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**Briefing Series – Issue 29**

**CHINA'S EXCHANGE RATE POLICYMAKING  
IN THE HU-WEN ERA**

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**October 2007**

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## **China's Exchange Rate Policymaking in the Hu-Wen Era**

### **Summary**

China's economic policymaking has become institutionalised in the post-Deng era. Policymaking in general since Mao and Deng has been moving towards pluralisation and institutionalisation under Jiang and the Hu-Wen administration. The style of economic policymaking in China is now more corporatist than individualistic.

Exchange rate policymaking is of high importance as any adjustment in the exchange rate can influence several sectors of the domestic economy in different ways. It can also have implications for global trade and capital flows, thus creating the need for a higher degree of policy coordination. This gives rise to professionalism and institutionalisation in exchange rate policymaking, which allows institutional actors to play a significant role in the policymaking process.

The decision for a certain exchange rate policy is the output of the exchange rate policymaking mechanism that transforms policy inputs from institutional actors into policy decisions by policymakers. Policy elites in these state or party organs play a significant role in contributing to the final decision of certain exchange rate policies.

In the Hu-Wen era, the most important policy organ in exchange rate policymaking is the Central Finance and Economics Leading Group (CFELG), which is the final decision-maker in creating certain exchange rate policies for China. The Chinese Premier Wen Jiabao, chair of the CFELG, is the key figure in exchange rate policymaking and takes charge of all major issues in monetary and financial affairs. The People's Bank of China (PBC) is becoming the most influential in exchange rate policymaking among domestic institutional actors. Zhou Xiaochuan, Governor of the PBC, chairs all major issues of exchange rate policy.

The new 2005 exchange rate policy can be interpreted as the output of the exchange rate policymaking process to balance interests of key domestic ministries and sectors, together with an account of regional and global interests. Wen Jiabao chaired all major issues in this new policy formulation and implementation and underlined the importance of the principles of independent initiative, controllability and gradual progress in pursuing the Chinese RMB exchange rate reform. The new formation mechanism of the RMB exchange rate did not allow for large fluctuations of the RMB exchange rate, but for its steady movement in order to achieve national and regional financial stability and sustainable economic growth.

In the Hu-Wen era, the objective is to strike a balance between promoting economic growth and improving economic structure, between investment and consumption and between domestic and external demand. The target for the RMB exchange rate reform is to gradually establish a market-based and well-managed floating exchange rate system so as to keep the RMB exchange rate basically stable at a reasonable level.

China has been moving towards a freely floating regime which allows the market to play a full role in exchange rate movements. However, this move requires a stable macroeconomic situation at home and sound domestic financial institutions and markets. China will carry out the reform of large state-owned commercial banks and the foreign exchange market in advance of the RMB exchange rate reform.

## China's Exchange Rate Policymaking in the Hu-Wen Era

Jingtao Yi \*

### Institutionalisation in the Making of China's Exchange Rate Policy

- 1.1 China's economic policymaking has become institutionalised in the post-Deng era. Policymaking in general since Mao and Deng has been moving towards pluralisation and institutionalisation under Jiang and the Hu-Wen administration. It is regarded as the result of market expansion and administrative decentralisation due to economic and political reforms.<sup>1</sup>
- 1.2 The complexity of market and political administration leads to a more sophisticated approach to economic policy formulation and implementation, which requires more professionalism in economic policymaking. The top leaders in the post-Deng era do not enjoy reputations as revolutionary leaders like Deng Xiaoping and Chen Yun, and have to rely on institutional rather than personal authority. The new style of economic policymaking is more corporatist than individualistic.
- 1.3 Exchange rate policymaking is of high importance as any adjustment in the exchange rate could influence several sectors of the domestic economy in different ways. It can also have implications for trade and capital flows in the rest of the world, thus creating the need for a higher degree of policy coordination. This gives rise to professionalism and institutionalisation in policymaking. Input into policymaking stems from specialists not only within but also outside the bureaucracy, which allows institutional actors<sup>2</sup> to play a significant role in the policymaking process.
- 1.4 The critical role of institutional actors in exchange rate policymaking lies not in their ability to determine either the policy or its implementation, but in their analyses of exchange rate policy issues and policy recommendations, i.e. policy preparation rather than policy implementation.<sup>3</sup>
- 1.5 The making of exchange rate policy in China can be described as a three-stage process to be followed in sequence, which is shown in Figure 1. The first stage is to collect policy inputs from formal and informal sources, including institutional actors. The second stage is to process and evaluate these inputs by key policy organs before making a final decision in the last stage. Bargaining among relevant key sectors of the domestic economy takes place before the final decision is reached, provided that exchange rate policymaking involves an uneven impact on these sectors. Compared to other arenas of economic policymaking, such as energy policy, the bargaining factor in exchange rate policymaking becomes part of policy formulation rather than policy implementation.
- 1.6 Exchange rate policymaking under the Hu-Wen administration is to follow the same institutional process as that of the era of Jiang, which allows for

