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CONFIDENTIAL

October 12, 1988

To: Members of the Executive Board
From: The Secretary
Subject: China - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Chinese renminbi.

Mr. Acquah (ext. 8661) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

CHINA

Real Effective Exchange Rate - Information Notice

Prepared by the Asian Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department
and the Research Department)

Approved by Douglas A. Scott and A. Basu

October 11, 1988

The recent evolution of China's real effective exchange rate, as measured by the standard index in connection with the Information Notice System, is set out in the attached table and chart. Based on this index, as of July 1988, the Chinese renminbi had appreciated by more than 10 percent since China's exchange rate developments were last discussed by the Executive Board, in February 1988 at the time of the 1987 Article IV consultation. The real appreciation from February to July 1988 is estimated to have amounted to 13 percent.

Between 1981 and 1984, China maintained an internal settlement exchange rate at which all foreign trade and trade-related transactions were conducted. At the beginning of 1985, the internal settlement rate was abolished and the official exchange rate of Y 2.8 per U.S. dollar was applied to all transactions. Subsequently, over the period to July 1986, the official exchange rate was depreciated by 25 percent to Y 3.7 per U.S. dollar, a rate which has been maintained to the present time. As a result of the adjustments to the official rate and the depreciation of the U.S. dollar relative to other major currencies, the renminbi depreciated by about 40 percent in real effective terms between end-1984 and February 1988, with the bulk of the depreciation taking place through end-1986. However, from February to July 1988, the real effective exchange rate appreciated by 13 percent, largely on account of a deterioration in China's relative price position: the inflation rate of the general retail price index (a weighted average of controlled, negotiated and market prices) has risen sharply in 1988, primarily as a result of rapid monetary growth. ^{1/} The nominal effective exchange rate also appreciated by about 6 percent between February and July 1988 reflecting the strengthening of the U.S. dollar against major currencies.

^{1/} The inflation rate for the index of market prices has recently been significantly higher than that for the general retail price index--about one half of consumer goods are sold at market prices.

While most international transactions take place at the official exchange rate, which is used in the calculation of the standard effective exchange rate indexes, an increasing amount of transactions has been taking place at negotiated exchange rates under state supervision in foreign exchange adjustment centers. Since late 1986, foreign investment enterprises and Chinese enterprises in special economic zones and coastal cities have been allowed to trade foreign exchange in these centers and, beginning in early 1988, selected export sectors have also been permitted to trade foreign exchange in the centers. The exchange rate at the centers is reported to have depreciated to about Y 7 per U.S. dollar in July 1988 from below Y 6 per U.S. dollar at end-1987.

There was a marked turnaround in the external current account from a deficit of 4.3 percent of GDP in 1985 to a small surplus in 1987, reflecting strong growth in non-oil exports and a decline in imports. Preliminary data indicates that this improvement was broadly maintained in the first half of 1988. The overall balance has also improved substantially, and gross official reserves had risen to \$19.6 billion (the equivalent of over 5 months of imports) by July 1988. Initially, the improvement in the external position was due to a tightening of monetary and fiscal policy in 1985, followed by the depreciation of the renminbi in 1986. More recently, the improvement was sustained in the face of expansionary financial policies through a tightening of import restrictions in 1987.

During the 1987 Article IV consultation discussion, Executive Directors noted the recent steps to introduce more flexible exchange arrangements for certain enterprises, and emphasized the advantages of extending the coverage of these arrangements while narrowing the spread between the administered exchange rate and more market-determined rates. Directors also encouraged reduced reliance on import restrictions in the context of exchange system and price reform. The importance of tightening financial policies to restrain inflationary pressures was also stressed.

Exchange rate policies and developments will be discussed with the authorities in the context of the next Article IV consultation discussions scheduled to take place in October/November 1988.

Table 1. China: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1982						
II	86.4	99.9	86.5	80.9	105.3	105.6
III	84.7	100.7	84.0	77.3	104.9	104.6
IV	82.6	101.9	81.0	75.9	103.3	103.6
1983						
I	82.2	101.0	81.5	76.7	105.8	105.4
II	82.8	103.0	80.4	75.4	106.6	106.9
III	85.0	107.8	78.8	75.5	106.9	106.6
IV	84.2	109.7	76.8	75.7	107.2	107.8
1984						
I	80.6	107.0	75.3	73.0	107.7	107.0
II	77.1	103.1	74.8	69.4	109.1	109.4
III	72.8	98.8	73.6	62.6	109.8	109.5
IV	66.9	91.9	72.8	56.2	111.3	112.3
1985						
I	66.7	91.7	72.7	53.0	114.0	113.0
II	66.8	90.6	73.8	52.5	118.6	118.7
III	63.6	86.1	73.9	51.4	120.8	120.5
IV	55.2	74.6	74.0	47.5	122.8	124.4
1986						
I	51.1	70.1	72.9	46.7	122.8	121.5
II	49.0	67.5	72.7	46.8	122.9	123.0
III	41.6	56.5	73.6	40.7	125.6	125.4
IV	42.0	56.0	75.0	40.3	129.4	131.3
1987						
I	40.1	54.1	74.1	40.2	129.5	127.9
II	39.2	53.0	73.9	40.2	132.1	132.0
III	40.6	54.4	74.6	40.2	136.0	135.8
IV	39.6	52.4	75.5	40.2	140.5	142.7
1988						
I	39.2	51.7	75.7	40.2	143.5	141.7
II	40.8	52.3	78.0	40.2	151.5	151.2
Monthly						
1988						
Feb. <u>3/</u>	39.5	52.1	75.9	40.2	143.8	141.0
Mar.	39.4	51.8	76.1	40.2	145.3	142.7
Apr.	39.5	51.7	76.5	40.2	147.4	146.8
May	40.7	52.1	78.2	40.2	151.8	152.4
Jun.	42.2	53.2	79.3	40.2	155.4	154.5
Jul.	44.6	55.2	80.8	40.2	160.1	159.0
Percentage change						
Feb. 1988- July 1988	12.9	6.0	6.5	—	11.3	

