Zhou Xiaochuan: Rules for developing a financial center and the reform of the RMB exchange rate regime

Speech by Mr Zhou Xiaochuan Governor of the People’s Bank of China, at the inauguration ceremony of The People’s Bank of China Shanghai Head Office, Shanghai, 10 August 2005.

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Honorable General Secretary Chen,
Honorable Mayor Han,
Colleagues and friends from the financial industry
Dear guests, and
Ladies and gentlemen,

First of all, I would like to take this opportunity to express my gratitude to all the concern and support you have kindly rendered to the People’s Bank of China over so many years, and I would also like to thank you for availing yourself from your busy schedule to attend the inauguration ceremony of the People’s Bank of China Shanghai Head Office. On today’s significant occasion, I wish to focus my remarks on two specific issues. The first issue explores the rules for developing a financial center, and the second issue aims to clarify questions concerning the reform of the RMB exchange rate regime.

For the first issue, the answer is quite straightforward. The People’s Bank of China Shanghai Head Office is established for the purpose of strengthening functions of the central bank head office related to improving financial market operations and financial services.

First, both international experiences and the Chinese practices in the process of reform and opening up have well demonstrated that greater marketization of the economy could lead to increased cross-region economic activities, and consequently an improved integration and scale of the economy which calls for strengthening of the functions of the central bank head office in terms of market operation and provision of financial services. Marketization and internationalization expose economic development undergo constant changes, leading to increased reliance of monetary policy conduct and transmission on the money market and foreign exchange market. The development of the financial market itself will also help to expand financial services to clients in different regions of the country and to cultivate a limited number of financial markets serving the whole nation and even the world, not segmented financial markets dotted across the country serving different regions. For the time being, Shanghai has already become the harbor for some financial markets with national influence, such as the foreign exchange market, the gold market, securities market, futures market and the inter-bank bond market etc.

However in the past when the centralized economic system was prevalent or in the early periods of reform when marketization was barely developed, financial organizations favored an institutional structure featuring “parallel set-up of business departments at the subordinate and head office level” which means branch offices of a financial institution in different locations must establish corresponding business departments as contact points to interface with relevant departments at the head office. By doing so, information could be collected and centralized to the highest authority that could in turn decompose the centrally made plans level by level to different regions and localities for implementation. With the socialist market economy preliminarily established and improved in China, the outdated organizational structure of the People’s Bank of China no longer fits in with its mandate to improve market operation and financial services. Likewise, large financial institutions in China also face such an organizational problem.

Second, the development of technologies and transportation facilities is producing a profound impact on the economy and the financial industry. In the past, the underdeveloped telecommunication and computer technology as well as backward transportation tended to restrict the economic activities and trade to localities with little cross-region business interactions. While now, the development of scientific technology and transportation has facilitated cross-region and even cross-country commercial activities, increased the economic scales of financial markets and financial services and fostered the modernization of financial infrastructures. This development has brought about dramatic changes to financial business mode and created great challenges to the regionalized structure of institutions and organizations. Under such circumstances, financial organizations more and more prone to set their views on the whole country rather on different regions and financial information and professionals also increasingly flow to financial centers providing services to the whole country. This in turn could help to facilitate the development of infrastructures of the financial centers and the cultivations of high-end technologies and financial products.

Finally, in today's world, a country's competitiveness depends on whether it has a dynamic financial center. A financial center has cluster effect, i.e., it attracts and fosters financial institutions, skilled labor force and various services, including intermediate institutions, such as legal, accounting, rating and appraisal services. Naturally, some activities can and will be out-sourced, but the rest is fostered based on the clustering of financial institutions and skilled labor force. In this regard, the existence of a financial center is the yardstick of whether a country is internationally competitive and whether the efficiency of domestic financial services can be elevated by large scales. General Secretary Hu Jintao called for continued efforts to make Shanghai four centers of the nation, and most importantly a financial center. In this sense, to build a national financial center is not based on the interest of a city or a particular region. Given its responsibility in conducting monetary policy, exercising macroeconomic management, fostering financial market development and maintaining financial stability, the People's Bank of China must give considerations to the development of a national financial center and carry out central bank functions based on the platform of the financial center. In this regard, the setup of PBC Shanghai Head Office is of historical significance.

Regarding the reform of the RMB exchange rate regime, I would like to elaborate a little bit about the contents of the basket of currencies.