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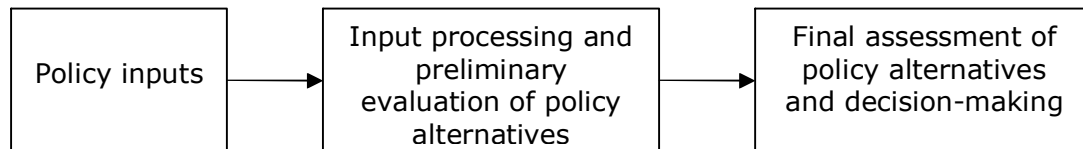
<sup>1</sup> Leong H. Liew, "Policy Elites in the Political Economy of China's Exchange Rate Policymaking", *Journal of Contemporary China*, Vol. 13, No. 38, February, 2004, pp. 21-22.

<sup>2</sup> Institutional actors here include ministries, research institutes, consultants, etc.

<sup>3</sup> Leong H. Liew, "Policy Elites", 2004, pp. 22-23.

a key role played by institutional actors in policymaking. However, there is clearly a shift in the focus of exchange rate policy from export-oriented to more balanced development. The target for exchange rate policy in the Hu-Wen era is to “maintain the RMB exchange rate basically stable at an adaptive and equilibrium level, so as to promote the basic equilibrium of the balance of payments and safeguard macroeconomic and financial stability.”<sup>4</sup>

**Figure 1: The Making of China’s Exchange Rate Policy**



Source: Leong H. Liew (2004).

### **China’s Exchange Rate Policymaking: Leaders, Structures, and Processes**

- 2.1 China’s exchange rate policymaking mechanism from collection of policy inputs to production of policy outputs involves three major types of policy organ: ministries and other institutional actors whose inputs into policymaking are particularly influential, key policymaking organs for gathering and evaluating inputs for decision-making, and key decision-makers for generating the final policy outputs. Policy elites in these state or party organs play a significant role in contributing to the final decision on particular exchange rate policies.
  
- 2.2 The precise structure of exchange rate policymaking under Jiang Zemin is shown in Figure 2. This structure only includes key policymaking organs over the period 1998-2003. The most important organ in exchange rate policymaking in the Jiang era is the Central Finance and Economics Leading Group (CFELG).<sup>5</sup> It is the final decision-maker in the creation of certain exchange rate policies for China. During the early 1990s, Jiang Zemin was the official chair with Zhu Rongji his deputy. Zhu chaired the CFELG from 1998-2003 when he was premier of China’s state council. In fact, Zhu was the key decision-maker in exchange rate policy over this period and took charge of all major issues in fiscal and monetary affairs. Wen Jiabao was head of monetary affairs and secretary-general of the CFELG, but did not play an important part in exchange rate policymaking.<sup>6</sup> However, Zeng Peiyan, Jiang’s principal economic adviser, was able to push his (and other colleagues’) views strongly to Jiang on exchange rate policy, despite being deputy secretary-general of the CFELG.

<sup>4</sup> The People’s Bank of China, 21/07/2005, “Public Announcement of the People’s Bank of China on Reforming the RMB Exchange Rate Regime”, <http://www.pbc.gov.cn/english/detail.asp?col=6400&id=542>, accessed on 26 August 2007.

<sup>5</sup> Lu Ning (2001) notes that the Central Finance and Economics Leading Group “has always been the most important organ in economic decision-making”. Lu Ning, “The Central Leadership, Supraministry Coordinating Bodies, State Council Ministries, and Party Departments,” in David M. Lampton, ed., *The Making of Chinese Foreign and Security Policy in the Era of Reform* (Stanford University Press, 2001), p. 47.

<sup>6</sup> Leong H. Liew, “Policy Elites”, 2004, p. 27.

