# Hu Xiaolian: Successful experiences of further reforming the RMB exchange rate regime

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China moved into a managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies on July 21st, 2005. Positive results produced thereafter showed that the reform was launched at the right time in the right direction.

## I. The reform of exchange rate regime has been furthered at an appropriate time

It is at the 3rd Plenary Session of 14th CPC Central Committee that the goal of establishing a managed floating exchange rate regime based on market supply and demand was outlined. In January 1994, with the unification of RMB's official exchange rate and swap rate, the single, managed floating exchange rate based on market supply and demand was officially adopted. The RMB exchange rate gradually approached an adaptive level, which helped enhance the competitiveness of export-oriented enterprises and facilitated the shift from trade deficit to surplus.

During the Asian financial crisis in 1997, the RMB exchange rate was kept stable around 8.3 yuan to one dollar in order to brake competitive devaluation of Asian currencies. Though the impacts of Asian financial crisis subsided in 2001, the RMB was kept at a stable level against the US dollar as unfavorable factors, such as deflation, arose domestically. Reflecting on the crisis, China stepped up the financial reform and infrastructure building. Researches and preparation on resuming exchange rate floating were also well underway. As financial institutions had not completed reform and were not yet prepared to handle exchange rate movements or provide enterprises with relevant services, the reform of large-sized state-owned commercial banks was conducted before exchange rate reform.

The reform in large financial institutions, which is the basis for exchange rate regime reform, was completed by July 2005. The Bank of Communications, China Construction Bank and the Bank of China finished financial restructuring and became listed companies. The financial restructuring of Industrial and Commercial Bank of China was put on agenda and the preparation for the reform of China Development Bank and the Agricultural Bank of China was underway. In addition, China's accession into the WTO had significantly enhanced the competitiveness of export-oriented enterprises. With continued expansion of trade surplus, Chinese enterprises and financial institutions were better prepared for the reform of the RMB exchange rate regime. With these conditions in place, the reform of exchange rate regime was launched decisively.

Around end July 2008, in order to address the deepening international financial crisis, China narrowed the floating range of RMB exchange rate and did not devalue the currency as many other countries did. This contributed much to stabilizing external demand, helped mitigate the impacts of the international financial crisis, and promote Asian and global economic recovery. Global economy is now recovering and China's economic recovery and upturn is more entrenched. In this context, as approved by the State Council, the PBC decided to further the reform of exchange rate regime and enhance the flexibility of RMB exchange rate on June 19, 2010. New challenges may arise as international economic and financial situations evolve, but the reform of RMB exchange rate regime will continue in line with our established policy.

## II. The exchange rate regime is consistent with the market-based economic reform in China and an integral part of the restructuring package

China has moved into a managed floating exchange rate regime based on market demand and supply with reference to a basket of currencies. This is a right choice based on China's specific circumstances and development strategy. As an important component of the socialist market system and in line with the scientific approach to development, the exchange rate regime is needed in the country's endeavor to deepen reform and opening-up, and adapt to the new situation after China's accession into the WTO. In line with China's long-term and fundamental interests, a managed floating exchange rate regime is an inevitable choice that will facilitate economic restructuring and comprehensive, balanced and sustainable development, help strengthen macroeconomic management and facilitate China's economic development at the juncture of strategic importance.

The goal of China's economic policies is economic growth, full employment, price stability and a balanced BOP account. A package of restructuring measures is needed to address structural problems of high savings rate and inadequate domestic demand. In this package, exchange rate policy plays a role no less important than general industrial policies as it has an impact on domestic and foreign relative price in an aggregate sense. A misaligned domestic and foreign relative price leads to the distortion of domestic prices and undermines the stable, balanced and sustainable development of the economy. A proper mix of other structural policies and exchange rate policy can be more efficient in facilitating a well-functioning pricing mechanism. What has been achieved showed that, since the launch of the reform in 2005, the restructuring package has created a basis for exchange rate policy to play a fundamental role in domestic and external sector resource allocation, and the successful launch of the exchange rate regime has created a more facilitating environment for other reforms, such as the reform of resource prices. Moreover, exchange rate policy, together with lifting import control, easing foreign exchange control and accelerating the "going global" initiative, has played an important part in halting further accumulation of BOP imbalance. Improved flexibility of exchange rate also helps make macroeconomic management more proactive and efficient.

## III. The positive results since the exchange rate regime reform in 2005

Core competitiveness of the corporate sector has been strengthened as a result of heightened efforts to upgrade and innovate products. This facilitated the optimization of export structure and the shift of trade and growth pattern. From 2006 to 2008, the structure of China's exports further improved. The share of machinery, electronic products and high-tech products continued to rise while the export by high-pollution, high-energy consumption and resource-intensive industries had been restricted. The share of export to developing countries and emerging markets went up while that to the developed countries declined. Meanwhile, the process of "Attracting Foreign Investment, Technology and Management Expertise" and "Going Global" gained momentum, enabling China to play a bigger part in global industrial chain and the international market. Being more responsive to exchange rate movements, large amount of export-oriented enterprises conducted proactive financial management and raised selling prices to cover exchange rate losses. Improved in quality, China's foreign trade registered further development.

Domestic demand supported by import expansion and lower import cost helped ease inflationary pressures. From June 2005 to June 2008, China's import volume totaled US$2.729 trillion. A total of 1.6497 trillion yuan of import cost was saved as a result of RMB appreciation against the dollar. Massive technology and equipment imports facilitated rapid improvement of China's capacity and productivity. Moreover, yuan appreciation against the US dollar in this period lowered the RMB-denominated price of import products and cushioned the impacts brought by the rise of international raw material price on domestic price level, which directly eased domestic inflationary pressures.

