale of global imbalances can be expected in the short term.

The Peoples Bank of China (PBC) has emphasised that managing the exchange rate "with reference to" a basket of currencies does not mean that the renminbi will be pegged to a basket of currencies. The objective of the new regime is to keep the renminbi exchange rate basically stable at an adaptive equilibrium level. While the weights of the currencies in the reference basket were not disclosed, the currencies were selected mainly on the basis of the relative shares of China's trading partners in goods and services. However, other variables considered included the sources of FDI into China and the currency composition of Chinese debt. The currencies with the highest weight in the basket are the US dollar, the euro, the Japanese yen and the Korean won. Other currencies in the basket include the Singapore dollar, the UK pound sterling, the Malaysian ringgit, the Russian rouble, the Australian dollar, the Thai baht, and the Canadian dollar. Under the new regime, the PBC announces at the end of each working day the closing price of the foreign currencies traded against the renminbi in the interbank market. This closing price then serves as the central parity for trading against the renminbi on the following day. As in the past, the daily trading price of the US dollar against the renminbi is allowed to float within a ±0.3% band around the central parity announced each day; however, the daily trading band of the renminbi against non-US dollar currencies has twice been widened to the current ±3.0%.

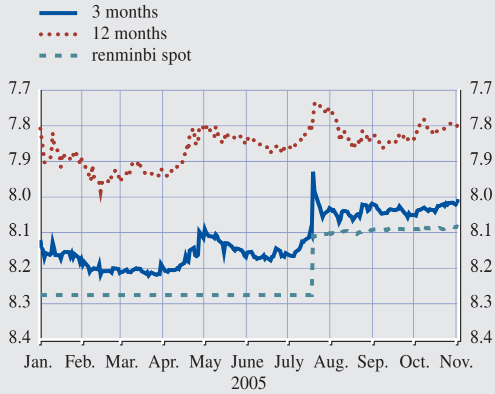
Chart B4.1 Intraday renminbi exchange rate against the dollar

(index: 21 July 2005 = 100, upward movement = appreciation of the renminbi)

Source: Bloomberg.

Chart B4.2 RMB/USD non-deliverable forwards

(inverted scale)



Source: Bloomberg.

Since 21 July 2005, the PBC has continued to manage the exchange rate tightly, and movements of the renminbi against the US dollar have remained well within the statutory bands (see Chart B4.1). Thus, although the new regime technically creates room for further market-driven appreciation, the renminbi had, as of early November 2005, appreciated by a maximum of 0.3% against the US dollar in addition to the initial one-off revaluation. The management of the transition to a more flexible regime had raised concerns for financial stability in China, in particular with regard to the possibility that the revaluation would be perceived as being insufficient by the markets, possibly precipitating expectations of further revaluation and triggering an increase in speculative capital inflows. So far the Chinese authorities appear to have been relatively successful in managing market expectations of a further renminbi appreciation, and these expectations have actually receded since the initial revaluation (see Chart B4.2). By early November, the non-deliverable forward market was pricing in a 0.97% appreciation of the renminbi against the US dollar over the following three months, and a 3.6% appreciation over the following 12 months.

Foreign exchange reserves have, however, continued to grow at a monthly rate of around USD 20 billion since July, indicating that intervention by the PBC has remained substantial in the aftermath of the reforms. In spite of this, and unlike patterns seen in 2004, most of the increase in reserves was accounted for by a surge in the trade surplus and not by non-FDI and non-trade-related inflows (a proxy for speculative inflows).

As of early November 2005 the Chinese reforms have had little impact on exchange rates in the rest of the region, with most other currencies remaining either relatively stable or continuing to depreciate against the US dollar against a background of declining trade surpluses and concerns about the impact of high oil prices on their economies.