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Exchange rate regimes: China's experience and choices

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Abstract

This short paper briefly reviews the evolution of China's exchange rate regimes over the last two decades, and analyzes China's choice of exchange rate regimes. While the current regime of a de facto peg to the U.S. dollar adopted in 1994, combined with other supporting mechanisms already in place, have served China's economy well, globalization and financial integration will lead China toward more liberal exchange rate regimes. The process of moving towards more flexibility should be undertaken cautiously, taking into consideration risk factors, including those related to market speculation, capital flight, macroeconomic fundamentals and the stability of China's financial system.

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Keywords: Exchange rate regimes; RMB; China

1. Introduction

China has maintained high and steady growth rates for over two decades, and its foreign reserves reached over $400 billion by the end of 2004. Since China is becoming an increasingly important player in the world economic scene, its exchange rate policy,

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among other issues, has attracted more attention in the world. Since mid-2003, external pressures for the renminbi (RMB) to be revalued have built up rapidly.

At the heart of the debate on China's exchange rate policy are two related issues: RMB exchange rates and exchange rate regimes. More specifically, what exchange rate levels are appropriate? Towards what exchange rate regimes should China move? This short paper focuses on the second issue. After briefly discussing the evolution of China's exchange rate regimes over the last two decades, we analyze China's choice of exchange rate regimes.

2. China's exchange rate regimes since the 1970s

Along with China's gradual economic reform since the 1970s, its exchange rate regime has evolved in "an experiment of gradualism" (Mehran, Quinton, Norman, & Laurens, 1996). The regime changed from a centrally planned administrative mechanism to a dual-rate system, then to a managed float with a narrow band, and finally to a managed float with a very narrow band—a de facto peg to the U.S. dollar.[1]

When China started its economic reforms in the late 1970s, it had administrative exchange rate arrangements that had been conceived to support its centrally planned economy. Its official exchange rates were linked to a basket of currencies. China also issued Foreign Exchange Certificates based on the official rates for foreign tourists and foreign residents in China. In late 1979, China started to permit state-owned enterprises (SOEs) to trade foreign exchange retention quota through Bank of China branches. In 1981, China introduced a dual-exchange-rate system: an official rate for non-trade-related transactions and an internal settlement rate for authorized current account transactions. Following the discontinuation of the internal settlement rate in 1985, all transactions were settled at the official rate. The official rates were adjusted from time to time to reflect exchange rate movements of the currencies in the basket.

After its establishment of special economic zones, China reintroduced a dual-exchange-rate system in 1986. Foreign and Chinese enterprises in special economic zones were permitted to trade foreign exchange among themselves at negotiated exchange rates in Foreign Exchange Adjustment Centers, the so-called swap centers. The swap centers allowed external trade to take place at a fluctuating market exchange rate and supported the state's efforts to continue using the foreign exchange plan and the official exchange rate for transactions.

The swap centers formed a platform for a market mechanism outside the central plan and at market rates, and they played a useful role in smoothing the transition from a centrally planned economy to a market economy. China had one official foreign exchange rate (RMB 5.7 per U.S. dollar) and often many market exchange rates because of imperfect arbitrage between swap centers. These market rates generated new market distortions and

[1] For more discussion on China's exchange rate policy, see Bottelier (2004) and Huang and Wang (2003).