- 2.3 The Central Financial Work Commission (CFWC) was established on 16 June 1998 to centralise national financial market supervision and to restore central policy decisiveness under the huge impact of the Asian financial crisis.<sup>7</sup> The CFWC was a party organ, characterised as the “power centre” of China’s financial business.<sup>8</sup> Zhu relied on the CFWC to establish centralised financial control. Part of its responsibilities in exchange rate policymaking is to collect policy inputs and evaluate their feasibility for the CFELG. However, the major role of the CFWC is to push through centralised supervision and regulatory innovations in China’s financial industry. Wen was secretary of the CFWC with Yan Haiwang his deputy.
- 2.4 The influence of the People’s Bank of China (PBC) over exchange rate policy has grown significantly since China launched the reform and opening up to the outside world in 1979. Its responsibilities were extended beyond regulating the country’s financial system to conducting short-term macroeconomic management in 1995 in accordance with the Administration Law of the PBC. The PBC was a very influential source of exchange rate policy input and also a key assessor of inputs from other institutional actors under Jiang. Dai Xianglong, Zhu’s right-hand man,<sup>9</sup> succeeded Zhu as governor of the PBC in 1995.
- 2.5 Dai was a key figure in exchange rate policymaking and reported directly to Zhu over issues of exchange rate policy formulation. Dai Genyou, head of the CFELG administration office and director of the PBC monetary policy department, was one of the most influential officials in exchange rate policymaking in Zhu’s government and his views could reach the CFELG and Zhu directly. The monetary policy department where he served was at the core of exchange rate policy formulation, including policy research, drafting, and implementing. The monetary policy committee (MPC) acted as a purely advisory institution and did not have any significant power on exchange rate policymaking at that time.<sup>10</sup>
- 2.6 The precise structure of exchange rate policymaking under the Hu-Wen administration is shown in Figure 3. The CFWC was dissolved in 2003 when the China Banking Regulatory Commission (CBRC) was formed to take over supervision responsibilities in China’s banking institutions. The Communist Party regulation functions in the financial system were then transferred from the CFWC to the state organ, the CBRC. The CFWC and the CBRC are absent from the structure under the Hu-Wen administration. There is a clear division of labour between the PBC and the CBRC as the CBRC took over supervisory functions from the PBC through the National People’s Congress (NPC) Standing Committee in 2003.<sup>11</sup> The PBC has therefore dominated other institutional actors in exchange rate policymaking and become the most influential source of exchange rate policy inputs and assessments. Zhou Xiaochuan, governor of the PBC, is one of the key exchange rate decision-makers. Yi Gang, secretary-general of the MPC and director of the PBC monetary policy department, plays a significant role in exchange rate policy formulation due to his expertise in monetary economics.

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<sup>7</sup> Sebastian Heilmann, “Regulatory Innovation by Leninist Means: Communist Party Supervision in China’s Financial Industry”, *China Quarterly*, No. 181, 2005, p. 3.

<sup>8</sup> *Ibid.* p. 2.

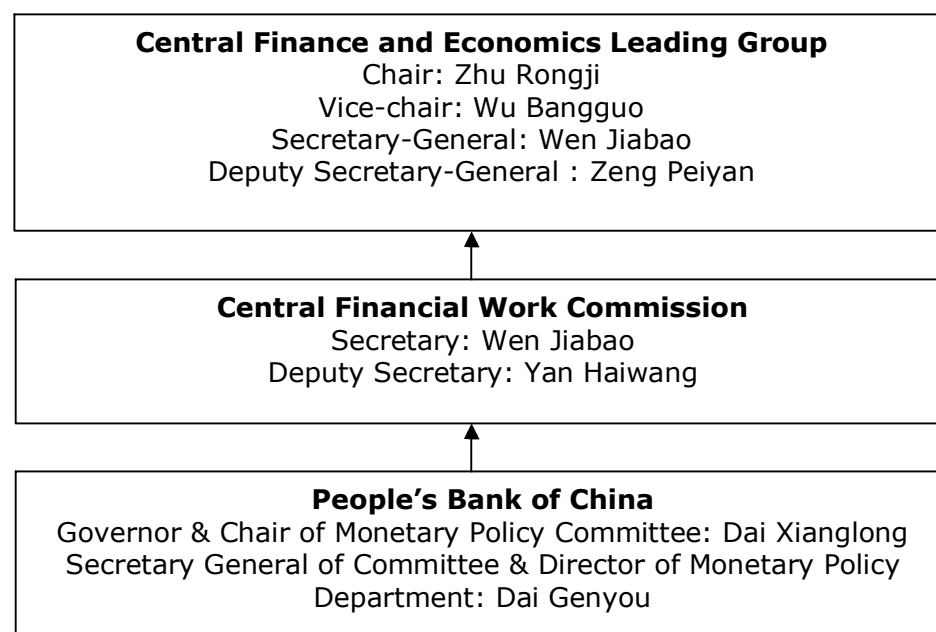
<sup>9</sup> Leong H. Liew, “Policy Elites”, 2004, p. 28.

