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China's Exchange Rate Regime and Reform Perspective

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Introduction

As of end 2002, China's official exchange rate regime is a managed floating exchange rate regime based on supply and demand.1 In effect, since 1997 the renminbi (RMB) rate has remained within a very narrow range of RMB8.27–8.28 per dollar. In reality, a strict fixed exchange rate regime has been in operation.

How will China's accession to the WTO, expanding and making more complex its external economic relationship, affect its exchange rate regime? Will China's exchange rate regime return to a managed float with flexibility in the real sense that will reflect supply and demand in the market? Under what circumstances is it possible? Will China take on a third alternative regime, e.g. pegging the RMB to a basket of currencies? These questions will be discussed in this paper, for a time framework of the next four years, which is a transitional period for structural adjustments allowed to China as a new member of the WTO.

In the long run the issue of the RMB's full convertibility should be unavoidable, as the Chinese economy strengthens its position on the international economic scene, especially in East Asia. The conditions necessary for the internationalization of the RMB, i.e., full convertibility, will also be discussed.

1. China's Existing Exchange Rate Regime

(1) Unification of Exchange Rates and the IMF Article VIII Nation

China reformed its foreign exchange control system fundamentally in January 1994, and introduced the current exchange rate regime and foreign exchange control system. The direct objective of this reform was for China to make ready to resume its status in GATT, by changing the old regime's strong tint of planned economy into a new one acceptable to the IMF and GATT's basic requirements. The major points of this reform

[1] Report of the Working Party on the Accession of China, p. 6

are as follows.

(a) Unification of the RMB's Exchange Rates and Introduction of a Managed Float

The practice of dual exchange rates that prevailed until 1993, with the official rate (RMB5.8 per dollar) and the foreign exchange swap center rate (RMB8.7 per dollar at the end of 1993), was abolished, and a single exchange rate was introduced, using the market rate at the swap center. At the same time, the managed floating exchange rate regime was adopted, based on market supply and demand.

(b) Authorized Foreign Exchange Bank and Restrictions on Foreign Exchange Holding

The foreign exchange settlement system operated by the central bank was abolished, and thirteen banks—including four major state-owned banks—were designated as "Foreign Exchange Banks," enabling foreign exchange settlements for their own accounts. In addition, the foreign exchange retention regime was abolished. As a result, state-owned enterprises were prohibited from holding foreign exchange and, in return, they were able to purchase it with due procedure at authorized foreign exchange banks, for settlement of trade and other transactions. As an exception to the foreign exchange concentration principle, foreign-funded enterprises and individuals were allowed to open foreign currency deposit accounts at designated foreign exchange banks.

(c) Establishment of Interbank Foreign Exchange Market

An interbank foreign exchange market was established in Shanghai in April 1994, connecting online major cities throughout the country by the network of the China Foreign Exchange Trade System (CFETS).

(d) Prohibition of Circulation of Foreign Currencies in the Domestic Market, and Abolishment of Foreign Exchange Certificates

The pricing in foreign currency and the circulation of foreign currencies in the domestic market were prohibited. The circulation of foreign exchange certificates, started in 1980, was suspended at the end of 1994, and then withdrawn by June 1995.

On December 1, 1996, China accepted the obligations of Article VIII of the IMF Articles of Agreement. As a result, China was no longer able to, according to Article VIII, Sec.2, "without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions" (giving China an IMF Article VIII nation status). Prior to the acceptance of the obligations, China was an IMF Article XIV nation (allowed to maintain, for a transitional period, restrictions on payments and transfers for current international transactions). The IMF confirmed in its staff report on the Article IV Consultation with China in 2000, that China had no

existing exchange restrictions for current account transactions.[2] When China became an Article VIII nation and accepted all related obligations, the RMB had been made formally convertible for current account transactions.

(2) Foreign Exchange Controls System

China's foreign exchange controls are under the jurisdiction of the State Administration of Foreign Exchange (SAFE, whose director-general, Mr.Guo Shu Qing, possesses the rank of undersecretary in the government) of the People's Bank of China. SAFE's major functions are to monitor and advise on balance-of-payments and foreign exchange related issues, and to draft appropriate regulations and monitor their compliance.

Before China became an Article VIII nation, the Foreign Exchange Control Regulation went into effect on April 1, 1996, as a basic law for foreign exchange controls (partially amended on January 14, 1997). The regulation stipulates exchange controls for both current account and capital account items, and controls the RMB's exchange rate and the foreign exchange market.

For payments of current account transactions, enterprises can purchase foreign currencies either upon presentation of valid documents to designated foreign exchange banks, or with a review (examination) by SAFE. The contents of these regulations are relatively clear, although there is rigidity in reviewing the legitimacy of documents for trade settlements. They are ambiguous, however, for invisible trade transactions (such as payments for services), and there are many cases that cannot be dealt with at the level of designated foreign exchange banks (according to information provided by foreign banks in Shanghai).

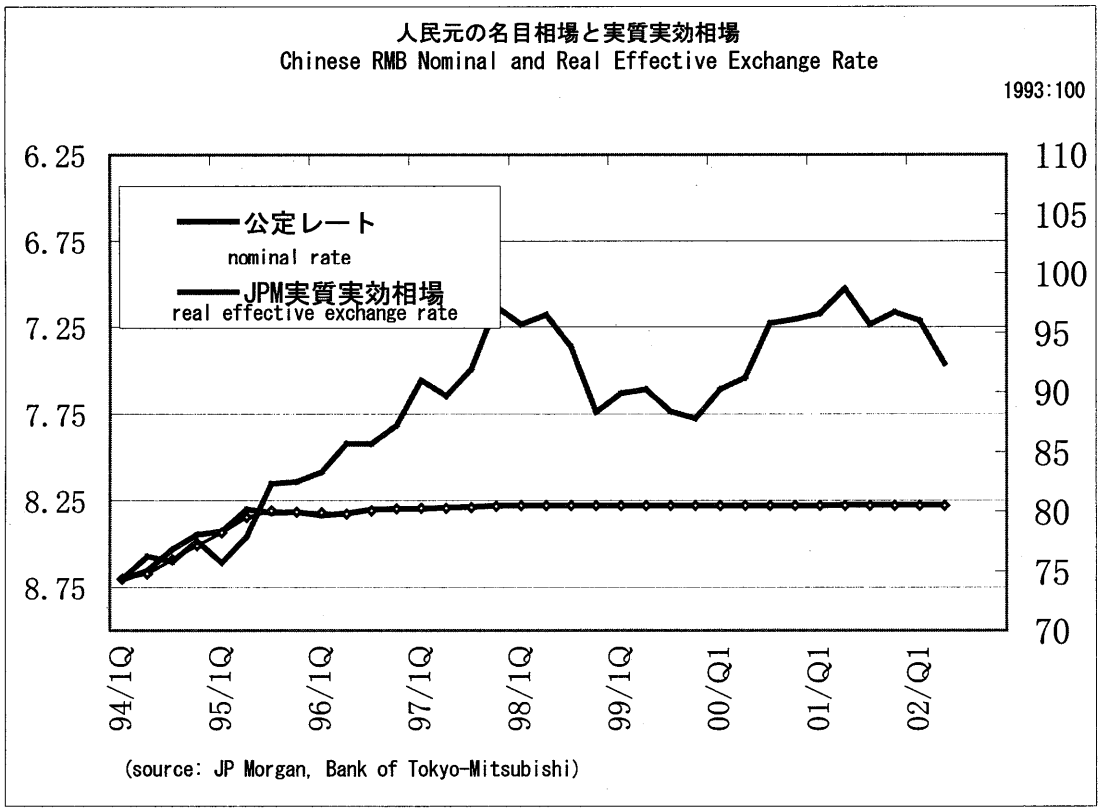
In relation to capital account transactions (direct investments, portfolio investments, foreign bond issues, loans, borrowing, guarantee, deposits, and others), specific permission is necessary for both purchasing and selling foreign currencies, and there is a strict control system by SAFE. In addition, in order to prohibit such unlawful acts as tax evasion, either a tax payment certificate or a tax exemption certificate issued by tax authorities should be presented to banks for payments for invisible trade transactions related to certain capital account transactions.

