Hu Xiaolian: A managed floating exchange rate regime is an established policy

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China's has moved into a managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies. As an important component of the socialist market system, this is a right choice based on China's specific circumstances and development strategy and is also an established policy.

I. A managed floating exchange rate regime has been in place since 1994

1. The unification of dual exchange rates in 1994 marked the official beginning of the managed floating exchange rate regime. Establishing a managed floating exchange rate regime based on market supply and demand and a unified and well-functioning foreign exchange market is stipulated in The Decision of the CPC Central Committee on Several Matters Concerning the Establishment of a Socialist Market Economic System adopted at the 3rd Plenary Session of 14th CPC Central Committee in November 1993. On the first day of 1994, with the unification of RMB's official exchange rate and swap market exchange rate, the single, managed floating exchange rate based on market supply and demand was officially adopted. The unification of dual exchange rates into a single exchange rate regime is worth mentioning because it put an end to the coexistence of official exchange rate and the swap market exchange rate which traded foreign exchange in the retention system.

In 1994, the exchange rate reform marked the launch of the foreign exchange surrender system where enterprises are required to sell to the banks their foreign exchange receipts and buy foreign exchange from the banks when necessary, ended the practice of foreign exchange retention and submission, and simplified the procedures for banks and enterprises to use foreign exchange, thus giving exporting enterprises a lot of incentives to export and earn foreign exchange. Meanwhile, with a unified inter-bank foreign exchange market being established, China began a new stage where the RMB exchange rate was based on market supply and demand. The RMB, as an important price tool, started to play a fundamental role in the allocation of foreign exchange resources. In 1994, when the dual exchange rates were unified, the RMB to dollar exchange rate adopted the swap market exchange rate of 8.7 yuan to one dollar. This reflected market fundamentals and the need of supporting exports to mitigate the shortage of foreign exchange reserve. The nominal RMB to dollar exchange rate appreciated to 8.3 yuan per dollar, or by about 5 percent between the beginning of 1994 and 1997 when the financial crisis was at its worst in Asia. This proves that RMB exchange rate was fluctuating and floating, reflecting the characteristics of a managed floating exchange rate regime.

2. The Asian financial crisis in 1997 caused a slow down in the improvement of managed floating exchange rate regime. After June 1997, as the crisis deepened, some Asian currencies depreciated by a large margins. With Chinese export seriously affected, there were strong domestic opinions calling for RMB's depreciation. If it took place, it would be understood by various parties. Yet, almost all countries and international organizations worried that a weaker RMB would be followed by a new round of competitive depreciation. In order to prevent the further contagion of the crisis, and preserve economic and financial stability in Asia, China made the announcement that the RMB would be not be depreciated, its floating range would be narrowed, and its exchange rate would be kept stable around 8.28 yuan to one dollar.

3. As the Asian Financial Crisis tided over, China has been more active on resuming and improving the managed floating exchange rate regime at an opportune time. Facing new situations after China's accession into the WTO and sluggish global economic growth after the 911 attack, the range for RMB exchange rate narrowed for a fairly long time to reduce uncertainties and maintain the continuity of RMB exchange rate policy. This measure, however, is ad hoc rather than a long-term institutional arrangement.

4. The exchange rate regime reform in 2005 was the continuation of the reform in 1994. The essential role of a stable and healthy financial system in preventing and addressing crisis was fully recognized in the wake of the Asian financial crisis. Around 2003, when financial reform in China was at a critical juncture, the country was faced with the urgent task of launching joint-stock reform in large state-owned banks, including the Industrial and Commercial Bank of China (ICBC), Agricultural Bank of China (ABC), Bank of China and China Construction Bank (CCB). The reform would improve their ability to adapt to the floating exchange rate regime and to provide companies with better risk management services, but it was an onerous work. In this context, the reform was first started in large state-owned banks in the summer of 2003. The Bank of Communications, Bank of China and Construction Bank of China completing the joint-stock reform and went public. Following that, in April 2005, the reform in the ICBC was started, and reform in the ABC and the China Development Bank was put on agenda. Reform in this front went ahead in parallel with the pilot reform program of non-tradable shares in listed companies, the introduction of short-term corporate financing bills and asset securitization products in the money market, and the progress in the reform of rural credit cooperatives. As a result, the deployment of reform in large financial institutions, which is the foundation for exchange rate regime reform, was completed by July 2005.

Meanwhile, the domestic pricing mechanism of resources was gradually reformed; reform in enterprises, particularly in state-owned enterprises (SOEs) proceeded smoothly; a group of large enterprises were listed in domestic and overseas markets; restructuring efforts aiming at better resources allocation was strengthened; and corporate governance and finance management were enhanced. Progresses in these areas reinforced the foundation for exchange rate regime reform on the micro level. Because of all these developments, it was believed that it was the right time to further reform the exchange rate regime. On July 21, 2005, China improved the managed floating exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies.

