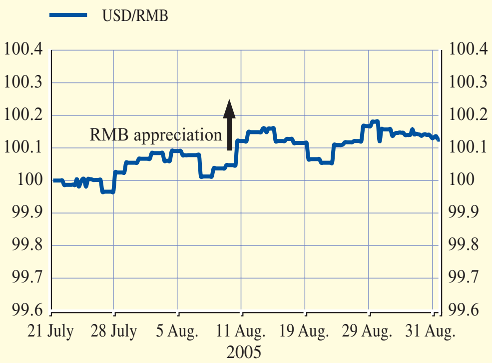
Box 8

THE REFORM OF THE RENMINBI EXCHANGE RATE REGIME

On 21 July 2005 China revalued its currency by 2% against the US dollar, from 8.2765 to 8.11, and moved to a "managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies", as the People's Bank of China (PBC) stated. The PBC pointed out that managing the exchange rate "with reference to" a basket of currencies did not mean that the renminbi would actually be pegged to a basket of currencies. While the weights of the currencies in the reference basket were not disclosed, the currencies were selected

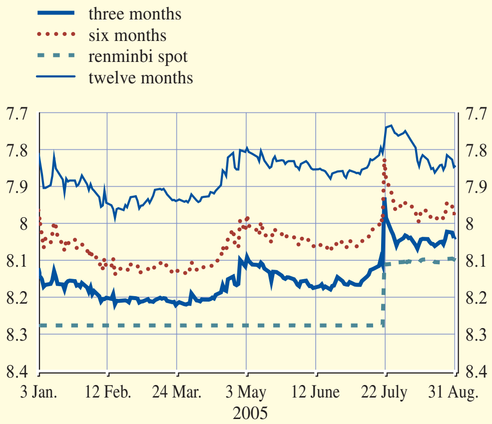
Chart A Recent intraday developments in the renminbi exchange rate

(index: 21 July 2005 = 100)



Source: Bloomberg.

Chart B RMB/USD non-deliverable forward contracts



Source: Bloomberg.

mainly on the basis of the relative shares of China's partners in goods and services trade (the other variables considered include the sources of foreign direct investment into China and the currency composition of Chinese debt). The currencies with the largest weight in the basket are the US dollar, the euro, the Japanese yen and the Korean won. The other currencies in the basket include the Singapore dollar, the pound sterling, the Malaysian ringgit, the Russian rouble, the Australian dollar, the Thai baht and the Canadian dollar.

The ECB welcomes China's exchange rate reform and expects the new managed floating exchange rate regime to contribute to global financial stability. The G7 finance ministers and central bank governors welcomed this move. The international community had considered such a move towards greater flexibility as desirable for a better functioning of the global economy.

Under the new regime, the PBC announces the closing price of the foreign currencies traded against the renminbi in the interbank market at the end of each working day. 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 by the PBC. The other currencies are allowed to move within a ±1.5% band in daily trading against the renminbi, a slight broadening compared with the previous ±1% band.

Since 21 July the actual movements of the renminbi against the US dollar (see Chart A) have been well within the statutory bands. The reform has thus far mainly resulted in a one-off revaluation against the US dollar, with an otherwise tightly managed exchange rate.

Looking forward, the new regime potentially creates room for further market-driven fluctuation. Indeed, market participants continue to expect some further renminbi appreciation over a 12-month horizon, as confirmed by trends in the offshore market where expectations about renminbi changes are traded through non-deliverable forward contracts (see Chart B).

Regarding the two other major Asian currencies that were formally pegged to the US dollar – the Malaysian ringgit and the Hong Kong dollar – Malaysia also abandoned its official peg to the US currency on 21 July. It shifted to a managed floating regime in which the central bank will monitor the exchange rate against an undisclosed trade-weighted basket of currencies. The central bank specified, however, that exchange rate stability continues to be its primary policy objective and that the current valuation of the ringgit is consistent with economic fundamentals. The Malaysian ringgit, which had been pegged at 3.8 to the US dollar before the change, has been allowed to appreciate only slightly since then.

The exchange rate regime in Hong Kong has remained unchanged following the PBC's exchange rate reform. The Hong Kong Monetary Authority had strengthened its 21-year old currency board arrangement with a number of measures taken on 18 May 2005 in order to ease possible market pressures to revalue the Hong Kong dollar. This approach seems to be working well, as expectations of appreciation as reflected by the six-month forward rate on the Hong Kong dollar have been brought within the band limit.