(3) RMB's Exchange Rate Trend Under the Current Regime

Two distinct periods emerged since the RMB's exchange rates were unified and the managed floating rate regime was adopted, one from 1994 to 1997, in which there was

[2] op. cit. p. 6

an uptrend of the RMB's rate, and the other after 1997, which has seen a de facto fixed exchange rate regime. The contrasting trend of exchange rates officially under the same exchange rate regime should be interpreted, taking into account international and domestic economic environments and movements of the balance of payments. The RMB's exchange rate is essentially controlled by monetary authorities, and straightforwardly reflects the monetary policy of the Chinese government.



(a) Uptrend Period of the RMB's Exchange Rate

When the RMB's rates were unified at a market rate of RMB8.70 per dollar at the end of 1993, it meant a 33 percent devaluation against the official exchange rate, and effectively a little less than 10 percent devaluation against the trade-weighted average of the foreign exchange swap center rate and the official rate. Since then, the RMB moved upward against the dollar, from RMB8.45 per dollar in 1994, to RMB8.32 in 1995, to RMB8.30 in 1996, and to RMB8.28 in 1997.

This trend was the direct result of a favorable balance of payments. From 1994 to the first half of 1997, China enjoyed expanding surpluses from the trade balance and capital account balance principally because of the inflow of foreign direct investments

(twin surpluses), greatly increasing foreign reserves from US$21.2 billion at the end of 1993, to US$139.9 billion at the end of 1997.

During this period, the US economy enjoyed a long-term growth of the so-called "New Economy"—and East Asian countries recorded high economic growth as well, giving rise to the designation of the 21st century as the "East Asian Century," although they were to be struck by currency crises later on. In such a favorable international environment, rationalization of production systems and improvements in product quality—thanks to the increase of foreign-funded enterprises—substantially enhanced efficiency of export industries, and Chinese products increased their competitiveness even with the appreciation of the RMB both in nominal and real terms. China's GDP growth rate gradually slowed during this period—12.6 percent in 1994, 10.5 percent in 1995, 9.6 percent in 1996, and 8.8 percent in 1997—but remained at a high level nonetheless, allowing a generous acceptance of the appreciation of the RMB.

(b) De Facto Fixed Exchange Rate Period

For five years between 1997 and 2002, the RMB's rate moved within a narrow range between RMB8.27 and RMB8.28 per dollar, under a de facto fixed exchange rate regime. The range of fluctuation during this period was only 0.1 percent, and exchange rates were managed with extreme rigidity, compared with the European Monetary System (which maintained a quasi-fixed rate regime within the EU territory) in the 1980s, where the range of fluctuation was in principle 2.25 percent in relation to an assigned central rate. Looked at more closely, the RMB's rate against the US dollar moved mostly between RMB8.2800 and RMB8.2770, perfectly managed microscopic fluctuations to the third decimal place, and having little to do with an official explanation of a rate determined by supply and demand.

The policy change from allowing appreciation of the RMB, to fixing the rate, resulted from the political judgment that the stability of the exchange rate should come first. In the balance of payments aspect, the twin surpluses gradually disappeared from 1997 to 2000, and the capital account surplus declined particularly sharply, recording a temporary deficit in 1998. The trade surplus slowly decreased from the record of US$46.6 billion in 1998 to US$34.0 billion in 2001. Among capital accounts, inward direct investments once decreased from US$44.2 billion in 1997 to US$38.4 billion in 2000, but revived to increase to another peak of US$52.7 billion in 2002. The problem was that untraceable capital flight (recorded in errors and omissions, and other investment items) probably reached US$50 billion from 1997 to 1999. As a result, the capital account recorded a surplus of US$23 billion in 1997, a deficit of US$6.3 billion in

1998, and small surpluses of US$7.6 billion and US$1.9 billion in 1999 and 2000, respectively. Foreign reserves increased only gradually to US$165.6 billion at the end of 2000, from US$139.9 billion at the end of 1997, and substantially increased to US$212.2 billion and US$286.4 billion at the end of 2001 and 2002 respectively. It appears that capital flight stopped in 2001.

In July 1997 international economic circumstances changed dramatically. The Asian currency crisis broke out in Thailand, and for two years until the first half of 1999, East Asian economies surrounding China suffered from a serious depression. Economies recovered toward 2000, but only briefly, since East Asian countries were greatly affected when the US economy slowed in 2001 and remained stagnant. The Chinese economy was not directly involved in the crisis, but the GDP growth rate declined to 7.8 percent in 1998, and 7.1 percent in 1999. In 2000, the government issued special construction bonds and stimulated the economy, resulting in 8.0 percent growth. The growth rate fell back to 7.3 percent in 2001, rebounding to 8.0 percent in 2002.

The RMB's exchange rate has retained stability over the last five years under the fixed exchange rate regime. Meanwhile, the market completely changed its views on the future trend of its exchange rate, from the pessimism of unavoidable devaluation, to the optimism of possible up-valuation. Currencies of neighboring countries (except Hong Kong) depreciated sharply during the Asian currency crisis, and the RMB's devaluation was considered a matter of time when the Japanese yen fell to as low as ¥147 per dollar in August 1998. The pessimism about the RMB surfaced from time to time until the first half of 1999, but all of a sudden, optimism took over in the second half of 1999. The reason for this change was that the view spread that China would certainly enter the WTO in the near future, taking into account the facts that the US Congress recognized China in September 1999 as a permanent most-favored nation, and that China agreed with the United States in November 1999 on the conditions to pave the way for joining the WTO.

In 2001 a positive sentiment on the RMB prevailed in the market, and in November, for the first time temporarily, the RMB showed a new price structure, i.e. a premium against the dollar in the NDF market.[3] At the time, the RMB's rate at the foreign exchange center in Shanghai briefly recorded RMB8.2668 against dollar, the highest rate breaking the previous ceiling of RMB8.27. In the same year, in Japan people in

[3] NDF (Non-delivery forward) is a kind of forward exchange transaction, in which the settlement of principal is not required, but only the difference between the contracted rate and the actual market rate of a certain future date is settled. NDF is traded in the markets of Hong Kong and Singapore mainly for currencies of developing countries, where forward exchange contracts are prohibited by foreign exchange controls. The RMB was traded at a rate of RMB9.2 per dollar in January 1998, but less than RMB8.26 in November 2001.

political and economic circles loudly demanded revaluation of the RMB, but leading figures in the Chinese government stressed the stability of the RMB, and never indicated any possibility of such up-valuation.

2. Current Issues in Financial Sector

(1) NPL and Risk Management of State-owned Commercial Banks

In the wake of China's membership in the WTO, and in light of future full-scale, global competition in financial services, the Chinese government endeavors the reform of state-owned commercial banks to enhance their competitiveness. The final target of financial reforms is to reorganize state-owned commercial banks into joint-stock commercial banks, whose majority shares will still be controlled by the government, when they become qualified for reorganization (see section 15, paragraph 4 of the Tenth Five-Year Plan). Their stocks will eventually be listed on stock exchanges, whenever appropriate.

After listing the stocks of state-owned commercial banks for partial privatization, their business performance is expected to be assessed by the market through market prices of listed stocks. Even if the government continues to hold majority shares of the state-owned commercial banks listed on stock exchanges, these banks will likely be released from the bondage of policy finances for supporting state-owned enterprises. The stock market will evaluate their management on commercial basis.

There still remain several problems to be solved before reaching this final goal, however, such as (a) improving the extremely low profitability of the four state-owned commercial banks, (b) upgrading their asset quality by disposing of non-performing loans (NPLs), (c) establishment of internal control and monitoring systems as well as corporate governance to manage risks such as credit, market, operational and other risks.

Even if the negative legacy of NPLs inherited from the former state-planned economy is detached from state-owned commercial banks, without appropriate risk control systems and corporate governance, newly emerged bad assets and business losses will give them no chance to gain the corporate strength and profitability needed for listing their stocks.