Resource allocation was optimized, promoting economic restructuring and more balanced development. As a result of macroeconomic policies including exchange rate policy, the industrial structure became more balanced with the service industry contributing 42.9 percent to GDP growth in 2008, a growth of 2.6 percentage points from 2005. The geographical distribution of industries improved as the labor-intensive industry accelerated its reallocation to the central and western part of China, facilitating the implementation of national development strategy. In 2008, share of central and western region in China's GDP was 37.1 percent, up 1.3 percentage points from 2005. As more resources have been channeled to economic sectors driven by domestic demand, domestic demand contributed 90.8 percent to economic growth in 2008, up 14.9 percentage points from 2005. The concentration of labor force in the export sector as a result of an undervalued exchange rate has been partly corrected as more jobs have been diverted to the services industry, which is largely non-tradable. According to the National Bureau of Statistics (NBS), the number of people employed in the services industry as a percentage of total employment increased by 1.8 percentage points between 2005 and 2008. In the long run, the manufacturing industry will evolve from a labor-intensive industry to a capital-intensive one, providing fewer jobs. The services industry, in comparison, is by nature a labor-intensive industry and can create more jobs in a sustainable manner.

The reform of exchange rate regime has demonstrated to the international community China's commitment to promote global economic balance, providing a more facilitating international environment. A floating RMB exchange rate shows that China is dedicated to promote global economic balance and that China is a responsible member in the international community. This helped ease the tension in China's trade relations with foreign countries and lessen trade protectionism attempts targeting China. Between 2005 and 2008, trade remedy investigations against China were mostly cases limited in size and scope and did not harm the free and open trade environment in China. In this context, China maintained high growth and low inflation for a fairly long time.

## IV. A dynamic approach is needed to assess the impact of exchange rate reform on the corporate sector

The potential adverse impact of the RMB exchange rate reform in 2005 was effectively managed thanks to the principle of making the reform a self-initiated, controllable and gradual process. The corporate sector became increasingly resilient to the reform, which was reflected in improving import and export indicators amid a host of shocks, including a stronger RMB, lower export rebate rate and rising labor cost. Export was not substantially affected. From 2006 to 2008, the golden period for China's foreign trade, export grew by 23.4 percent annually, and import by 19.7 percent. Exchange rate floating helped upgrade the export model from simple processing to deep and intensive processing, extended the production chain, and improved division of labor, ultimately contributing to higher employment. According to the NBS, total employment increased by 16.55 million during the period from 2006 to 2008.

Before the exchange rate reform was launched, there were concerns that companies could not adapt to the reform, and a floating exchange rate would thus lead to widespread shutdown and sharp decline in export and employment. There were also people who believed a 3 percent appreciation would result in mass closures and bankruptcy in textile and light industries. Looking back, these concerns reflected an overestimation of the side effects of the reform and an underestimation of companies' resilience. They are a result of the then popular static approach to studying policy implications, which assumes a constant cost, pricing and profitability and then observes the direct impact of exchange rate reform on selected economic indicators. In fact, most Chinese companies have developed the ability and mechanism to adjust to changes in the market after nearly three decades of market-oriented reform, which warrants the application of dynamic analysis.

Static approaches, including assessing exchange costs of exports and sales profits, did not fully capture the flexibility and adaptability of the corporate sector. In addition to expanding profits through technological upgrading and product innovation, exporters could transfer the cost of a stronger domestic currency by raising price. Moreover, exporters with import businesses would benefit from lower import costs, and exporters who also sell to the domestic market could offset exchange cost by selling more to domestic consumers. In addition, companies can employ a wide range of flexible finance management means to deal with exchange rate movements.

In an ever-changing market environment, the corporate sector manages market and other risks including exchange rate risks in a dynamic manner. Operating in a market economy, an enterprise has to face many changing parameters, including raw material prices, wage, export tax rebate, market demand, distribution channel, product mix and cycle, public utility price, and etc. The annual movement of any of these factors is often more than then 10 percent. As one of these variables, the exchange rate usually does not experience large swings. In a market economy, it is no longer feasible to adopt the planned economy measures to fix the external factors for enterprises. In a globalized environment, enterprises have fewer and fewer risk free long-terms orders and have to accept orders with shorter maturities. Enterprises around the world are adapting to the changing market conditions, including the changes in demand, distribution channel and price of input and output, exchange rate, hedge price, insurance price, and etc, and are managing the risks through information technology (such as low or zero inventory, shorter production cycle and outsourcing) and financial instruments.

It is important to look at the situation in most industries and companies to assess the impact of exchange rate movements. While some of the industries and companies manage to grow through innovation, others lag behind and are eliminated. Vulnerable companies are the first to feel the pressure to adjust, and they should be supported by policies to improve the social safety net and enhance training programs to improve labor force quality and adaptability. The competitiveness of the manufacturing sector as a whole, rather than that of individual companies, should be the focus in measuring the impact of exchange rate movements. Similarly, the assessment of the exchange rate regime reform should mainly look at the overall trade situation and the improvement of development quality.

Information and voice that are prone to systemic deviation need to be assessed properly. Exchange rate movements bring gains and losses to different companies. To win policy support, companies tend to highlight the losses in export, profits and employment while play down merits of the reform, such as reduced import costs. This helps generate a negative picture of companies' ability to deal with exchange rate movements. Therefore, a careful and comprehensive analysis is needed in order to produce a subjective assessment.

In summary, the RMB exchange rate regime reform has been advanced smoothly in a self-initiated, gradual and controllable process since 2005. The reform plays a positive role in supporting the real economy, and creates favorable conditions for meeting macroeconomic management objectives. It helps promote a balanced BOP account, expand domestic demand and restructure the economy, and has been important in China's efforts to address various domestic and global developments.