Hu Xiaolian: Three characteristics of the managed floating exchange rate regime

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The content of the managed floating exchange rate regime includes three aspects. First, the floating of exchange rate is based on market supply and demand so that the exchange rate plays a role as a price signal. Second, the range of floating adjustment is based on trade and current account balances to reflect the "managed floating" nature. Third, the exchange rate is determined with reference to a basket of currencies, rather than the bilateral exchange rate between RMB and any single currency.

I. A managed floating exchange rate regime based on market supply and demand is to achieve the general balance of the balance of payments account.

In theory and practice, resource allocation is efficient when the supply and demand is broadly in balance. When the supply and demand is not in balance, optimization of resource allocation is not possible. When total exports are persistently smaller than total imports, resources are not adequately channelled to the export sector, and it would result in shortage of foreign exchange and consequently import demand for consumer and capital goods cannot be met; when total imports are persistently smaller than total exports, resources are overly concentrated in the export sector and subsequently the foreign exchange earned through export cannot be absorbed by import and can only be invested overseas. If investment is concentrated in low-yield sectors overseas, the resource is not allocated efficiently. Since the establishment of a socialist market economy was identified as an objective in the 14th CPC National Congress, efficient resource allocation based on market supply and demand has become the focus of reform.

To evaluate the efficiency of resource allocation from a BOP perspective, we mainly look at whether the current account is in balance. The capital and financial account, the component of the BOP account other than the current account, records, among others, inter-temporal investment and would inevitably include speculative activities. International experiences have shown that the capital and financial account does not offer a perspective as good as the current account in measuring the impact of the exchange rate on efficiency of resource allocation. Foreign exchange reserve is an important item in the BOP account. A country's need for foreign exchange reserve may vary in different development stages. The build-up of foreign exchange reserves may also be inter-temporal. Inadequacy of foreign exchange reserve can be made up by appropriate-surplus, but in the medium and long run a balanced current account is best for resource allocation and social welfare.

The BOP balance, and current account balance in particular, is the basis for equilibrium exchange rate analysis. An internationally accepted indicator is the current account balance to GDP ratio. For example, the current account norm is the core concept in the macroeconomic balance (MB) approach, which is used by the IMF to assess member country's exchange rate. If a country's current account balance exceeds the norm in the medium term, its exchange rate is believed to be undervalued, and otherwise the exchange rate is overvalued. The size of the gap between current account balance and the current account norm indicates the degree of undervaluation or overvaluation.

In the medium and long term, the correlation between exchange rate and current account balance may not be this simple because resource endowment, industrial division of labor and consumption behaviors are more significant factors in international trade and economic activities. Nevertheless, good policy-making on exchange rate needs to be supported by forward-looking judgment on the supply and demand on the foreign exchange market and such judgment is based on analysis of current account balance. The supply and demand on the foreign exchange market is of course related to the overall BOP situation, not only the current account. Generally speaking, however, the current account reflects activities of the real economy, and the current account balance accounts for the major part of BOP. Since 2007, the share of current account surplus in China's BOP surplus has been over 75 percent. Moreover, with a full convertibility, China's current account is responsive to market supply and demand. Therefore, the analysis of the foreign exchange market based on the current account will not lead to systematic errors.

Since return on investment as a current account item is related to the capital account, as a practical consideration, it is not included in current account balance analysis. Instead, the analysis looks at trade balance, which is represented by trade statistics from the Customs because it is regularly updated and readily available.

II. The Exchange rate floating is based on the current account, mainly the trade account balances

Managed floating exchange rate serves three purposes. It is needed to deal with any unexpected movements in domestic and international markets to avoid dramatic currency fluctuations and curb financial speculation; to bring the exchange rate to an appropriate level that helps improve resources allocation and promote a balanced BOP account; and to make sure that any improvement in resources allocation could be absorbed by most companies and would not lead to massive closures and job cuts.

The equilibrium exchange rate determination theory treats exchange rate as a function of current account balance or trade balance. If the function has a linear relationship with current account balance, it could be adjusted accordingly. However, the relationship is much likely to be non-linear, which means exchange rate floating needs to be progressed in a gradual and proper manner and should be managed in line with the state of the economy and BOP position.

