

Economic Analysis on Currency Basket System in China

~Research of RMB Exchange Policy~

Summary

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The features of Chinese external economy in 1990s are independent monetary policy, capital controls and quasi fixed exchange regime. With the acceleration of China's capital account liberalization, this policy mix is proved unsustainable, and a new fix is needed. After the Renminbi exchange rate formation mechanism reform in July 2005, China announced to apply managed floating exchange rate regime with reference to currency basket, the Renminbi exchange rate regime reform launched. However, how to take further reforms to lead Renminbi exchange rate to a pure floating regime steadily still hangs in doubt.

On July 21, 2005, China announced to implement managed floating exchange rate regime with reference to currency basket.

The clearer rule will be applied widely, considering the debates on currency basket, the definition, policy objective, formation mechanism and features of currency basket regime are discussed in this thesis. Comparing with the single dollar peg, currency basket regime is able to reduce the volatility of exchange rate among major currencies, it assumes the function of "condenser" to ensure the stability of exchange rate in terms of major currencies. Currency basket peg regime will increase the exchange rate flexibility and expand the space for macro control, reduce the pressure for the central bank's intervention in foreign exchange market, enhance the independence of monetary policy. In accordance with the rule of currency basket peg regime, in order to maintain the stability of total trade, China can organize the currency basket with reference to trade share. Under the currency basket peg regime, the Renminbi exchange rate in terms of US dollar is flexible, it will not bring the one-way appreciation or depreciation. This mechanism will be conducive to manage the one-way speculation in the foreign exchange market, eliminate the worries on one-way Renminbi appreciation pressure. Then the transition from "managed floating with reference to currency basket" to the standard currency basket regime is needed for

Chinese economy , and finally move to the pure floating regime. Therefore , the targets of monetary policy will switch from the external economy to internal economy , Renminbi exchange rate regime, the macro economic policy will move to a new mix : independent monetary policy , effective capital controls and floating exchange rate. As the capital controls are lift up, China should actively search the path to exit the current exchange rate regime safely, and determine the medium and long run strategy.