II. The framework of the managed floating regime was enhanced and its content enriched

1. The mechanism that moves the exchange rate towards the adaptive and equilibrium level has been gradually established. The RMB exchange rate first dropped and then climbed up in general over the past three decades. Since 1978, the yuan depreciated from the initial 2.8 yuan per dollar, then moved downward to 8.7 yuan per dollar in early 1994, after which it edged up to 8.11 yuan per dollar in July 2005, and further rose to 6.85 yuan per dollar in late 2009. The exchange rate has been allowed to move within a wider band, i.e., from a daily band of 0.3 percent against the US dollar at the start of the reform in 2005 to 0.5 percent in 2007. As a result, market participants began to search for the adaptive and equilibrium exchange rate level by looking at balance of payments positions and foreign currency supply and demand.

2. Market supply and demand has an increasingly important role in determining the exchange rate. Following the liberalization of the RMB current account in late 1996, and with increasing channels for capital flows such as direct investment, portfolio investment and cross-border financing since 2001, foreign exchange supply and demand has improved, facilitating trade and investment, and making the holding and use of foreign currency more convenient. The role of supply and demand is becoming increasingly important in the foreign exchange market.

3. The foreign exchange market mechanism has improved. Before 1994, the RMB exchange rate was determined both by the authority and the swap market. Now it is determined in the interbank foreign exchange market through OTC transactions and supported by market makers. As the foreign exchange market grows rapidly, the role of market participants in determining the exchange rate central parity has been increasing. In response to the diversified trade and investment structure, the exchange rate regime is with reference to a basket of currencies, rather than pegging to the US dollar.

III. A managed floating exchange rate regime is in China's long-term and fundamental interests and we will continue to implement the regime

Adopting a managed floating exchange rate regime is an inevitable choice for China to deepen reform and opening-up, and adapt to the new pattern of development and opening-up after China's accession into the WTO. In line with the scientific approach to development, this is a choice consistent with China's economic development level, improvement in market-based institutional arrangements and financial regulation and enhanced resilience of the corporate sector. Continued efforts will be made to implement the regime.

1. The regime is essential for economic restructuring and the optimization of resource allocation. Exchange rate represents the price relations between tradable and non-tradable goods and services. A fixed exchange rate may make accounting and risk management easier for market participants for some time, but if misaligned with the fundamentals of supply and demand for too long a time, such a regime will distort relative prices on domestic and foreign markets, undermine the efficiency of resource allocation and accumulate domestic and foreign economic imbalances. A managed floating exchange rate regime will enhance the efficiency of resource allocation, adjust the relation between domestic and foreign prices in a flexible manner, channel resources to the sectors that are driven by domestic demand such as the services sector, promote industrial upgrading, transform the pattern of economic development, reduce trade imbalances and over-reliance on export, enable domestic demand to play a more important role in economic development and thus promote sustainable and balanced economic growth.

2. We need such a regime to strengthen and improve macroeconomic policy-making. Since the beginning of the reform and opening-up and especially since the entry into the WTO, China has seized the historical opportunity of international industrial relocation and improved productivity and economic strengths. Nevertheless, the economy has problems such as large BOP surplus, rapid growth of foreign reserves, oversupply of liquidity, inflation and heightened pressures from asset bubbles. Meanwhile, growing magnitude of capital flows has posed challenges to the independence and flexibility of monetary policies. Given the impossible trinity of achieving monetary policy independence, fixed exchange rate and free capital flow in an open economy, a managed floating exchange rate regime will help enhance the proactiveness and capability of macroeconomic management and the effectiveness of monetary policy, curb inflation and asset bubbles and contain the macroeconomic risks.

3. A rigid exchange rate regime is not responsive to crisis and may even trigger monetary and financial crises. According to international experiences, prolonged BOP imbalances and peg to a single currency by a medium- or large-sized economy can hardly sustain, and may increase its vulnerabilities to crises. A rigid exchange rate has been an important contributing factor to the Mexican financial crisis in 1994, Asian financial crisis in 1997, Brazilian financial crisis in 1999 and Argentine financial crisis in 2001. Not much harm will be done to a small country if it links its currency with that of a large one, but this is hardly the case for large countries as they have larger interaction with global economy. In addition, a fixed exchange rate is an easy excuse for trade friction and protectionism. Thus, it is necessary for large countries to have flexible exchange rate policy. China has adopted and will continue to improve the managed floating exchange rate regime. While furthering the exchange rate regime reform provides a great deal of potential for future benefits, efforts would also be needed to minimize possible negative impacts. These measures help maintain a facilitating environment for free trade, achieve long-term cooperation and common development, facilitate China's economic development at the juncture of strategic importance and foster a favorable international economic and trade environment.

On June 19, 2010, the PBC announced to further reform the RMB exchange rate regime based on measures taken in 2005. According to the announcement, continued emphasis will be placed to reflecting market supply and demand with reference to a basket of currencies and the exchange rate floating bands will remain the same as previously announced in the inter-bank foreign exchange market. This is an important move in reforming the managed floating exchange rate regime and will help maintain RMB exchange rate basically stable at an adaptive and equilibrium level, promote a balanced BOP account and financial market stability and realize quality and rapid growth of the economy.