Exchange rate adjustment poses pressures on the corporate sector's structural adjustment. A large or rapidly growing trade surplus means companies are generally adaptive to such pressures, while a shrinking surplus suggests companies need to enhance their ability to deal with exchange rate adjustment. The adjustment process needs to be properly paced to take full advantage of favorable factors and contain the impact of disadvantages. It should also take into account global economic development and international cooperation to help secure the current period of strategic opportunities.

Exchange rate adjustment helps improve the relative position of domestic and external prices, and optimize resources allocation between domestic-oriented sectors and the external sector. It supports domestic consumption growth, industrial restructuring and innovations. This progress will in turn facilitate market-based adjustment of current account position and ultimately contribute to balanced and sustainable growth.

Exchange rate adjustment also affects capital account. Therefore, it is necessary to closely monitor capital flows, stand ready to conduct sterilization operations, and impose limits on external debts. It is important to put restrictions on converting the external debts of foreign currencies into RMB, and step up efforts to address irregularities in foreign exchange flows, as experiences from Thailand and other countries show, borrowing external debt and converting it into domestic currencies by the private sector, corporate sector or other sectors is a major channel for capital inflows. Temporary control on capital inflow and outflow may also be introduced if circumstances warrant, as what has been done recently by a number of emerging market economies.

III. Measure the exchange rate with reference to a basket of currencies

A floating exchange rate has impact on total imports and exports of an economy. Therefore, the floating cannot be aimed to adjust bilateral trade balance and it is not advisable to just look at the RMB/USD exchange rate. Theoretically, the best indicator to measure the international relative price of tradables is real effective exchange rate, i.e. the exchange rate measured by a basket of currencies of major trading partners. Real effective exchange rate reflects the movement of dollar exchange rate to other major currencies and has been adjusted against the cross country inflation differentials. There are various opinions on the currencies in the basket. Though it is necessary to take into account trade, capital flow and other factors, weighted trade is usually the major factor to consider because capital flow fluctuates. Specifically, the effective exchange rate basket should have a variety of currencies to reflect diversification of trade and investment. The weight is to be determined based on the current account situation and the currency structure of capital and financial account and of cross-border receipt and payment.

The reference of a basket of currencies is reasonable in theory. In practice, however, the nominal effective exchange rate, which is not inflation-adjusted, is more frequently used, for the following reasons: ***First***, it is hard to settle on a universally accepted and comparable price index. Though commonly used, the CPI may not be appropriate according to academicians as it includes prices of many non-tradables. Other options, such as PPI, GDP deflator and the index of per unit labor cost, are not widely accepted. ***Second***, the calculation of real effective exchange rate has to deal with the time lag and availability of data, and price indices such as the CPI are subject to time lags and comparability. There are easily accessible and real time data for nominal exchange rate while it takes one month to get CPI and PPI readings, at least one quarter to get GDP deflator and even longer for the index of per unit labor cost. Moreover, statistical coverage of countries varies greatly and some countries hardly have comparable data.

Compared with pegging to a single currency, the exchange rate regime with reference to a basket of currencies will help adjust exports and imports, current account, and balance of payment in a more effective manner. It has two-way movements of exchange rate. The RMB exchange rate has been basically stable at an adaptive and balanced level though it may fluctuate in both ways against any particular single currency.

Since the RMB exchange rate regime reform that started in 2005, the focus of public communications has been the RMB exchange rate regime with reference to a basket of currencies. But the mindset of focusing too much attention on RMB/USD exchange rate cannot be changed overnight due to behavioral habits and the dominant use of US dollar in accounting and statistics. This underpins the necessity for China to make more efforts to improve the exchange rate regime based on market supply and demand (mainly through the current account and especially the trade account balances) with reference to a basket of currencies. In the future, consideration can be given to disclosure of the nominal effective exchange rate information on a regular basis and to gradually shift the public’s attention on RMB/USD exchange rate to the effective exchange rate of RMB, which is the true reference for its movement.