

# Reform of the RMB Exchange Rate System and Future Prospects

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**ABSTRACT.** *China's RMB exchange rate system has gone through four stages: dual exchange rate system, pegged exchange rate system, exchange rate floating system, and perfecting the mid-price quotation mechanism, which has already made individual achievements. However, China's exchange rate system still has many problems, such as the failure of exchange rate prices to fully reflect market supply and demand levels, as well as much government intervention. In the future, we should continue to improve the market maker system and promote the market-oriented reform of the RMB exchange rate system.*

**KEYWORDS:** *RMB exchange rate system reform; RMB internationalization; RMB reform prospect*

## 1. Introduction

With the acceleration of globalization and the deepening of China's opening to the outside world, China, as an important economy in the world, is playing an increasingly important role in the international market, which economic and trade relations with other countries have deepened. Against this background, the issue of exchange rates has become an increasingly important issue. China's exchange rate system has also become a critical system that affects China's economic development process. How to choose an exchange rate system that is suitable for our economic development situation has also become a vital issue facing our country.

At present, China still faces the problems of the imperfect financial system and flawed financial system. Under the premise of leading the international market, how to narrow the gap with developed countries is still an issue that needs to be explored and resolved. The RMB exchange rate system will not only have a broad impact on China's foreign exchange market, foreign exchange reserves, and international monetary capital flows, but also have a significant impact on China's domestic macroeconomic stability and development. For example, since 2019, the Renminbi exchange rate has fallen below the 7 Yuan mark, which has led to the continuous rise in the prices of Chinese imports. Some small and medium-sized enterprises have been retrenched by the exchange rate, which has negatively affected the normal operation of the Chinese economy.

At present, the RMB exchange rate system is in a critical period of reform. Choosing an RMB exchange rate system is very important for the country's economic development. Therefore, this article elaborates the course of the RMB exchange rate system, its current status and prospects, and has particular reference significance for the reform of the RMB exchange rate system.

This article consists of four parts. First, it briefly describes the background of the reform of the RMB exchange rate system in China and the significance of this research topic. Second, it studies the reform process of the RMB exchange rate system. It is explained in four stages. Difficulties, finally summarize the reform process of the RMB exchange rate system and look forward to future development trends.

## **2. Reform Process of RMB Exchange Rate System**

The RMB exchange rate system is advancing toward marketization. The goal of China's reform is to establish a managed floating exchange rate system based on market supply and demand and to maintain the RMB floating within a reasonable range. The reform process of the RMB exchange rate system is going through four stages. The first stage is the dual exchange rate system implemented from 1978 to 1993. It is characterized by the simultaneous coexistence of official exchange rates and foreign exchange adjustment and settlement prices. The second stage was the pegged exchange rate system in 1994. Under this system, the RMB exchange rate is determined by a designated bank, forming a managed floating exchange rate system. The third stage is a floating exchange rate system after 2005, and the RMB exchange rate is no longer pegged. Live in dollars, but refer to a basket of currencies. At present, we are in the fourth stage of improving the mid-rate exchange rate system. At this stage, the marketization of the RMB exchange rate system has further deepened.

### ***2.1 1978-1993: Dual Exchange Rate System***

From 1978 to 1981, China implemented a single exchange rate system. After 1981, to avoid the loss of non-trade foreign exchange income, China increased the internal settlement price. However, the two exchange rate mechanisms have caused serious confusion in the scope of use, and have placed China in a passive position in foreign relations. In January 1985, China abolished the internal settlement price of foreign trade exchange and implemented a single RMB exchange rate. With the development of the import and export industry, a foreign exchange market has been formed.

From 1985 to 1993, China transformed into a dual exchange rate system in which both official exchange rates and foreign exchange adjustment prices coexisted. As the pace of China's opening to the outside world continues to accelerate, foreign-invested enterprises and individuals were allowed to participate in the swap market around 1991. At the same time, the business scope of foreign exchange adjustment is also extensive, including foreign exchange retention of all foreign

exchange earning units, international exchange of foreign-funded enterprises and local governments, and domestic and international trade and non-trade foreign exchange and personal exchange [1].

At this stage, the exchange rate system closely follows the development of China's national conditions, effectively allocates resources, and promotes China's opening up to the outside world and the development of international trade. At the same time, it weakens international capital flows and exchange rate shocks, which is conducive to the stability of the domestic economy and also to avoid the illegal transaction.

### ***2.2 The 1994 Exchange Rate Reform: Pegged Exchange Rate System***

In 1993, China issued the "Announcement on Further Reforming the Foreign Exchange Reform and Declaration System" to establish a single, managed floating exchange rate system based on market supply and demand. A unified inter-bank foreign exchange market was established, and the RMB exchange rate system was further market-oriented. Since January 1, 1994, 8.72 Yuan has been exchanged for one US dollar as the nation's unified RMB market exchange rate. After the implementation of this system, the RMB exchange rate has remained relatively stable. Under this system, China's import and export trade and balance of payments have improved significantly.

