

**The renminbi pegged to a basket:
cautious policy under precarious global finances**

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Abstract

On 19 June 2010 the Chinese authorities announced that the RMB would henceforth be managed with reference to a currency basket. Yet, recognising that it has smoothly appreciated against the USD, the daily observations indicate that it has followed a crawling peg against a basket dominated by the USD.

The dominance of the USD and the movements between the major currencies since June 2010 have meant that despite appreciation against the USD by an annual rate of five per cent, over more than 12 months after June 2010 the RMB was significantly weaker against a broad trade-weighted basket and the EUR until autumn 2011. At issue is the intrinsic volatility of the RMB against its broad-based basket and against currencies other than the USD: under the observed policies of the PBC it will depend significantly on the unpredictable cross-rates between the major currencies.

This paper argues that the PBC can reduce the overall volatility by pegging the RMB to a basket that better reflects the direction of trade flows. This led us to consider a basket peg with a significant weight for the EUR, with the SDR being a strong option for practical implementation since it seems to reflect reasonably well the relative importance of the four major convertible currencies to China and the global economy. This would reduce the overall currency risks for the producers and traders engaged in China's foreign trade and enhance the role of both the SDR and the RMB internationally. The EU economies would also benefit from a less volatile RMB/EUR rate.

Fundamental change in international financial institutions and instruments will take time to emerge. Most notably, the RMB will not assume a significant role until it becomes freely convertible, which will not happen without transparency in managing the external value of the RMB as otherwise private agents will not use it widely. More transparency will reduce the risks for market participants; but, at the same time, a more open capital market will be more difficult for the Chinese authorities to control. This is a dilemma that all authorities have to face. The Chinese have expressed their long-term objective of moving in this direction as it is necessary for an enhanced role for the RMB globally.

The possible transition to a more balanced basket is a complex issue as the change in the composition of the basket would possibly have implications for China's USD-dominated asset holdings and thereby for the dollar/euro exchange rate, potentially triggering an excessive depreciation of the USD. This could have costly consequences and thereby call for new rules for the global financial architecture. China's economic expansion will inevitably lead to a diminishing international role for the USD.