Table 1 Financial Data on Industrial and Commercial Bank of China and Bank of China

Unit: RMB100 million	Industrial and Commercial Bank of China (Head Office in Beijing)			Bank of China (Head Office in Beijing)		
	1999	2000	2001	1999	2000	2001
Number of Employees	549,030	476,000	429,000	208,790	210,600	201,590
Number of Branches	36,908	31,700	28,300	14,679	13,542	13,089
Total Asset Balance	35,399	39,737	43,181	29,039	34,413	33,616
Loan-Asset Balance	24,461	24,136	26,594	15,290	15,462	16,317
Customer Deposits	29,824	32,485	35,805	19,849	23,904	24,771
Capital Account	1,815	1,874	1,910	1,483	2,022	2,184
Profit After Tax	41	51	59	44	77	79
Return on Total Assets	0.12%	0.13%	0.14%	0.23%	0.35%	0.32%
Capital Adequacy Ratio	5.13%	5.38%	5.76%	9.80%	8.31%	8.30%
NPL Ratio	N.A.	34.43%	29.78%	37.42%	27.20%	27.51%
Substandard	N.A.	9.87%	6.36%	13.16%	9.45%	6.87%
Doubtful	N.A.	18.57%	16.91%	18.61%	13.70%	14.79%
Loss	N.A.	5.99%	6.51%	5.65%	4.05%	5.85%
S&P Credit Rating	BB+	BB+	BB+	BB+	BB+	BB+

Notes:

- Industrial and Commercial Bank of China figures for 1999 are quoted from Standard & Poor's, "Analysis of Industrial and Commercial Bank of China," December 6, 2000. The number of employees of the Industrial and Commercial Bank of China under 1999 is data for 1998.
- Bank of China's figures for 2000 are quoted from the 2001 annual report, although there are some differences between the 2000 and 2001 reports. Figures for 1999 are quoted from the 2000 annual report.
- Return on total assets = Pre-tax profits / Total asset balance. Denominators of the Bank of China's return on total assets as of 1999, 2000, and 2001, are respectively the average balance of fiscal 1999, balance at the end of fiscal 2000, and balance at the end of fiscal 2001.
- Numerators of NPL ratios are loans classified in the worst three categories (substandard, doubtful and loss) from among the five category loan classification system (normal, special-mention, substandard, doubtful, and loss).

Sources: Annual reports and Standard & Poor's homepage

The total assets of the four major state-owned commercial banks amounted to RMB12 trillion (as of the end of 2001), and accounted for 55 percent of the aggregate assets of all financial institutions in China, including securities and insurance companies. Governor Dai Xianglong of the People's Bank of China announced that the NPL ratio (ratio of NPLs to total assets) of these four banks dropped to 25.37 percent at the end of 2001, due to a decrease of NPLs by RMB90.7 billion (3.81 percent) during the year.[4] (The disclosed NPL ratio of the four banks was 25 percent at the beginning of 1998.)

Considering that NPLs for RMB1.3 trillion were transferred meanwhile from the four state-owned commercial banks to their asset management companies, reducing the NPL ratio by ca. 10 percent, NPLs did not actually decrease at all. Apparently they continued to increase even after the 1996 prohibition of policy finances by state-owned commercial banks. The NPL ratio is 25.37 percent based on the former Four Category Loan Classification System (normal, overdue, doubtful and bad). If this ratio is recalculated using the new Five Category System applied to financial statements since fiscal 2001, it is estimated to increase by 5 percent to 30 percent.[5]

This disclosed NPL ratio does not include the financial bonds (with no official state guarantees), amounting to RMB846 billion, underwritten by the four state-owned commercial banks for funding NPLs transferred from them to their asset management companies. These bonds are to be regarded potentially as disguised bad assets, and if included, will raise the NPL ratio to over 40 percent, according to the internationally-common loan classification.[6]

Chinese financial authorities are currently guiding state-owned commercial banks to lower their NPL ratios by 2 to 3 percent every year, to an eventual level of 15 percent within five years. Although some progress was reported in the reduction of NPLs in 2001 and 2002, questions are now what measures are available for reaching the final target of 15 percent, and what problems exist in attaining this goal, since the disposal of NPLs via asset management companies has already been used up and no further transfer of new NPLs is scheduled.

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[4] *Daily Economic Reports*, January 24, 2002, and February 24, 2002.

[5] Industrial and Commercial Bank of China's bad asset ratios are disclosed according to both old and new classifications of bad loans: 29.3 percent (old classification as of the fiscal end of 2000), 34.43 percent (new classification as of the fiscal end of 2000), 25.71 percent (old classification as of the fiscal end 2001), and 29.78 percent (new classification as of the fiscal end of 2001).

[6] According to Standard & Poor's estimation, Chinese banks' bad asset ratio for 2001 and 2002 are both 50 percent, and their bad asset recovery ratio for 2001 and 2002 are both 15 percent. These levels are same as those of Indonesia, and are the worst in Asia. (Source: S&P homepage, "Low Recovery Rates Exacerbate Problem Assets for Banks in Emerging Asia," April 17, 2002.)

To decrease NPL ratios, efforts are needed to decrease the numerator (NPLs) and increase the denominator (total assets). It is essential, on the one hand, to write off NPLs and to suspend unprofitable high-risk loans for reduction of the numerator or limitation of its increase, on the assumption that no manipulation of asset classification is made by additional loans or other means to cover arrears of loan services.

The operating profits of the state-owned commercial banks are the major source of funds to write off NPLs, but much progress cannot be expected due to their low profitability. The pre-tax profit ratio (ratio of pre-tax profit to total assets) of the Bank of China, whose asset quality is reportedly the best among the four state-owned commercial banks, was only 0.32 percent for fiscal 2001 (RMB10.9 billion / RMB3.3616 trillion x 100). The total amount of NPLs written off by the Bank of China in fiscal 2001 was RMB23.2 billion, comprising only a quarter of the NPLs classified "loss" (RMB92.7 billion).The loan loss reserves covered only 1 percent of total loan assets at the end of fiscal 1999 (Refer to Table 1).

The state-owned commercial banks, on the other hand, attempt to build up assets with low credit risks, to increase the denominators of their NPL ratios. Banks are reluctant to extend loans to small and medium enterprises with weak credit standing. Under the current regulation of the People's Bank of China on deposit and loan interest rates, the inflow of funds into small and medium enterprises will be limited despite the government's strong instruction on helping them.[7] Financial institutions increased sharply the outstanding balance of bank bonds issued by policy financing banks and government bonds by 6.3 times from RMB367.2 billion in 1997 to RMB2,311.3 billion (15.1 percent of total assets) in 2001.[8]

Reserve deposits by financial institutions at the People's Bank of China bear interest (1.89 percent, identical to that of six-month term deposits as of February 20, 2002). The balance reached RMB1,708.9 billion, and the reserve deposit ratio rose to 13 percent, at the end of 2001, twice as much as the official requirement of 6 percent. Lending is concentrated on corporate loans to foreign invested enterprises of good standing, as listed in the Fortune 500, and to state-owned enterprises of national priority in the information, telecommunications, and petroleum sectors, as well as

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[7] People's Bank of China admits some additions (30 percent as of end 2002) to the regulated interest rates of loans applicable to small-to-medium sized corporations. As noted on the quotation list of interest rates: "Any enterprise, individual and financial institution will have the right to refuse payment of that pa of an interest rate higher than the norm. The PBC will according to law punish the relevant responsible institutions or individuals that violate the interest rate policies of the state," (Source: PBC homepage, "PBC Tunes Down Renminbi Interest Rates of Financial Institutions," February 20, 2002).

[8] Sources: PBC homepage, and Fujitsu Research Institute, page 43.

mortgage and auto loans backed by collateral. Competition for such customers of good credit standing, regardless whether among Chinese or foreign funded banks, is increasingly severe.

Solutions to NPL problems depend mainly upon rehabilitation and reconstruction of state-owned enterprises, whose loans make up 80 percent of the total loan assets of state-owned commercial banks. The China Economic and Trade Commission announced that the reform of state-owned enterprises made a considerable success, transforming 4,391 loss-making companies (two-thirds of 6,599 deficit enterprises in 1997) into profitable ones.[9] Positive factors contributing to raise profits of SOEs include such temporary elements as oil price rises in the petroleum sector and waivered interest payment of debts by debt-equity swap arrangements, in addition to rationalization of business management and the good business climate of the global economy. It is yet unknown, however, whether the reform of state-owned enterprises will continue smoothly under the new competitive environment brought on by China's access to the WTO in December 2001.

The autonomy of state-owned commercial banks is still so limited that their asset quality has hardly improved. Article 34 of the commercial banking law stipulates that commercial banks must carry out loan business according to the state industrial policies and corresponding to the actual demand of the national economy and social development. For example, national construction projects obligate state-owned commercial banks to finance the same amount of money as that of government bonds issued for such projects. The People's Bank of China continues strong window-addressing even after the 1998 abolishment of the loan volume regulation, interfering in the loan business of state-owned commercial banks. So far as they are "state owned," it is difficult to put banking operations solely on commercial basis. As a result, their transition to become privatized joint-stock companies (albeit partially) by listing their stocks will be all the more remote.