Source: Information Notice System.

1/ Increases mean appreciation.

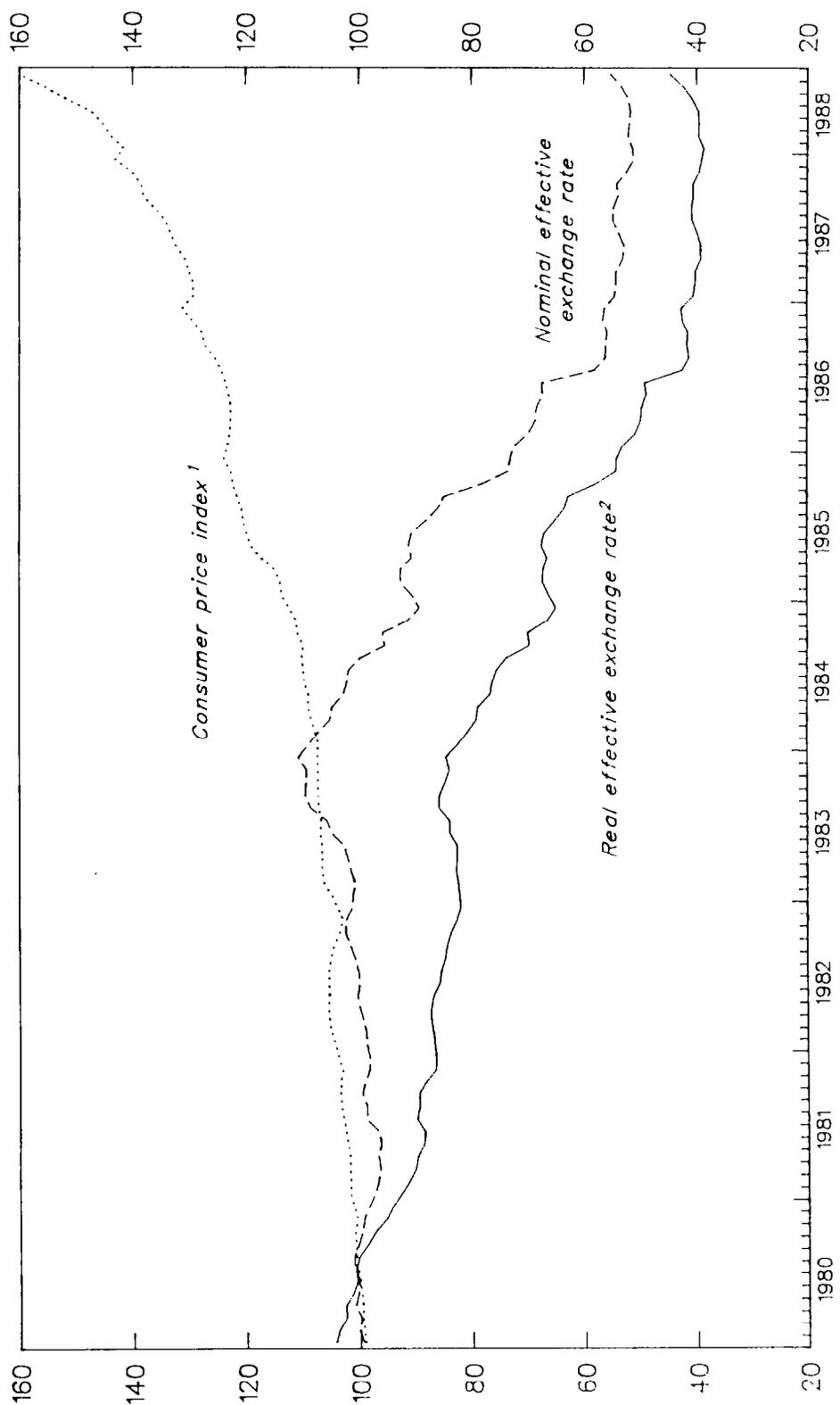
2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.

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CHART
CHINA
INFORMATION NOTICE SYSTEM INDEX OF REAL EFFECTIVE EXCHANGE RATE
(1980=100)



Source: Information Notice System.
1. Seasonally adjusted.
2. Trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices, increases mean appreciation.