<sup>10</sup> *Ibid.* p. 29.

<sup>11</sup> Sebastian Heilmann, “Regulatory Innovation”, 2005, p. 19.

- 2.7 The CFELG is still the final decision-maker on exchange rate policy outputs. Wen took over Zhu's responsibilities as chair of the CFELG after Zhu retired in 2003. He is a key figure making final decisions on certain exchange rate policies together with his colleagues. Hua Jiamin, secretary-general of the CFELG with Ma Kai as his deputy is also set to make significant contributions to evaluating policy alternatives and making final decisions.
- 2.8 The process of exchange rate policymaking goes through initial policy formulation and policy evaluation to final decision-making. In the Hu-Wen era, aside from the PBC, the Ministry of Commerce is an important source of exchange rate policy inputs. The Ministry of Commerce was established in 2003 to formulate guidelines and policies and to draft laws and regulations concerning domestic and foreign trade and international economic cooperation.<sup>12</sup> Given the significant impact of exchange rate policy adjustments on the Ministry of Commerce, it is supposed to play a great part in initial policy formulation.
- 2.9 Zhou Xiaochuan mentioned in an interview with Xinhua that the Chinese government aimed at a rough overall balance in the current account and that this was also a policy followed by the Ministry of Commerce.<sup>13</sup> This demonstrates the need for cooperation between both state organs in exchange rate policymaking. Bargaining occasionally takes place between the PBC and the Ministry of Commerce over certain exchange rate policies. The result of their negotiation will then become a significant source of policy inputs for decision-makers. When reaching the final stage, these policy inputs from ministries are assessed by the CFELG and Wen before they make the decision to generate certain policy outputs.

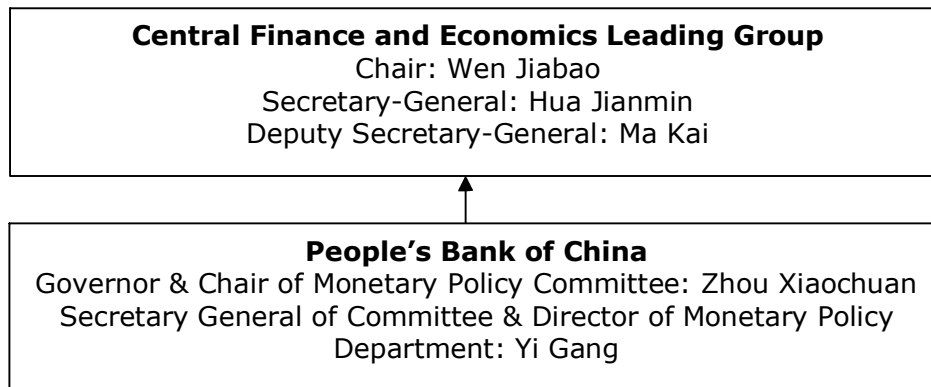
**Figure 2: China's Exchange Rate Policymaking Structure under Jiang Zemin 1998-2003**



<sup>12</sup> Refer to the Ministry of Commerce website, <http://english.mofcom.gov.cn/mission.shtml>, accessed on 27 August 2007.

<sup>13</sup> *Xinhua* News, 19/10/2003, "Central Bank Governor on RMB Exchange Rate", [http://www.chinadaily.com.cn/en/doc/2003-10/19/content\\_273372.html](http://www.chinadaily.com.cn/en/doc/2003-10/19/content_273372.html), accessed on 27 August 2007.

