

Box 4

CHINA'S REFORM OF THE RENMINBI EXCHANGE RATE REGIME

Following almost two years of the renminbi being de facto pegged to the US dollar (USD), on 19 June 2010 the People's Bank of China (PBC) announced that it intends "to proceed further with reform of the renminbi (RMB) exchange rate regime and to enhance the RMB exchange rate flexibility".¹ In particular, continued emphasis will be placed on "reflecting market supply and demand with reference to a basket of currencies". The PBC also specified that "the basis for large-scale appreciation of the RMB exchange rate does not exist", given the fact that China's current account is "moving closer to equilibrium".

It is too early to assess how the PBC will manage the exchange rate in practice under the new regime. Looking at market expectations, non-deliverable forward contracts currently price a less than 2% appreciation of the renminbi vis-à-vis the USD in one year's time (see Chart A). The PBC is also expected to allow for increased volatility in the RMB-USD bilateral exchange rate in order to mitigate speculative capital inflows. The PBC announcement did not, however, lead to any change in China's de jure exchange rate regime. Since the reform of July 2005, this regime has been defined by the Chinese authorities as a managed float based on market supply and demand with reference to a basket of currencies.

While the currency weights in the RMB basket are not disclosed, several studies looking at movements of the RMB against the USD concluded that the RMB has, in practice, been closely managed to reflect movements in the USD over the last five years, in the form of either a crawling peg (from July 2005 until July 2008) or a fixed peg (from July 2008 until June 2010). In the first period, the RMB steadily appreciated against the USD, gaining around 21% in bilateral terms (see Chart B). However, the appreciation of the RMB in nominal effective terms was only about 8%, mainly on account of the pace of appreciation

Chart A RMB non-deliverable forward contracts' implicit appreciation vis-à-vis the USD

(percentages)



Source: Bloomberg.

Notes: A negative number indicates a depreciation. Last observation: 7 July 2010.

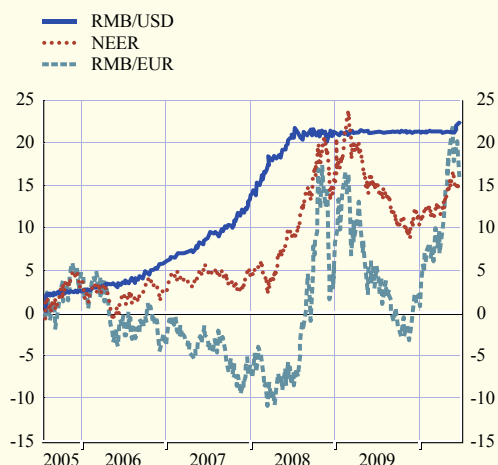
¹ Excerpts taken from the PBC's public announcement on 19 June.

of the euro against the USD. In the summer of 2008, given the worsening of the external outlook and the unfolding of the global financial crisis, the Chinese authorities decided to halt the RMB's steady appreciation against the USD. Nonetheless, since December 2009 the RMB has appreciated further, by 5.0% in nominal effective terms, by 1.4% against the yen, and by 17.1% vis-à-vis the euro. Along with the broad-based depreciation of the euro, the price competitiveness of Chinese exporters has deteriorated in euro area markets.

As the Chinese authorities have emphasised, the recovery of Chinese exports in 2010 has also played a key role in driving the recent exchange rate decision, alongside domestic economic developments. In particular, the recent build-up of inflationary pressures – including in the property market – made the costs associated with a fixed exchange rate with the USD higher. An appreciating RMB may help to moderate inflationary pressures emanating from external sources and will also give the PBC greater scope to use monetary policy tools to fight inflation while managing a soft landing of the economy.

Chart B RMB exchange rate

(cumulative percentage changes since 20 July 2005; daily data)



Source: Bloomberg.
Notes: NEER is the nominal effective exchange rate of the RMB; index: 2000 = 100. Last observation: 7 July 2010.