(2) Government-controlled Money Market and Foreign Exchange Market

(a) Short-term Money Market

The implementation of financial policies for macro-economic control requires a well-developed short-term money market. Policy intentions that are expressed through

[9] Sources: Japanese Finance Ministry homepage, Ministry of Finance, Chinese Study Group, "Problems in the Chinese Financial and Capital Markets—Disposition of Bad Loan Assets and the Reform of State-owned Enterprises," October 19, 2001.

open market operations, commercial-bill rediscounts, and minimum reserve ratios by a central bank are indirectly communicated to financial transactions of the private economy via money market interest rates. The efficient function of money market is also a prerequisite for the development of foreign exchange market. This is because in foreign exchange transactions (e.g. dealings of the renminbi against the US dollar or any other foreign currency), forward exchange rates of the renminbi against the dollar or other foreign currencies are arbitraged by the differences of interest rates between two currencies.

The Chinese money market has in recent years undergone a substantial expansion with its center at the Chinese Inter-bank Money Market Trade Center in Shanghai,. Transactions in money markets are divided into three major categories: call loan transactions (inter-bank money lending and borrowing), repo transactions (dealing of government bonds with short-term repurchase agreements) and discounts of commercial bills.

Repo transactions are the most active, their annual turnover rapidly growing from RMB104.2 billion in 1998 to RMB4,013.3 billion in 2001. The amount of repo transactions per day is RMB15.86 billion, of which repurchase agreements of government bonds within seven days make up 77.9 percent. The accumulation of the balance of government bonds to finance fiscal deficits accounts for this large expansion of repo transactions.

The total turnover of call loans per year increased from RMB98.9 billion in 1998, to RMB808.2 billion in 2001. Their volume per day is RMB3.19 billion, of which those with due dates within seven days make up 82.3 percent. The rate of expansion is far behind that of repo transactions due to the credit risks of market participants. Participants of money markets are diverse, including ten joint-stock commercial banks, urban commercial banks reorganized from urban credit cooperatives, foreign funded banks, securities companies and insurance companies, as well as the four major state-owned commercial banks. The main fund suppliers are the four state-owned commercial banks, and main borrowers are the rest of financial institutions including securities companies. The credit risks of small-to-medium sized financial institutions are major obstacles to the expansion of money market transactions.

The balance of accepted commercial bills increased from RMB133.5 billion at the end of 1997 to RMB511.2 billion at the end of 2001, while the balance of discounted commercial bills rose from RMB58.1 billion at the end of 1997 to RMB279.5 billion at the end of 2001. The People's Bank of China's rediscount policy of commercial bills was reviewed in 1998. The Chinese government tries to make more use of the official

rediscount rate to expand commercial bills markets, but the balance remained only RMB65.5 billion at the end of 2001.

The market functions for interest rate formation do not effectively work in the Chinese money markets despite the government's efforts. The problems of the Chinese money market come from their small size and from strict controls by the People's Bank of China. The size of money markets, in terms of the outstanding balance of call loans and repo transactions, is estimated at about RMB140 billion, which is less than 1 percent of the total deposit balance of all financial institutions at the end of 2001. (In Japan, the ratio of the outstanding balance of call loans and repos to the total deposit balance of all the financial institutions was over 10 percent in the 1990s.)

The four major state-owned commercial banks, which are major participants in the money market, tend to adjust surpluses and shortages of renminbi funds only within their provincial organizations, and to keep surplus funds as reserve deposits bearing no credit risks at the People's Bank of China. These account also for a slow expansion of Chinese money markets. Several measures have been implemented, such as the introduction of the inter-bank foreign fund market, to activate the Chinese money market since the beginning of 2002, but the credit risks of market participants hinder its expansion. Formation of a market-driven interest rate system is vital to the future expansion of China's money markets.

(b) Foreign Exchange Market

Foreign exchange markets in international financial centers like New York, London, and Tokyo function on the basis of invisible networks that connect banks, brokers and other market participants via telephones and computer terminals. Foreign exchange transactions in global markets are continuously executed, following the time differences of individual markets. All foreign exchange transactions in China are centralized at the Foreign Exchange Trading Center in Shanghai, which is connected with its nationwide sub-centers in 36 cities by an online network, and whose headquarter is located in the same building as the Chinese Inter-bank Money Market Trade Center, Shanghai's short-term money market.

Foreign exchange transactions stayed stagnant since the establishment of the Foreign Exchange Trade Center in 1994. The annual turnover of foreign exchange transactions peaked at US$72 billion in 1995, and later fluctuated at US$30–60 billion, finally rebounding to US$75 billion in 2001.The breakdown of dealings by currencies is as follows: the US dollar makes up 98.8 percent of all foreign exchange transactions, and the Hong Kong dollar and Japanese yen share the remaining 1.2 percent. Since

April 2002, the euro was added to the market. The total volume per day is only US$297 million, which is far behind the volumes of Tokyo (US$146.78 billion), Singapore (US$100.66 billion) and Hong Kong (US$66.82 billion) markets, and, according to the BIS survey of April 2001, even distant from those in Jakarta (US$3.86 billion), Bangkok (US$1.90 billion), Kuala Lumpur (US$1.25 billion), and Manila (US$1.06 billion). The foreign exchange trading is limited to spot transactions, with no outright forward, swaps or derivatives (such as currency options) in Chinese markets.

The low foreign exchange turnover is due to (a) inconvenient market mechanisms and strict control of exchange rates by the authorities, (b) strict foreign exchange controls of capital accounts and (c) underdeveloped short-term money markets.

China's official exchange rate regime is a managed floating exchange rate system based on supply and demand. Since the outbreak of Asian crisis in 1997, however, the Chinese government has adopted a de facto fixed exchange rate system, aligning the exchange rate of renminbi against the US dollar within a very narrow range of 8.27–8.28 yuan. In 1998-99 there was a strong market sentiment that the renminbi would be devaluated, but in 2001 expectations of its future revaluation took place. The reasons why the renminbi's fixed exchange rate could have been maintained, despite extreme changes in views concerning the exchange rate of the renminbi, include closed access of Chinese markets from overseas markets, market controls by the State Administration of Foreign Exchange under the umbrella of the People's Bank of China and its market mechanisms.

Trading at the Foreign Exchange Trading Center has been limited to only one hour and 40 minutes, from 9:20 a.m. to 11:00 a.m. (from the 10th February 2003 the operating hours are to be extended to 9:30-15:30). One business day prior to the date of execution of foreign exchange transactions (which must be based on actual demand, such as export and import, and excluding speculative dealings), financial institutions (about 350 banks and their branches) qualified to participate in the Foreign Exchange Trading Center must report to the State Administration of Foreign Exchange on the specification of foreign currencies and amounts (this practice is expected to change with the extension of operating hours of the market). The People's Bank of China intervenes to keep the renminbi's exchange rate against the US dollar within a range of 0.3 percent from the reference rate (the weighted average of exchange rates on the previous day) quoted every day.

Table 2 Chinese Foreign Exchange, Money and Capital Markets

Unit: RMB100 million		1994	1995	1996	1997	1998	1999	2000	2001
Annual foreign exchange turnover (US$100 million)		408	720	628	697	520	315	422	750
Annual volume of interbank money transactions		n.a.	n.a.	n.a.	n.a.	2031	7339	22540	48215
	Inter-bank call loans	n.a.	n.a.	n.a.	n.a.	989	3292	6728	8082
	Inter-bank repos	n.a.	n.a.	n.a.	n.a.	1042	4047	15782	40133
Stocks	Aggregate market value of listed stocks	3640	3474	9842	17529	19506	26471	48091	43522
	Ratio to GDP (%)	7.89	5.94	14.50	23.44	24.52	31.82	53.79	45.37
	Of which, negotiable stocks	965	938	2867	5204	5745	8214	16088	14463
Bonds	Government bond bal.	2286	3300	4361	5509	7766	10542	13020	15618
	Policy financing banks' bond balance	0	1613	2400	3487	5121	6447	7383	8534
	Corporate bond balance	682	647	597	521	676	779	862	1009

Sources: Volumes of foreign exchange transactions are quoted from *International Finance Journal* No. 1085, "China's full participation in the WTO and liberalization of foreign exchange controls," by Ké Lóng; volumes of money transactions are based on China's *Financial Year Books* from 1999 through 2001; figures on stocks and bonds are based on China's *Forward Securities Transactions Statistic Year Book* of 2002.