**Figure 3: China's Exchange Rate Policymaking Structure under Hu-Wen 2003-2007**



### **The Making of the New Exchange Rate Policy in 2005**

- 3.1 In 1994, China unified the official exchange rate with the prevailing swap market rate and since then, the Chinese RMB was pegged to the U.S. dollar for over a decade after China abandoned a dual-track exchange rate arrangement. The dramatic rise of China's presence in world markets and its remarkable economic growth over this period focused considerable global attention on an "undervalued" RMB and its dollar-pegged arrangement as an "unfair" advantage in explaining the country's increasing competitiveness.<sup>14</sup> Not only did external pressure from the G-7 countries mount on the Chinese administration to revalue the RMB and de-peg the dollar, but this pegged arrangement also caused significant imbalances in the economy. Rapid accumulation of foreign exchange reserves and increasing domestic inflation is generally read as a sign of these imbalances.
- 3.2 Given these complicated internal and external circumstances, the Chinese administration ultimately made the decision to launch a new exchange rate regime in July 2005 after an initial 2.1 per cent appreciation of the RMB against the U.S. dollar, leading to a move from the de facto U.S. dollar-pegged regime to a managed floating regime with reference to a basket of currencies. In accordance with the political economy approach, this can be interpreted as the output of the exchange rate policymaking process to balance interests of domestic key ministries and sectors, together with an account of regional and global interests. Zhou Xiaochuan, governor of the PBC, stated that "China's exchange rate policymaking is mainly founded on its domestic conditions, but also takes into account the regional and global economic conditions."<sup>15</sup>
- 3.3 Policy organs involved in the policymaking process play a great part in collecting and evaluating policy inputs for decision-makers to make a final decision. In the Hu-Wen administration, key policy organs in exchange rate policymaking are the Ministry of Commerce, the PBC, and the CFELG, of which the PBC and the CFELG are the two most influential. Wen Jiabao

<sup>14</sup> Steven Dunaway and Xiangming Li, "Estimating China's 'Equilibrium' Real Exchange Rate", International Monetary Fund Working Paper WP/05/202, 2005, p.3.

<sup>15</sup> *Xinhua News*, 19/10/2003, "Central Bank Governor".

chaired all major issues in this new policy formulation and implementation as Zhu Rongji did during the Asian financial crisis in 1998.<sup>16</sup> The new policy package was much more complicated than before and comprised two major issues: the revaluation of the RMB (against the U.S. dollar) and the formation mechanism of the RMB exchange rate.

- 3.4 The Ministry of Commerce is a key player in Chinese exchange rate policymaking as the appreciation of the RMB has a significant negative impact on exports and further lowers the profitability of export-oriented enterprises, some of which are labour-intensive. It was reported that if the RMB were to rise by 3-5 per cent in 2005 in comparison with the U.S. dollar, the growth rate of China's exports might drop to 10 per cent or below; a rise of 15 per cent or more might cause its export growth to go into decline.<sup>17</sup> The fear of these negative impacts leads the Ministry of Commerce to take up a strong position against the large appreciation of the RMB. Due to differences in industries and cost structures, the influence of RMB appreciation on the Chinese exporters differs among industries. The textile industry suffers the worst. Textiles have always comprised the biggest exporting industry for China, and 50 per cent of Chinese textile products rely heavily on exports. In accordance with an estimation in a report, every 1 per cent appreciation of the RMB against the U.S. dollar will cause a 2-6 per cent drop in textile commodity profit.<sup>18</sup> Statistics also show that this industry's gross profit margin and net profit margin in 2005 was around 10.38 per cent and 3.18 per cent respectively.<sup>19</sup> This implies that the Ministry of Commerce would allow for a RMB appreciation of not more than 3 per cent (against the U.S. dollar) in its exchange rate policy proposal. The Chinese Minister of Commerce Bo Xilai has said that RMB appreciation could put many Chinese enterprises in a difficult situation.<sup>20</sup>
- 3.5 In addition, regarding the formation mechanism of the RMB exchange rate, the Ministry of Commerce is clearly supportive of a gradual move to more flexibility of the RMB exchange rate. Bo has also stated that the completion of a flexible RMB exchange rate mechanism is required to deepen financial system reform in China and will help optimise China's import and export structure and accelerate the transformation of the growth mode of its foreign trade.<sup>21</sup>
- 3.6 The PBC is in a different position from the Ministry of Commerce when it comes to exchange rate policymaking and is also one of the key decision-makers. The major concern of the PBC is with short-term macroeconomic management intended to smooth macroeconomic fluctuations and achieve domestic price stability. RMB appreciation could help repress domestic inflation and cool down the overheated economy. The PBC could allow for a relatively higher degree of RMB appreciation. Wei Benhua, deputy director of the State Administration of Foreign Exchange (SAFE, a bureau under the PBC), said in an interview that if the RMB appreciated, it should

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<sup>16</sup> Leong H. Liew, "Policy Elites", 2004, pp. 41-50.

<sup>17</sup> Chinanews, 11/05/2005, "RMB Appreciation would Affect Exports", <http://www.chinanews.cn/news/2004/2005-05-11/4279.shtml>, accessed on 30 August 2007.

