China's exchange rate and monetary policies

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1. Chinese economic growth maintains good momentum and the exchange rate shows increasing flexibility

In 2010, the global economy continued to recover, but the road to recovery was uneven and fragile. The Chinese government strengthened the macro-adjustment policy, and the Chinese economy maintained good momentum, growing by 10.3%.

During the global financial crisis, mainland China experienced capital outflows as a result of the contagion effect. In the fourth quarter of 2008 alone, the capital outflow amounted to USD 41 billion. Facing turbulence in the global financial market, especially the G7 currency market, the Chinese monetary authority adopted a prudential approach of narrowing the band of the renminbi's exchange rate against the US dollar so as to stabilise the domestic financial market, mitigate the impact of the global crisis and maintain market confidence. This has helped to curb the volatility of cross-border capital flows.

As far as international banks in mainland China are concerned, there are more than 100 foreign-funded banks, accounting for roughly 2% of total banking sector assets. They are too small to play as influential a role in the financial system as they do in other emerging markets, especially after the global financial crisis, in which most of them suffered great losses. On the other hand, most domestic banks are currently in good shape, with sound capital adequacy, after issuing stocks in 2010. Nevertheless, the rapid expansion of credit, and the introduction of the Basel III Framework, will require banks to raise new capital next year.

In 2010, China's balance of payments posted a total surplus of USD 471 billion, with USD 306 billion in the current account and USD 166 billion in the capital and financial account.[2] Both China's foreign trade and its cross-border capital flows picked up steadily in 2010. As a result, the total volume exceeded the historical peak reached in 2008, before the global crisis erupted.

On the other hand, the balance of payments fluctuated significantly last year. In the first quarter, the increase in goods imports was significantly higher than the increase in exports, the current account surplus decreased and there was a large surplus in the capital and financial account. In the second quarter, the current account surplus increased again, exceeding the first quarter increase. But as a result of the European sovereign debt crisis, net inflows under the capital and financial account slowed down. The third quarter saw a recovery of the trade surplus, and the worry about Europe reversed in the fourth quarter, when capital inflows surged.

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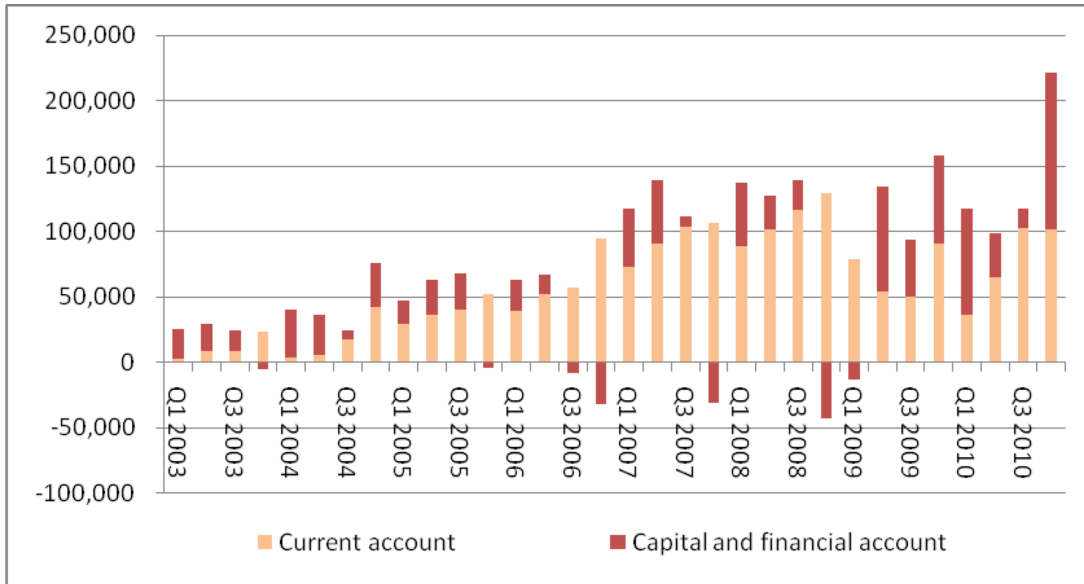
[2] Unless otherwise noted, all data are from the State Administration of Foreign Exchange. Differences in totals are due to rounding.