One can hardly expect active dealings under the current market management system, in which participating banks cannot but bring only final positions resulting from transactions dealt with customers on the previous day to the market for adjustment with other market participants. The People's Bank of China intervenes by buying or selling differences between the supply and demand of foreign currencies brought into the market by participants. In other words, it sells foreign currencies when demand exceeds supply, or buys foreign currencies when supply exceeds demand, which is eventually reflected in the state foreign reserves.

The extremely low volume of foreign exchange dealings in the Shanghai market is also due to its separation from overseas markets under the strict control of capital

account transactions. In global markets capital transactions bearing speculative elements make up no less than 90 percent of all transactions. Particularly, securities investments and deals related to banking loans, deposits and other operations play an important role. It is unlikely that the Chinese market grows to an international level under the current exchange control system, which requires authorization for such capital account transactions from the authorities.

In hedging exchange risks it is a problem that no forward foreign exchange transactions are allowed in Chinese foreign exchange trading centers. According to the 2001 BIS survey, spot dealings accounted for one-third (50 percent in 1992) of total worldwide foreign exchange dealings, while outright forwards and swaps make up two-thirds, gradually raising their importance. Since 1997, the Bank of China has experimentally concluded with customers forward exchange contracts due within 6 months, but the volume is limited because of the lack of forward foreign exchange market for cover deals. In September 2002 the Construction Bank of China was newly admitted to offer forward exchange services to customers, and the remaining state owned banks are scheduled to follow. As the main factor determining forward exchange rates of a currency against another is the interest rate differential between the two currencies, institution of a forward foreign exchange market requires the interest rate functions in renminbi money markets.

Although the renminbi's spot exchange rate against the US dollar is now managed under a fixed exchange rate regime, the need for forward exchange contracts should be potentially large to avoid exchange risks involved in increasing international transactions. When the foreign exchange policy is eventually changed by widening a fluctuation band or adopting a new regime, it will be indispensable to provide with market instruments to hedge exchange risks such as forwards and derivatives. It is an urgent issue to institute a forward exchange market in China.

(3) Monetary Policy and Independence of the People's Bank of China

The People's Bank of China (PBC) is exclusively responsible—as China's central bank—for monetary policies with emphasis on control of the money supply (M2: base money + demand deposits + fixed deposits) and maintenance of a stable financial system. The PBC has been shifting its basic policy techniques to indirect financial controls including open market operations and official discount rate policy, revoking such traditional direct financial controls as the regulation of the total loan volumes. This orientation of monetary policies toward indirect financial controls is clear and has been endorsed by the Tenth Five Year Plan, but there are still problems in practical

implementation.

The ratio of money supply to GDP (1.31 in 1998, 1.46 in 1999, 1.52 in 2000 and 1.65 in 2001) is rapidly increasing, indicating potential monetary risks and inflation pressures in the medium to long term.[10] The change of money supply largely depends upon banking loan trends, and policy instruments for the indirect control of money supply include such orthodox polices as open market operations, official discount rate and minimum reserve requirement, whose effective functioning requires establishment of appropriate economic, institutional and market environments.

The PBC resumed open market operations in 1998, and the amount of operations increased from RMB282.7 billion in 1998 to RMB1.6781 trillion in 2001. The short-term money markets, where these operations are carried out, are still so small that it is unknown to what extent applicable policy interest rates and the adjusted volume of funds affect the credit attitudes of commercial banks when they provide loans. The official discount rate has relatively minor importace under the current system, in which the PBC totally controls both loan and deposit interest rates. One typical example is the case, in which the regulated interest rates of deposits and loans were lowered, respectively, by 0.25 and 0.5 percent in February 2002, while the official discount rate remained unchanged at 2.97 percent (re-lending rates were lowered) (Refer to Table 3).

It is a normal banking practice that commercial banks place only a minimum volume of reserve deposits at a central bank to maximize money available for loans. In China, however, commercial banks increased their reserve deposit balances at the PBC recently, leading to levels more than twice as high as the reserve requirement, on the ground that such deposits bear interest and without credit risks.

The PBC is virtually enhancing window-addressing (direct financial control) to implement specific financial policies and tasks, while effective indirect control measures are limited. Commercial banks are strongly urged to implement many types of policy financing, including parallel loans equal to the amount of the government bond issued for national construction projects, loans to small and medium sized enterprises and loans to farmers under the small credit loan system.

To maintain a stable financial system, the PBC provides funds not only to small-sized bankrupt financial institutions, but also to the asset management companies for the four major state-owned commercial banks by refinancing acquisition of RMB547.9 billion nominal value of NPLs. These loans appear to be booked in the debit account of loan to non-bank financial institutions on the balance sheet of the PBC, which amounts to RMB854.7 billion at the end of 2001, making up 20 percent of its total

[10] Sources: PBC homepage, "PBC Issues Analysis Report on Sound Monetary Policy," February 26, 2002, pages 1-2.

Table 3 Interest Rates of Chinese Financial Institutions as of February 20, 2002

Deposit Interest Rates				Loan Interest Rates			PBC's Official Bank Rates		
		Old	New		Old	New		Old	New
Demand Deposits		0.99	0.72	**Short-term Loans**			**Required Reserves**	2.07	1.89
Time Deposits	3 months	1.98	1.71	Less than 6 months	5.58	5.04	**Re-lending Rates**		
	6 months	2.16	1.89	6 months to 1 year	5.85	5.31	20 days	3.24	2.7
	1 year	2.25	1.98	**Medium-to-long-term Loans**			3 months	3.51	2.97
	2 years	2.43	2.25	1 to 3 years	5.94	5.49	6 months	3.69	3.15
	3 years	2.70	2.52	3 to 5 years	6.03	5.58	1 year	3.78	3.24
	5 years	2.88	2.79	Over 5 years	6.21	5.76	**Rediscount Rate**	2.97	2.97

Sources: PBC's homepage. old rates from June 10, 1999 until February 19, 2002; new rates as of February 19, 2002.

assets. The cash recovery rate for the NPLs of these asset management companies is estimated to be 15 percent according to Standard & Poors, and one can interpret that the PBC's refinancing was meant effectively for their assumption of bad assets from the four major state-owned commercial banks.

It is possible that the PBC's refinancing to the asset management companies is deteriorating in quality, although the degree depends upon how their losses are to be shared among the Ministry of Finance, state-owned commercial banks and the PBC[11]. Other loans by the PBC, including finances to bankrupt financial institutions, are also likely to be deteriorating to a great extent. Once a substantial portion of PBC's assets becomes non-performing, it will surely have adverse effects on the confidence of the renminbi.

[11] Dai Xianglong was reported to have mentioned the eventual undertaking of losses of AMCs by the Ministry of Finance.

3. China's WTO Accession and Greater Flexibility of Exchange Rate

(1) Comments by Chinese Government Officials on the RMB's Rate

Governor Dai Xianglong of the People's Bank of China said that the range of RMB fluctuation should gradually be widened once China joined the WTO, a view which the IMF also recommends. Important comments on the subject in the last two years are as follows:

January 17, 2001:

Governor Dai: "After China's entry into the WTO, the balance of payments will fluctuate substantially, and exchange rates will move more flexibly." (*Nihonkeizai Shinbun,* January 18, 2001.)

August 24, 2001:

"Looking ahead, they agreed that a gradual move toward greater flexibility would facilitate China's growing integration into the world economy and the major structural changes underway . . . . Director welcomed the recent greater use of the existing trading band, and encouraged its full use in the period ahead. At an appropriate time, this should be followed by a gradual widening of the band and its linkage to a basket of currencies."[12]

January 16, 2002:

Governor Dai: "The current level of RMB rate is relatively adequate. But, after China's entry in the WTO, the market mechanism should be more reflected on determining exchange rates. As far as the RMB's rate can be kept stable, China should have a rate fixing mechanism that works more smoothly. (*Economic Daily,* January 16, 2002.)

January 18, 2002:

Governor Dai: "We will make the range of fluctuation of the RMB appropriately wider from now on . . . . The current level of the RMB's rate is adequate . . . . The RMB's rate should continuously be kept stable . . . . The RMB's exchange rate regime should constantly be improved. (*Nihonkeizai Shinbun,* February 19, 2002.)

September 3, 2002:

"(Following a sentence that is effectively identical with the first sentence of the

[12] International Monetary Fund, Public Information Notice (PIN) No. 01/91 dated August 24, 2001.