With the development of China's economy and the increasing dependence on foreign trade, the independence of China's monetary policy has been limited to some extent. Exporting companies are increasingly relying on the low-price advantage formed by the RMB exchange rate, leading to extensive export expansion, which is not conducive to the long-term economic development. At the same time, other countries have also implemented countermeasures against China and began frequent anti-dumping investigations on Chinese products. At the same time, many countries in the international community have also accused the RMB of undervaluation. With the deepening of China's economic system reform, China also began to reform the RMB exchange rate system in July 2005 to improve the RMB exchange rate formation mechanism further.

### ***2.3 Exchange Rate Reform in 2005: Floating Exchange Rate System***

On July 21, 2005, the People's Bank of China announced the implementation of a managed floating exchange rate system based on market supply and demand and adjusted concerning a basket of currencies. The primary purpose of this reform is to solve China's imbalance in foreign trade, expand domestic market, increase the independence of monetary policy, and enhance the international competitiveness of enterprises.

The exchange rate reform is aimed at realizing the promotion of macroeconomic stability, ensuring stable economic growth and employment. The RMB has also appreciated, and international hot money has flowed into China, and China's capital controls have also created a certain threshold for the inflow of hot money. At this

stage, capital continued to flow into China. China's foreign exchange reserves continued to increase rapidly.

#### ***2.4 Exchange Reform in 2015: Improve the Median Price Quotation Mechanism***

In June 2015, after the domestic stock price fluctuated, China further accelerated the RMB convertibility process. The People's Bank of China officially released the Report on RMB Internationalization (2015), publicly announcing the strategy for RMB internationalization. In 2017, the central bank announced the introduction of a "counter-cyclical factor" into the RMB exchange rate intermediate pricing mechanism, forming a tool for the formation of a medium rate of exchange rates determined by the three factors of "close price of the previous trading day + changes in the exchange rate of a basket of currencies + counter-cyclical factors". Since then, the RMB exchange rate has begun a two-way floating pattern [2].

The exchange rate reform has promoted the freely convertible Renminbi and the internationalization of the Renminbi. It has improved the mid-price quotation mechanism, is conducive to maintaining the continuity and transparency of the price, solved the long-term deviation between the mid-price and the transaction price, and further improved the middle. The market benchmark position of the price has also enhanced the flexibility of the RMB exchange rate.

### **3. Achievements and Predicaments of RMB Exchange Rate System Reform**

The reform of the RMB exchange rate system has made many achievements so far. The RMB exchange rate system is working hard to promote marketization. At the same time, it has further enhanced the flexibility of the exchange rate and improved the mid-price system. However, China's exchange rate marketization reform still faces many challenges.

First, the autonomy of the exchange rate formation mechanism is insufficient. At present, the formation mechanism of the RMB exchange rate in China is still affected by the exchange rate of other countries' currencies. The US dollar-based arbitrage has limited the independence of the RMB exchange rate. The current pricing method based on a basket of currencies also restricts the autonomy of the RMB exchange rate formation, and the role of the market in it is still insufficient.

Second, the current RMB exchange rate is still tricky to reflect the market's supply and demand situation, and it is subject to more government intervention. At present, the number of market makers in China is still small, and it is difficult to match the size of China's massive foreign exchange market, which leads to incomplete competition. It is difficult for the exchange rate prices to reflect the market level fully. At the same time, China's central bank will still directly intervene in the exchange rate market in a relatively simple and direct manner, affecting the trend of the exchange rate, which makes it difficult for the RMB exchange rate to clearly reflect market supply and demand [3].

Third, China has not yet achieved an indeed managed float. At present, there is still a particular gap between China and the real managed floating exchange rate system. Real managed floating belongs to floating exchange rates. The market mainly determines the exchange rate. There is no open exchange rate management target. Government intervention based on exchange rate stability is allowed. From our point of view, the implementation of indeed managed floating means that the market can find the equilibrium exchange rate level, maintain government exchange rate stability through government management, and keep the exchange rate stable at a reasonable equilibrium level, thereby achieving the coordination of the dual goals of equilibrium exchange rate and exchange rate stability.

#### **4. Summary and Outlook**

Reform of the RMB exchange rate is still on the way, and it will confront many challenges in the future. At the same time, the changing international situation has also put forward new requirements for the reform of the RMB exchange rate system. Improvement of the RMB exchange rate system is facing more uncertainties [4].

In the future, China should further improve the market maker system in the foreign exchange market, expand the participants in RMB pricing and transactions, and make the RMB exchange rate more reflect the market supply and demand. At the same time, China should also appropriately adjust the means of intervening in the exchange rate market. Attempts can be made to establish indirect exchange control or stabilization funds for indirect control or to improve the supply and demand of foreign exchange through various methods such as forward transactions. China should also establish a regular foreign exchange market intervention information disclosure system as soon as possible and announce the central bank's intervention in the foreign exchange market to enhance the predictability of the RMB exchange rate [4].

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