Chart 1

China's quarterly balance of payments

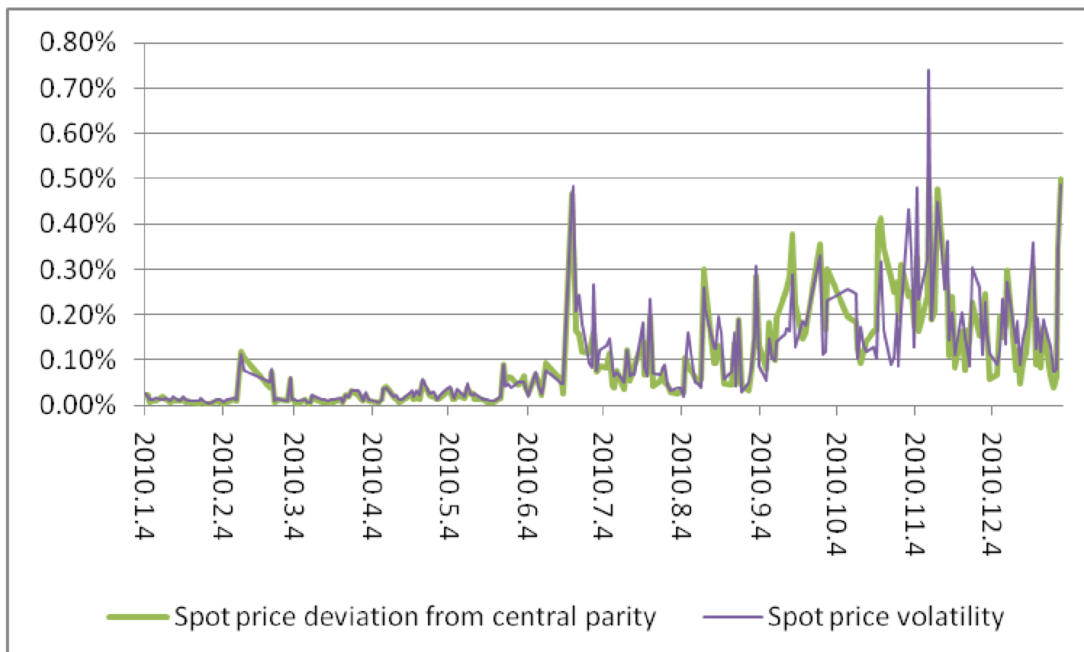
In millions of US dollars



With the global crisis fading away, the first half of 2010 saw the global economy move steadily onto the path of recovery, and the market gradually regain confidence. Accordingly, in mid-June 2010, China relaunched the exchange rate mechanism reform, expanding the flexibility of the renminbi, to better adjust it to external factors. From 20 June 2010 to the end of the year, the daily fluctuation of the currency's spot exchange rate against the US dollar over USD-CNY central parity was 0.16%, with a maximum of 0.5%, and the daily volatility of the spot exchange rate averaged 0.17%, sometimes reaching as high as 0.75%. At the end of 2011, the USD-CNY central parity closed at 6.6227, an appreciation of 3.1% from end-2009, or an annual rate of 6%.