As you all know, with authorization of the State Council, on July 21, 2005 China moved into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The RMB will no longer be pegged to the US dollar. Instead, the RMB exchange rate will be determined based on a basket of certain major currencies with assigned weights selected in line with the real situation of China's external sector development. At the same time, proper measures could be taken to manage and adjust the RMB exchange rate based on market supply and demand while considering the changes of the basket of currencies, so as to maintain the RMB exchange rate basically stable at an adaptive and equilibrium level. In this sense, it is quite natural that people are increasingly concerned about how the composition of the basket currencies is determined. To enhance public understanding of China's exchange rate policy, I would like to make the following clarifications regarding the determination of the basket currencies.

As a reference for the floating of the RMB exchange rate, the selection of the basket currencies and the determination of the weights assigned to these currencies must abide by a fundamental principle which is to give due considerations to the countries standing as China's trading counterparts in current account transactions and their national currencies. As you all know, there are four items under current account, namely, trade in goods, trade in services, income (including interest income and dividend income) and current transfers (such as remittance of overseas Chinese). To put it more simply, the basket should be composed of currencies of the countries to which China has a prominent exposure in terms of foreign trade, external debt (interest repayment) and foreign direct investment (dividend). And the weights respectively assigned to these currencies should also consist with the proportional importance of these countries in China's external sector.

- **Shares of trade in goods and services should be the fundamental considerations in the selection of the basket currencies and the weights assigned to the currencies in the basket**.

Current account is a major component of China's balance of payments, whereas trade in goods and services is the predominant item of current account. The current situation in China shows that trade in goods and services dominates current account balance. Therefore, the shares of trade are the major considerations in the determination of the currency components of the basket. China's major trading partners are the United States, the Euro land, Japan, Korea, etc., and naturally, US dollar, euro, Japanese yen and Korean won become major currencies of the basket. In addition, China also trades significantly with Singapore, UK, Malaysia, Russia, Australia, Thailand, and Canada, currencies of these countries are also important in determining China's RMB exchange rate. Generally speaking, annual bilateral trade volume in excess of US$10 billion is not negligible in weight assignment, whereas that exceeding US$5 billion should also be considered as a significant factor in currency weight deliberation. When you look at currencies used in trade settlement, although some countries and regions prefer US dollar as the currency for trade settlement with China, this situation is changing gradually and trade settlement in local currencies are increasingly the choice of trading partners. Moreover, we encourage this development. Since the basket represents currencies of countries covering a significant share of China's external trade, the RMB exchange rate against a basket of currencies is therefore a better indicator of the value of RMB and the changes in China's terms of trade than that against the US dollar, and consequently serves as an important reference in achieving basic trade balance in goods and services.

- **currency structure of foreign debt should be considered**

As China further opens to the outside world, the size of foreign debt incurred continue to grow significantly. By the end of last year, China's foreign debt reached US$228.6 billion with the origins increasingly diversified. In most cases, foreign debt repayment would require purchasing a specific foreign currency with RMB. The resulting conspicuous demand for this specific foreign currency in the market would become a factor influencing the RMB exchange rate. As such, in determining the currency weights in the basket, we also take into consideration of the currency structure of China's foreign debt.

- **FDI should be considered**

In recent years, rapid growth has been witnessed in FDI which has been gaining importance in our foreign economic relations. By now, the accumulated FDI flowed into China has reached over US$560 billion, a significant part of which was denominated in the currencies of the originating economies. The investment returns in the form of dividends will need to be exchanged into relevant foreign currency before being repatriated. Therefore the factor of FDI has to be considered in the selection of the basket currencies.

- **current transfer items under the current account should also be considered**

Though current transfers are not as important proportionally as other items in the current account, the currency structure of these transfers still needs to be considered in the determination of the weights assigned to the currencies in the basket.

In sum, the reform of RMB exchange rate regime to allow RMB exchange rate float with reference to a basket of currencies is in line with the needs of diversifying foreign economic and trade relations as well as the development of the international economic and financial system. Referring to a basket of currencies is not equal to pegging to such a basket. Pegging means mechanically adjusting the exchange rate of RMB against the US dollar according to the exchange rate movements of the currencies in the basket in an attempt to keep the nominal effective exchange rate unchanged. Quite differently, what we are having now is a managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies. In comparison with an exchange rate regime of pegging to the US dollar solely, it can better reflect the competitiveness of RMB against major currencies, better absorb the impact generated by an unstable US dollar and moderate the fluctuations of RMB exchange rates at the multilateral level, safeguard the overall stability of China's foreign economic and trade environment and consequently promote the basic equilibrium of balance of payments as well as the sustained, coordinated and healthy growth of the Chinese economy.

Thank you very much.