2001 consultation) They acknowledge that a variety of factors will be relevant for the authorities in deciding the appropriate pace, at which the move toward greater flexibility should be achieved, such as the strength of the domestic financial sector, the pace of capital account liberalization, and the global financial environment."[13]

September 9, 2002:
Finance Minister Xiang Huaicheng: "The present managed floating rate regime will be changed (in a more flexible one) in future, but not in foreseeable near future." (Interview at the US Treasury, *Nihonkeizai Shinbun*, September 10, 2002)

(2) Pros and Cons of Fixed and Floating Exchange Rate Regimes for China

Although the Chinese government repeatedly said that in principle the exchange rate should become flexible after China's accession to the WTO, their concrete policy is still unclear as to when and how much they will approve such flexibility. As of this writing (February 2003), there seems to be no indication on this point. What follows is a summary of the advantages and disadvantages to China of fixed and floating exchange rate regimes, as a basis of discussions on China's future exchange rate regime.

(a) Fixed Exchange Rate Regime

China has kept a fixed rate regime since 1997, with a narrow band of less than 0.1 percent fluctuation. Such rigidity is rarely seen in major countries. (Japan had a band of 0.75 percent in the ¥360 per dollar era.) China has been able to maintain this rigid exchange rate level thanks to the peculiarities of the Shanghai foreign exchange market, that is, a small, government controlled market completely shielded from world markets.

When choosing either a fixed or floating exchange rate regime, the theory of "irreconcilable trinity" must be taken into consideration, which states that only two policy objectives among three can be successfully achieved at one time: exchange rate stability, free international capital mobility, and independent monetary policy. China has placed priority on the stability of the RMB (with a fixed exchange rate regime), and prohibited free capital flows across borders by imposing strict restrictions on capital account transactions, in order to maintain the effectiveness of the People's Bank of China's monetary policy. In contrast, Hong Kong has adopted a fixed exchange rate regime and allows free capital flow, indispensable as an international financial center, abandoning the independence of monetary policy.

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[13] International Monetary Fund, Public Information Notice (PIN) No. 02/97 dated s September 3, 2002

The advantage of a fixed exchange rate regime for China is that it can keep the RMB's rate stable and predictable. China's total exports and imports in 2001 recorded US$509.8 billion, and the trade dependency ratio (trade amounts ÷ GDP) should reach as high as 50 percent. The stability and predictability of exchange rates are critically important in economies with a high trade dependency ratio. European countries had the same reasons for retaining the European Monetary System's quasi-fixed rate regime in the EU for the last 20 years, ending with adoption of a single currency, the euro. In particular, the fixed exchange rate regime is an appropriate policy when China has no financial products to hedge the RMB's exchange risk now.

As to disadvantages, firstly the level of the fixed rate is not necessarily an equilibrium exchange rate for the RMB, and there easily comes a pressure for either revaluation or devaluation. Secondly, in order to maintain the independence of monetary policy, restrictions on capital account transactions are to be imposed, increasing costs for both businesses and monetary authorities. Costs for businesses include not only direct costs for clerical procedures, but also opportunity costs for losing opportunities for favorable fund raising and investments. Thirdly, exchange controls often bring on corruption and capital flight, evading regulations.

During the course of the Asian currency crisis, countries with loose or no restrictions on capital account transactions fell victim to speculations, and China learned lessons what risks capital account easing could bring about. Even Hong Kong, Taiwan, and Singapore, with healthy domestic economies and stable financial systems, were no exception, and had to fight to protect themselves from speculators. Since the Chinese economy is by no means well developed yet in any sense, China has had no other choice but to impose strict restrictions on capital account transactions. From this viewpoint, the fixed exchange rate regime until now has been a reasonable and appropriate policy.

(b) Managed Floating Exchange Rate Regime

The IMF divides floating exchange rate regimes between "managed float" and "independent float." "Managed float" is a regime by which a central bank tries to keep an official rate stable, but often changes it due to balance-of-payments and foreign reserves requirements. China is officially categorized in this group. In the independently floating regime adopted by most industrial countries, the rate is determined in the foreign exchange market, and there is no target rate. Interventions are conducted to smooth rate fluctuations.

There are two advantages to a floating exchange rate regime, should China return

to it. First, assuming that capital account transactions remain restricted, when the RMB's rate floats, the balance of payments is expected to reach equilibrium according to changes in the external competitiveness of the Chinese economy. As the export competitiveness of Chinese products strengthens, and the trade surplus expands, the RMB's rates appreciate to decelerate exports, on one hand, and accelerate imports on the other. In the medium to long-term perspective, structural reform of the Chinese economy will be promoted, and its competitiveness will improve through this mechanism. Second, with a future liberalization of capital account transactions, the integration of domestic and overseas capital markets will enable Chinese enterprises to raise and invest funds efficiently.

Of the disadvantages, the first is exchange rate instability. Under the floating rate regime, even if the foreign exchange market is controlled by monetary authorities, the RMB's rate will become unstable since the rates are determined fundamentally by supply and demand in the market, and there is no guarantee that the market rate will converge at a level of equilibrium. Once capital account transactions are liberalized, extreme volatility and misalignment of exchange rates could occur. Second, deregulation and liberalization of capital account transactions may give rise to the risk of sudden, substantial inward and outward capital flows. Therefore, the government must be prepared to maintain sound macroeconomic policies and to keep the financial system stable, and ready to respond to emergencies in order to protect the economy from extreme movements of capital across the border.

(3) China's WTO Accession and Its Effect on the Balance of Payments

The balance of payments is broadly divided between current accounts and capital accounts. Current accounts consist of trade balances (imports and exports), services, income and current transfers. Capital accounts are made of direct investments, portfolio investments, and other investments (loans, deposits, trade credits, and others). The items that will be substantially affected by China's WTO accession will be trade balances, services, and direct investments. Other items should only be affected indirectly (for example, an increase in inward foreign direct investments should expand the income account deficit).

In the trade balance, the reduction of tariffs and abolishment of non-tariff barriers may cause imports to grow more rapidly than exports. In 2002, the first year of China's WTO membership, the trade surplus increased, contrary to the forecast of many China watchers, thanks to the high growth of exports. Although China tries to drive exports to maintain its economic growth, exports will be dependent upon several factors other

than exchange rate factors, such as economic situations in the United States and other industrial countries, development of processing trade (which amounts to more than 50 percent of Chinese trade), and the possible recovery of general exports coming from the accumulation of spare parts industries and reformed state-owned enterprises. Imports depend upon the domestic business cycle and the extent to which tariff and non-tariff barriers are removed. As a whole, the trade structure will change according to the terms of trade, reflecting the RMB's real effective exchange rates, oil and other international commodity prices. The future of trade balances is therefore full of uncertainty.

Inward foreign direct investments amounted to US$44.2 billion on a disbursement basis in 2001 (US$52.7 billion in 2002), the largest amount equal to the 1997 level, in anticipation of China's joining the WTO. Contract amounts are also at a high mark of US$69.1 billion (US$82.7 billion in 2002), and inward direct investments are expected to increase further. The investment climate in China is steadily improving. For example, China will conform with the principle of national treatment of foreign-funded enterprises, and is gradually implementing regulations compatible with WTO commitments. Combined with the improvement of general skills and excellent, inexpensive work forces, China should offer one of the world's most advantageous locations for industry.

Services accounts consist of transport, travel, communication, construction, insurance, finance, royalties, consulting, and other services. Services accounts in China have recorded a deficit in the past. Total services balance in the future depends much on a travel surplus, but may continue on a deficit trend because non-travel items are less competitive internationally. Moreover, the deficit will expand once China opens various service fields to the world.

To sum up, due to possible reductions of the trade account surplus and a larger deficit in services and income accounts, the current account surplus is likely to decrease, and may even post a temporary deficit. At the same time, an increase in foreign direct investments to China will complement the decrease in the current account surplus, balancing the external equilibrium. A risk factor, however, is the problem of capital flight. The possibility cannot be excluded that the capital account might fall into a deficit due to the reemergence of capital flight, in spite of surplus in foreign direct investments, if something unpredictable breaks out politically or socially and a pessimistic view spreads about the future of the Chinese economy.

4. Future Prospects

(1) Alternatives of Exchange Rate Regimes

Regardless of the official explanation of a managed floating exchange rate system based on supply and demand, the RMB'rate has been fixed at the present level since 1997. This reflected the government's preferential policy of stabilizing the RMB's rate, maintaining restrictions on capital account transactions, which proved to be adequate in light of the international as well as Chinese domestic economic circumstances since the Asian currency crisis.