<sup>18</sup> Beijingreview, 12/02/2007, "Gains and Pains from RMB Appreciation", [http://www.bjreview.com.cn/background/txt/2007-02/12/content\\_55920.html](http://www.bjreview.com.cn/background/txt/2007-02/12/content_55920.html), accessed on 30 August 2007.

<sup>19</sup> Hongkong Trade Development Council, 23/01/2006, "Slower Profit Growth Awaits Textiles Industry", [http://www.tdctrade.com/report/indprof/indprof\\_060105.htm](http://www.tdctrade.com/report/indprof/indprof_060105.htm), accessed on 30 August 2007.

<sup>20</sup> People's Daily, 02/06/2006, "How will RMB Exchange Rate Reform Affect Trade", <http://www.chinaembassy.org.in/eng/zgbd/t256186.html>, accessed on 30 August 2007.

<sup>21</sup> *Ibid.*



be an increase of less than 10 per cent.<sup>22</sup> This implies that a RMB appreciation of not more than 10 per cent will be suggested in its exchange rate policy proposal. Zhou Xiaochuan summarised the principles of Chinese exchange rate reform as: independent initiative, controllability and gradual progress.<sup>23</sup>

- 3.7 The exchange rate reform objective of the PBC is to ultimately achieve a freely floating exchange rate regime through a sequential approach to achieving more flexibility of RMB movement in response to market demand-supply relations. In its proposal, the PBC could allow for an improvement in the RMB exchange rate flexibility by reforming the de facto U.S. dollar peg regime. The managed floating exchange rate regime was adopted officially by the PBC in 1994 and was more likely to re-exercise in the 2005 exchange rate policy. Zhou pointed out that the goal of the new exchange rate reform was to put in place a managed floating exchange rate regime based on market supply and demand.<sup>24</sup> In addition, the RMB peg to the U.S. dollar was highly disputed and the de-pegging of the dollar must be an option for the PBC, which may have implications for the linkage of the RMB to several major trading currencies, rather than the U.S. dollar alone.
- 3.8 The CFELG makes the final decision on the new exchange rate policy. It is a joint party-state policy organ and should take into account national overall interests with intention to balance the interests of all sides, not only in China, but also in the Asian region and the international community as a whole. The Chinese premier Wen Jiabao, chair of the CFELG, mentioned at the opening ceremony of the Sixth Finance Ministers' Meeting of the Asia-Europe Meeting that "since the RMB exchange rate reform involves many areas and will have a far-reaching impact, it requires a great deal of preparation to help create the best environment for all sides to deal with the consequences."<sup>25</sup> Wen also stressed that China would choose an exchange rate mechanism and policy suitable to its own national conditions. In his policy proposal of "four phases" when he first became Chinese premier in 2003, how to solve unemployment was the first of "three major economic problems".<sup>26</sup> The RMB appreciation will have a seriously negative impact on export-oriented domestic enterprises, most of which are labour-intensive. This directly results in a rise in unemployment, which contradicts Wen's policy target and leads him to prefer a lower degree of RMB appreciation.
- 3.9 The foremost of the "reforms in four aspects" is the reform of the rural economy intended to raise the incomes of farmers.<sup>27</sup> This appreciation will induce large imports of cheaper agricultural products from the rest of world, which lowers the price of agricultural products and the income of farmers in China. This effect will also induce Wen to opt for a lower

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<sup>22</sup> Chinanews, 25/04/2005, "10% at Most, if RMB Appreciates", <http://www.chinanews.cn/news/2004/2005-04-25/3666.shtml>, accessed on 30 August 2007.

<sup>23</sup> People's Daily, 25/07/2005, "Central Bank Governor on RMB Exchange Rate Reform", [http://english.peopledaily.com.cn/200507/25/eng20050725\\_198105.html](http://english.peopledaily.com.cn/200507/25/eng20050725_198105.html), accessed on 6 September 2007.

<sup>24</sup> *Ibid.*

<sup>25</sup> China Daily, 27/06/2005, "Premier Wen Jiabao Strengthened the Asia-Europe Meeting Economic Cooperation", <http://english.mofcom.gov.cn/aarticle/counselorsreport/europereport/200506/20050600135332.html>, accessed on 7 September 2007.

<sup>26</sup> *Xinhua* News, 18/03/2003, "Chinese Premier Outlines Objectives and Policies of New Cabinet", [http://news.xinhuanet.com/english/2003-03/18/content\\_785543.htm](http://news.xinhuanet.com/english/2003-03/18/content_785543.htm), accessed on 7 September 2007.