Chart 2

CNY exchange rate flexibility

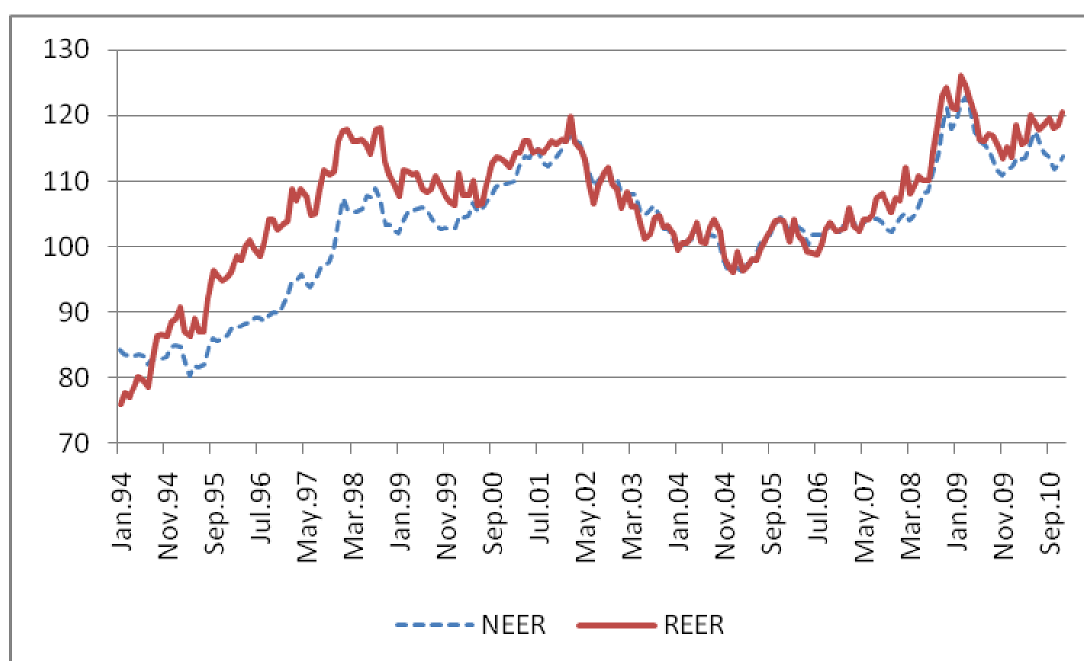


In terms of the effective exchange rate, the renminbi was also on track to appreciate in the first half of 2010. According to the BIS, the renminbi's nominal effective exchange rate (NEER) index reached 117.42 in June 2010, an overall appreciation of 5.1% from end-2009, 8.6% from June 2008, prior to the outbreak of the global financial crisis, and 18.5% from the exchange rate regime reform in July 2005. The renminbi's real effective exchange rate (REER) reached 119.05 in June 2010, an overall appreciation of 3.4% from end-2009, 8.2% from June 2008 and 21.7% from the exchange rate regime reform in June 2005.

However, the second half of 2010 witnessed a slightly different picture, in which the global foreign exchange market gradually priced in the Federal Reserve's second round of quantitative easing, igniting the depreciation of the US dollar, with the US Dollar Index (DXY) declining by 9% to 79 at year-end. As a result, the renminbi's NEER climbed to 113.74 at the end of 2010, an appreciation of 1.8% compared to end-2009. On the other hand, China's inflation began accelerating quickly in the second half of 2010, fuelled by the global rise in food and commodity prices. It peaked at around 5%, year on year, at end-2010. As a result, the renminbi's REER, increasing by 4.7% for the whole year, appreciated faster than the NEER. In fact, the REER has appreciated by 23.2% since the launching of the exchange rate mechanism reform in July 2005. Therefore, measured by the REER, the renminbi is near its historical peak, and hence is nearer to equilibrium than at any time since the launching of the exchange rate mechanism reform.

Chart 3

CNY NEER and REER, 1994–2010



Source: Bank for International Settlements.

2. The gradual approach in reforming the CNY exchange rate mechanism works with China's economic system

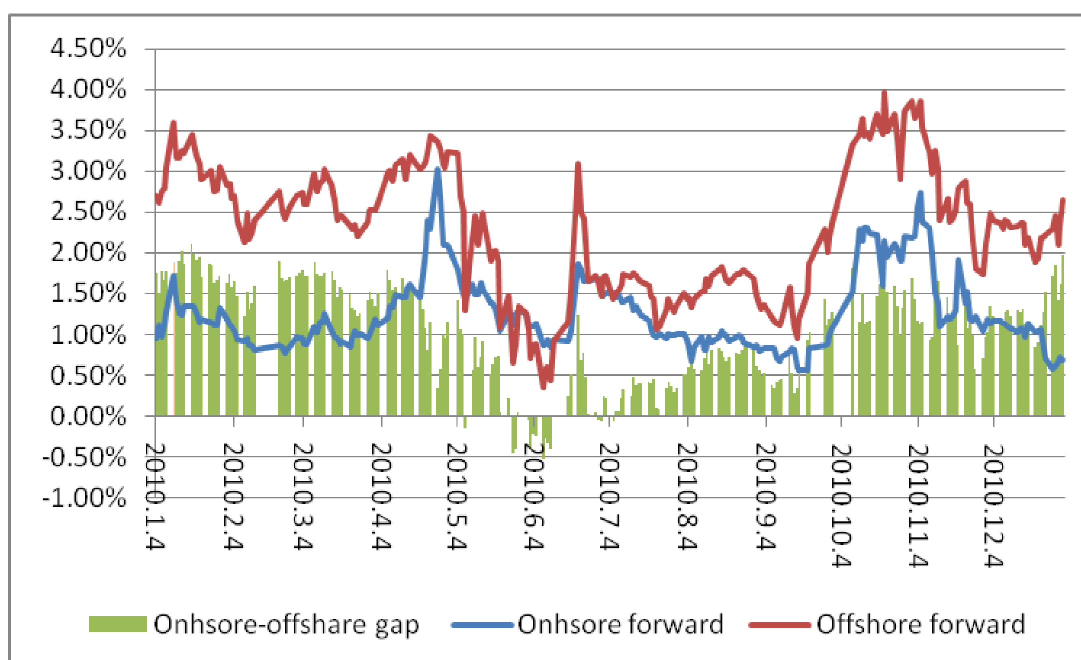
Why did the Chinese authorities take a gradual approach to reforming the exchange rate mechanism and not let the exchange rate float freely? The answer can be summarised as follows:

First, a free-floating exchange rate regime is usually applied to countries that issue reserve currency, which helps to immunise their domestic firms against exchange rate risk. Second, empirical studies show that the random walk behaviour of G7 currencies cannot be rejected. Third, China's foreign trade has two different components, namely, processing trade, which is dominated by foreign-funded enterprises, and general trade, which is traditionally carried out by small and medium-sized domestic firms. The enterprises in the first group enjoy a surplus equivalent to around 140% of the total trade surplus, while those in the second group run a deficit equivalent to 40% of the total trade surplus. Thus, the export enterprises specialising in general trade need a transition period in which to absorb the impact of appreciation. Fourth, the banks need time to acquire risk management expertise and to build the necessary infrastructure under the new exchange rate environment, and more hedging instruments have to be designed and introduced into the foreign exchange market. In short, it takes time to prepare for structural and financial reform, so as not to endanger expectations and domestic demand in these sensitive and fragile post-crisis conditions.

China has not fully liberalised the capital account, as can be seen from the wide gap between the onshore and offshore forward markets. By the end of June 2010, the US dollar discounts in the onshore and offshore CNY forward markets were equivalent to 0.7% and 2.7%, respectively, down 0.2 percentage points and up 0.1 percentage point from end-2009. Therefore, with the support of other government policies, the central bank can sustain a real exchange rate target in the medium term. However, it must be kept in mind that China's business cycle is much longer than that in advanced economies and in other emerging economies.

Chart 4

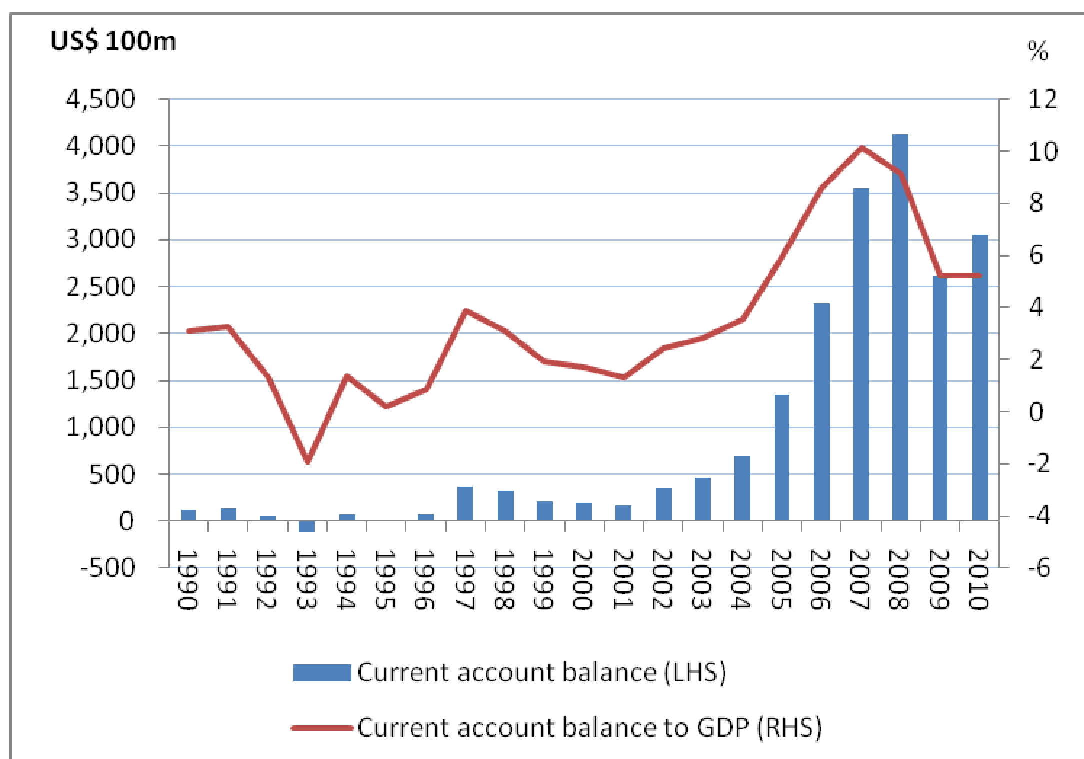
Prices in the onshore and offshore CNY forward markets