China's balance of payments structure is likely to change substantially in a few years' time, following its WTO accession in December 2001. The rights and obligations attached to the WTO membership are mainly related to trade and services in current accounts, and direct investments in capital accounts. Other capital account items—portfolio investments, loans, deposits, and other capital transactions—are not directly affected. In other words, it is to be noted that the WTO accession does not require alteration or relaxation of existing strict restrictions on capital account transactions.

China's balance of payments structure had been expected at first to change into a combination of a smaller current (or trade) account surplus and a larger inflow of foreign direct investment. In 2002, both the trade surplus and inflow of FDI increased. As to the development in future, it is difficult to clearly predict the direction and magnitude of changes under current unstable international political and economic circumstances.

On the other hand, in managing the Chinese domestic economy, the employment problem is becoming serious despite high economic growth. The 2002 growth rate has reached 8.0 percent due to the increased fixed capital formation upheld by a budgetary deficit amounting to 3 percent of GDP, and still the urban unemployment rate is supposed to increase (from 3.6 percent to about 4 percent in 2002[14]). Under such circumstances, the first priority in economic policy management is to keep the economy and society as stable as possible, and the exchange rate policy goes along this basic line. So long as capital account transactions remain subject to strict scrutiny, it should be possible that the existing fixed exchange rate regime will continue for some time to come.

The structural changes in the balance of payments resulting from China's entry

[14] "The National Re-employment Working Conference", held in September 2002 forecast an urban unemployment rate for 2003 at 4.5%.

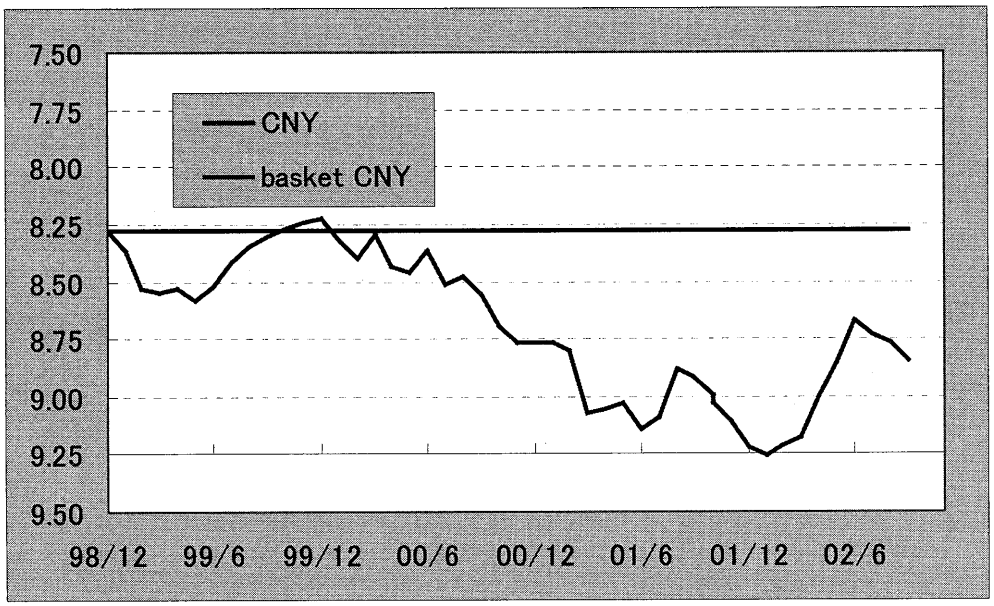
into the WTO will probably put a revaluation pressure on the RMB. Having said this, however, devaluation due to social unrest or other unexpected events is not altogether unlikely. It is anticipated that criticism will soon emerge, not only from Japan, but also from other trade partners, when exports and foreign reserves keep increasing. To take necessary steps for adjustment without delay, China should widen the band of RMB fluctuation. Under the existing rigid fixed rate regime, China cannot cope with substantial changes of external equilibrium, and in addition, the exchange rate rigidity is not appropriate in enhancing China's economic competitiveness from the medium- to long-term perspective.

The Chinese monetary authorities are in a stability-versus-change dilemma. The widening of the range of exchange rate fluctuations implies that the RMB's rate reflects foreign exchange supply and demand in the market, albeit under monetary authorities' control. As prerequisites, the foreign exchange market must function properly, and risk hedge products must be developed, since the flexibility of the RMB's rate accompanies exchange risks. As a realistic measure, although China speaks of a policy of gradually widening the RMB's fluctuation band, it will hesitate to cross a bridge by continuing to stress the maintenance of stability. Watching carefully how the foreign exchange market develops, and how hedge instruments for exchange risks are innovated, the band will be made flexible little by little from today's less than 0.1 percent margin. At the same time, financial institutions and enterprises will likely be asked to tighten their exchange risk control.

The Chinese government will hope to avoid as much as possible a simple widening of the band that may cause an appreciation of the RMB, because they consider nothing more important than the stability in the domestic economy and society. In its staff report on the Article IV Consultation with China in 2001, the IMF again recommended—as in 2000—a gradual widening of the band and the linkage of the RMB to a basket of currencies (in the 2002 report the possibility of a currency basket peg is not mentioned). In a simulation under the assumption of the RMB being linked to a basket of currencies of China's major trading partners (the Economic Division of the Bank of Tokyo-Mitsubishi calculated for the author), the RMB's exchange rate has moved as follows: had the RMB changed its pegging currency from the US dollar to a basket of currencies at the time of the launching of the euro in 1999, the RMB's rate would have dropped to RMB9.25 per dollar at the beginning of 2002, recovering to RMB8.8 in October 2002 as the euro appreciated to a par value to the dollar.

Even if the existing exchange rate regime switches to a currency basket peg, there is no guarantee that the RMB would weaken against the dollar as in the past two years.

Exchange Rate Simulation if the RMB Were Linked to a Basket of Currencies



Source: Economic Division of the Bank of Tokyo-Mitsubishi, Ltd.

If non-dollar currencies—such as the yen and euro—depreciate against the dollar, the value of a currency basket would depreciate against the dollar as well, and accordingly the basket-linked RMB would also depreciate. On the contrary, if the dollar depreciates against other currencies, as it did from 1985 to 1995, the RMB would appreciate against the dollar along with the value of the basket. If the euro and yen move in the opposite direction against dollar, the RMB might remain neutral against the dollar. The People's Bank of China commented[15] that they had discussed internally a possible linkage to a currency basket, but this was not included in the Tenth Five-Year Plan,[16] due to unsolved problems concerning the currency component. The RMB's linkage to a currency basket is likely to be discussed again in future as one of the available choices. The basket can be determined along the line of Chinese trade pattern and other external economic activities, as against existing linkage to the US dollar.

How would have been the development of the real effective exchange rate (REER)of the renminbi, should it have been pegged to a basket of trade partner currencies since

[15] The author interviewed with the Research Division of the International Department, the People's Bank of China, in February 2002.

[16] The Tenth Five-Year Plan states:
"The central bank's control system based on indirect control should be strengthened, the money market should be positively and steadily developed, the open market operation should be expanded, and the reform of the market interest rate mechanism should be promoted. The RMB's exchange rate determination mechanism should be improved, and the managed floating exchange rate regime based on supply and demand should be strengthened."

the start of the euro? The result of simulation is shown in the following chart that indicates the REER of the basket-pegged renminbi would have been lower than the actual development in the past three years. The REER index (1990: 100) of the basket-pegged renminbi as of the 3rd quarter of 2001, for example, was 98.67 in comparison with 106.25 of the actual renminbi. The coefficient of variation of the basket-pegged renminbi (0.02658) was slightly larger than that of the actual renminbi (0.02381) for the simulated period of three years.