<sup>27</sup> *Ibid.*

appreciation. In addition, macroeconomic stability is one of key factors in exchange rate policymaking under Wen. He emphasised that exchange rate reform should give consideration to the possible impact on the country's macroeconomic stability and economic growth.<sup>28</sup> A large RMB appreciation is not preferred in this policy context. However, the new more balanced development model that the Hu-Wen administration proposes intends to promote domestic demand and transform the economic growth model with its reliance on external demand into a model reliant on domestic demand. This strategic adjustment will allow Wen's government to tolerate a higher RMB appreciation. Regarding the RMB exchange rate formation mechanism, Wen underlined the need to continue improving the mechanism and develop an exchange rate system that is more market-oriented and more flexible.<sup>29</sup>

- 3.10 Regional and international factors are also of high importance in exchange rate policymaking in China. The decision of no devaluation during the Asian financial crisis was generally explained by placing great emphasis on the role played by international relations.<sup>30</sup> In spite of the fact that external pressures from the U.S. and the European countries mounted on China to revalue the RMB, the macroeconomic stability of the Asian region was crucial for Wen's government to make any final decision on exchange rate policy. Wen emphasized that the stable RMB exchange rate was in the interests of economic development not only in China but also in neighbouring countries and the Asian region as a whole, and contributed to the world's financial stability and the expansion of trade.<sup>31</sup> Most Asian countries adopt export-oriented development strategies and work as a production platform to process materials for exporting to developed countries.
- 3.11 The RMB appreciation will no doubt lead to a general appreciation of their currencies, with a detrimental impact on their macroeconomic stability and economic growth. Wen emphasised that China was a responsible country and reform of the RMB exchange rate system had to take into consideration its impact on neighbouring countries, regions and global finance and economy.<sup>32</sup> The stable RMB helped alleviate the strain on China's neighbouring countries and regions and contributed to economic and financial stability and development in Asia during the Asian financial crisis of 1997. Given these regional experiences, a large RMB appreciation will not be favoured. In principle, the new formation mechanism of the RMB exchange rate will also not allow for large fluctuations of the RMB, but for its steady movement in order to achieve regional stability in accordance with Wen's proposal.
- 3.12 In the rest of the world, the U.S. played a great role in pushing Wen's government to revalue the RMB and de-peg the U.S. dollar. In response to this, Wen Jiabao underlined that the reform of RMB exchange rates was China's business and the politicization of an economic matter would not be conducive to a solution.<sup>33</sup> Zhou Xiaochuan stated that since China was still a developing country, the impact of China's trade development on other

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<sup>28</sup> China Daily, 27/06/2005, "Premier Wen Jiabao".

<sup>29</sup> *Ibid.*

<sup>30</sup> Leong H. Liew, "Policy Elites", 2004, p. 41.

<sup>31</sup> China Daily, 27/06/2005, "Premier Wen Jiabao".

<sup>32</sup> *Xinhua* News, 16/05/2005, "China Not to Yield to outside Pressure on RMB: Premier Wen", <http://www.chinaembassy.org.in/eng/zgbd/t195911.htm>, accessed on 7 September 2007.

<sup>33</sup> *Ibid.*

countries' economies and employment should not be exaggerated.<sup>34</sup> However, if domestic conditions permit, China must come to a compromise with the U.S. over this hot issue. It would have the added advantage of persuading the U.S. to deal with other international affairs in a way that will profit China. The new 2005 exchange rate policy is the output of balancing the interests of all sides with an emphasis on political, economic, and social domestic conditions.