In 2010, China's external balance improved for the third consecutive year. The current account balance as a percentage of GDP was 5.2%, down 5 percentage points from the peak in 2007. Taking into account the ongoing structural reform designed to boost domestic demand through measures such as improving the social security system, as well as strengthening the enforcement of environmental regulations, China will rebalance its economy further in the future.

Chart 5

China's current account balance and its ratio to GDP



As far as the integrated monetary and exchange rate policy framework is concerned, monetary conditions are a useful tool for coordinating monetary and exchange rate policies. In practice, inflation and exchange rate appreciation are alternatives in terms of cooling down the economy. However, it is helpful to look at the bigger picture, including the international monetary system (which, as mentioned above, is unfair to emerging economies), domestic structural factors, capital controls and the stage of development of financial markets, especially the foreign exchange market.

The notion of long-run equilibrium exchange rates is helpful in formulating monetary policy strategy. Nevertheless, there are doubts about how far into the future a rational person can see. In practice, the assessment of long-run equilibrium exchange rates is more of an art than a science. This is an especially difficult task for China, as a fast-growing economy in transition. Different evaluations of the renminbi's equilibrium exchange rate diverge from one another, ranging from an overvalued 5% to an undervalued 45%.

3. Multiple options for policy instruments to sterilise the abundant liquidity and stabilise the financial system

As mentioned above, the total balance of payments surplus in 2010 amounted to USD 470 billion. The People's Bank of China (PBOC) conducted sterilisation operations, mainly by raising the reserve requirement ratio, issuing central bank notes to commercial banks, and hiking the interest rate. The reserve requirement ratio climbed to the historical peak of 19% and is expected to go on climbing. By the end of 2010, the PBOC's total assets increased to CNY 2.45 trillion, and M2 expanded to CNY 7.23 trillion, up 19.7%. As a result of the stimulus package and abundant liquidity, commercial banks have more incentives to expand their domestic lending. The PBOC has taken many measures to deal with abundant liquidity, and its monetary policy stance has also shifted from relatively loose to prudent.

China has not liberalised control over foreign purchase of domestic debt securities issued by the central bank for sterilisation. The foreign-funded banks in mainland China have large interests in the central bank notes, investing 30% of their bond portfolio in them because they are benchmark assets and share high liquidity.

To cope with the dilemma facing the central bank, the State Administration of Foreign Exchange (SAFE) is also exploring ways to deepen the reform of the foreign exchange management system. The SAFE is now improving the verification system for trade receipts and payments, abolishing the remittance requirement for export receipts and eliminating supervisory loopholes. Furthermore, China will continue to develop the foreign exchange market so as to provide domestic investors with the tools to hedge exchange rate exposures. Measures to cool down the housing sector, which has attracted large capital flows, have been announced in order to reduce distortions and risks. These measures include requirements relating to higher down payments on mortgages, higher real interest rates on speculative purchases, and a real estate tax to raise real estate holding costs.

In addition to these measures, there are some other policy alternatives to be considered.

First, macroprudential policy packages can be explored to help address the system-wide challenges posed by external factors. For instance, measures to dampen the procyclical effects of capital flows are now under consideration.

Second, widening outbound investment channels and simplifying approval procedures can encourage capital outflows and reduce imbalances over time, provide for a more efficient allocation of resources, curb expansion of the domestic money supply, and contribute to domestic financial stability.

Third, further financial deepening can enhance the domestic capacity to allocate investments to more productive uses and avoid asset price bubbles. Greater progress can be achieved in broadening investment categories, improving market liquidity and strengthening regulatory oversight.

Fourth, a shift to prudent fiscal policies can help to mitigate the dilemma facing the central bank. In addition, the early warning framework for monitoring capital inflows and outflows can be improved.