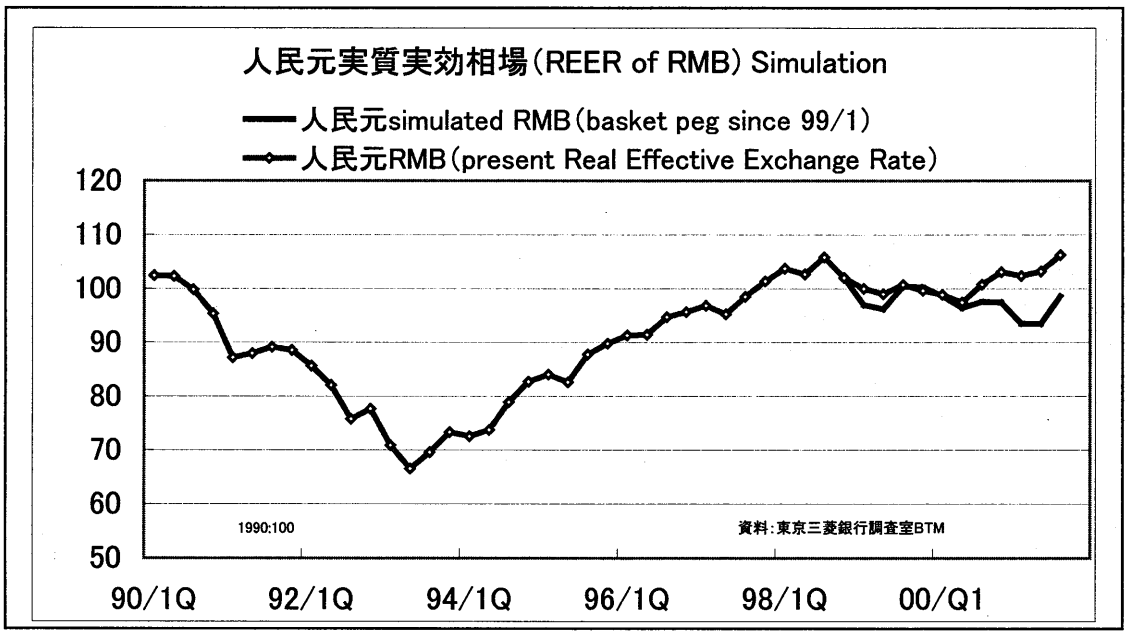
(2) Convertibility of the RMB

The convertibility of a currency means that a home currency can be freely changed to a foreign currency at a single exchange rate. Convertibility has two phases: convertibility for current account transactions stipulated in Article VIII of the IMF Articles of Agreement, and full convertibility for all transactions including capital account transactions.

(a) Convertibility for Current Account Transactions

After China became an IMF Article VIII nation in December 1996, the RMB officially became a convertible currency for current account transactions, since China was prohibited to restrict payments and transfers for current account transactions. This designation did not necessarily carry any substance. Now that China entered the WTO, the RMB will become a partially convertible currency in name and in substance.

Under the Bretton Woods system, the IMF Agreement and GATT were closely related in monetary and trade aspects to promote the abolishment of barriers that hindered the expansion of international trade. Once a country changed its status from an IMF Article XIV to Article VIII nation, and accepted the general obligations stipulated in that article, it also moved from being either a GATT Article XII nation (one with difficulties in its balance of payments) or a GATT Article XVIII nation (developing country) to a GATT Article XI nation, which was in principle prohibited from restricting imports quantitatively. Now that the Bretton Woods regime no longer exists, the importance of the relationship of these two agreements may be debatable. The acknowledgement that currencies of IMF's Article VIII nations have convertibility for current account transactions without any restriction on related payments is normally understood as meaning at the same time that there are no import quotas levied or permissions necessary. This understanding should still be valid.



Since China was not a member of GATT, when it became an IMF Article VIII nation, there were no arguments over the fulfillment of the obligations of either GATT or the WTO Agreement. Although China tried to reduce non-tariff barriers, anticipating its entry into the WTO, the results remained moderate.

China fulfilled its wish to join the WTO after five years of its transition to the IMF Article VIII status, and will liberalize current account transactions fully along WTO commitments within five years. The RMB will realize convertibility for current account transactions in true sense of the term. It will be worth noting whether China will allow overseas payments in RMB for current account transactions (of RMB-denominated trade and foreign remittances). The RMB is currently not used at all for overseas settlements, which are conducted only in US dollars and other convertible currencies. Non-residents cannot receive the RMB for payments of export and commissions on current account transactions, nor can they open non-resident RMB accounts at domestic banks in China. The question whether the RMB will be permitted in settlement of current account transactions is an important issue in predicting the policy of the Chinese government on the RMB's internationalization in future.

(b) Full Convertibility—A Long-term Goal

Once the RMB gains full convertibility, it will be made an international currency, such as the Japanese yen and Hong Kong dollar, and both Chinese residents and non-residents will be able to buy, sell, and hold it freely. Liberalization of both current and capital account transactions will cause domestic and foreign capital to move freely

in and out of the border in the form of securities, deposits, loans, derivatives, and other instruments. The RMB will be traded not only in the Shanghai foreign exchange market, but also in major international financial centers.

There are several advantages for China in having the RMB as an international currency. From the micro-economic viewpoint, Chinese enterprises can use their home currency for foreign settlements, thereby avoiding exchange risks, and the increased use of the RMB will expand business opportunities for Chinese financial institutions. Shanghai may grow to an international financial center on a par with Hong Kong. From the macro-economic point of view, since the Chinese economy will be extensively integrated into the world economy in capital transactions as well as trades and services, it is expected that, through international competition and disciplines demanded of economic management, there will be increased efficiency in the Chinese economy, resulting in the improvement of the people's living standard. For East Asian countries, the RMB's full convertibility is welcome for the possible formation of a regional currency zone. On the other side, it involves, under the current or managed floating exchange rate regime, risks that would invite currency crises, brought on by sudden movements of short-term capital, unless sound management of the domestic economy and a solid financial system are well established.

The Chinese government has set the RMB's full convertibility as a long-term goal, but has not announced a specific schedule.[17] This objective can be achieved by liberalizing capital account transactions, but the observations of Chinese leaders have become more cautious recently since realizing the risks accompanying such liberalization, particularly after the Asian currency crisis. The Tenth Five-Year Plan does not touch at all upon the liberalization of capital account transactions or the RMB's convertibility.

Former Deputy Governor Chen Yuan of the People's Bank of China (currently president of the China Development Bank) stated that there were four conditions necessary for achieving the RMB's convertibility in capital account transactions as well as for other transactions (*Reform of Chinese Financial System,* Chen Yuan, ed.; 1994): first, a well organized and completed foreign exchange system, and the existence of a

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[17] Governor Dai Xianglong of the People's Bank of China delivered a speech in Hong Kong:
"In order to liberalize capital account transactions, and to achieve the RMB's full convertibility, a reasonably strong national power, a moderate financial system, and a reasonably strong capability of the government to manage the macro economy are needed. At the moment, our country is not necessarily prepared for meeting all these requirements. Therefore, we should take step by step measures, and should not hurry to liberalize capital transactions or achieve the RMB's full convertibility. After WTO accession, however, as our capital market develops, and as trade and direct investments of overseas capital expand, the liberalization of capital account transactions and the RMB's full convertibility will surely proceed." (*Economic Daily,* February 21, 2002.)

rational exchange rate level; second, the availability of liquidity for international settlements, such as foreign reserves; third, a sophisticated control system for the macro economy; and fourth, a sound enterprise structure.

To achieve the first of these conditions, the RMB's exchange rate should become more market-oriented and flexible. For the second there seems to be no problem, since China has the second-largest foreign reserves in the world, and has foreign debts well controlled (as of end 2001, US$170.0 billion, of which short-term debt was US$50.5 billion, and medium- and long-term debts was US$119.5 billion). For the third condition, both fiscal and monetary policies are still on the way of development. As to the fourth condition, reforms involving state-owned enterprises, started as one of three important reforms, have not fully materialized. This is still a major issue remaining on the agenda in face of intensive competition arising from the WTO accession.

As a result of the Asian currency crisis, an additional issue was recognized as a fifth condition necessary for any currency to become fully convertible. It is the importance of a sound financial system and adequate financial supervision. A financial institution is a direct receiver of funds and a fundamental infrastructure for a national economy. As capital liberalization proceeds, the movement of capital across the border becomes active in velocity and magnitude, and financial and/or economic crises are likely to break out if a banking system remains fragile. China's state-owned commercial banks has a non-performing asset ratio of 25 percent at the end 2001 according to the official announcement, and there are speculations that the real ratio is still higher.[18]

Strong efforts and many years are still necessary for China to comply with the five conditions to achieving the full convertibility of the RMB. Since stability and growth have priority over other economic policies, the government should be very careful as to when and how restrictions on capital account transactions are eased, to avoid creating any uncertainty in Chinese economy and society. It will require quite a long time for the RMB to become an international currency with full convertibility.

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