### **Future Developments in the Hu-Wen Era**

- 4.1 China's exchange rate policymaking has become institutionalised, which allows institutional actors to play a greater role. The Chinese premier Wen Jiabao put forward in the work of his new cabinet in 2003 that China would draw opinions from officials, experts and civilians on major issues to forge a scientific and democratic decision-making system.<sup>35</sup> The decision for a certain exchange rate policy is the output of the exchange rate policymaking mechanism that transforms policy inputs from institutional actors into policy decisions by policy-makers.
- 4.2 In the Hu-Wen administration, the PBC will have become the most influential in exchange rate policymaking among domestic institutional actors as China increases its integration with the global economy. The CFELG is expected to remain the key decision maker of exchange rate policy and rely upon the PBC for expert advice on feasible policies, given the sophistication of exchange rate policymaking and its major external impact on regional and global economies. The PBC will therefore play a joint role in exchange rate policymaking as a policy advisor as well as a decision maker.
- 4.3 In principle, China's exchange rate policymaking is mainly founded on its domestic conditions, but also takes into account regional and global economic conditions. Given the internal and external impacts of exchange rate policy, a decision on exchange rate policy is made to balance interests of all sides, placing greater emphasis upon domestic conditions. Wen Jiabao highlighted the importance of the principles of independent initiative, controllability and gradual progress in pursuing the RMB exchange rate reform.<sup>36</sup> By "independent initiative", China is able to independently determine the modality, content, and timing of reforms in accordance with its own needs. By "controllability", China intends to properly manage changes in the RMB exchange rate at the level of macro-regulations to prevent large fluctuations in the financial market and economic instability. By "gradual progress", China will push forward reforms step-by-step and take into consideration both present needs and future development, guarding against undue haste.
- 4.4 The Hu-Wen government's objective is to strike a balance between promoting economic growth and improving economic structure, between investment and consumption and between domestic and external demand.<sup>37</sup> Wen Jiabao stressed that China would deepen reform of the financial sector to develop a modern banking system, a comprehensive monetary regulatory mechanism and a multi-tiered capital market, and

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<sup>34</sup> *Xinhua News*, 19/10/2003, "Central Bank Governor".

<sup>35</sup> *Xinhua News*, 18/03/2003, "Chinese Premier".

<sup>36</sup> *China Daily*, 27/06/2005, "Premier Wen Jiabao".

<sup>37</sup> *Xinhua News*, 06/09/2007, "A Growing China Embraces A Bright Future", [http://news.xinhuanet.com/english/2007-09/06/content\\_6677320.htm](http://news.xinhuanet.com/english/2007-09/06/content_6677320.htm), accessed on 8 September 2007.

continue to reform the RMB exchange rate.<sup>38</sup> The target for the RMB exchange rate reform is to “gradually establish a market-based and well-managed floating exchange rate system so as to keep the RMB exchange rate basically stable at a reasonable level”.<sup>39</sup>

**4.5** China has been moving towards a freely floating regime which allows the market to play a full role in exchange rate movements. Wu Xiaoling, a deputy governor of the PBC declared that RMB flexibility was increasing gradually and it would ultimately allow market supply and demand to play a fundamental role in forming the exchange rate.<sup>40</sup> Under the 2005 exchange rate regime, the cumulative appreciation since 21 July 2005 when China discontinued the RMB peg to the U.S. dollar is more than 7.5 per cent. The RMB exchange rate might appreciate against the U.S. dollar by 5 per cent in 2007.<sup>41</sup> Although the RMB has already become fully convertible under current accounts since 1996, the long-term target for China is to achieve the full convertibility of the RMB under capital accounts.<sup>42</sup> This move requires “a stable macroeconomic situation at home” and “sound domestic financial institutions and markets”.<sup>43</sup> Zhou Xiaochuan stated that China always puts the reform of large state-owned commercial banks first to ensure substantial progress in the RMB exchange rate reform, and another condition was that the foreign exchange market must have risk management instruments available to enterprises and financial institutions so that they would be able to protect their interests by using these instruments on the market when the RMB exchange rate floated.<sup>44</sup> He also said that once these were achieved, financial conditions would be mature and it would be time for the central leadership to take action.

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<sup>38</sup> *Ibid.*

<sup>39</sup> China Daily, 27/06/2005, “Premier Wen Jiabao”.

<sup>40</sup> China Daily, 20/03/2006, “Chinese Central Bank Reaffirms Policy over Currency”, <http://www.chinaembassy.org.in/eng/zgbd/t241186.html>, accessed on 8 September 2007.

<sup>41</sup> Xinhua News, 01/01/2007, “RMB Exchange Rate Might Appreciate by 5% in 2007”, [http://news.xinhuanet.com/english/2007-01/01/content\\_5556950.html](http://news.xinhuanet.com/english/2007-01/01/content_5556950.html), accessed on 8 September 2007.

<sup>42</sup> Xinhua News, 05/07/2004, “RMB Convertibility ‘Long-term Target’”, <http://www.chinaembassy.org.in/eng/zgbd/t142114.htm>, accessed on 8 September 2007.

<sup>43</sup> People’s Daily, 25/07/2005, “Central Bank Governor on RMB Exchange Rate Reform”.

<sup>44</sup> *Ibid.*