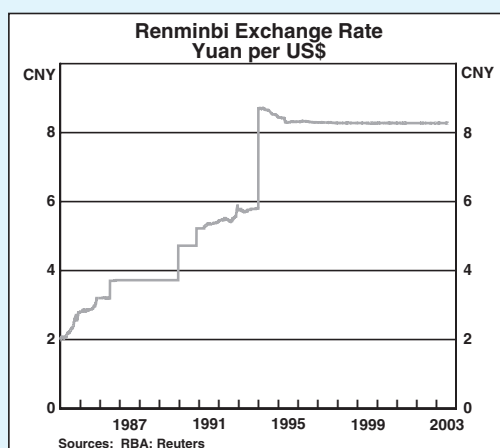


Box C: The Chinese Renminbi

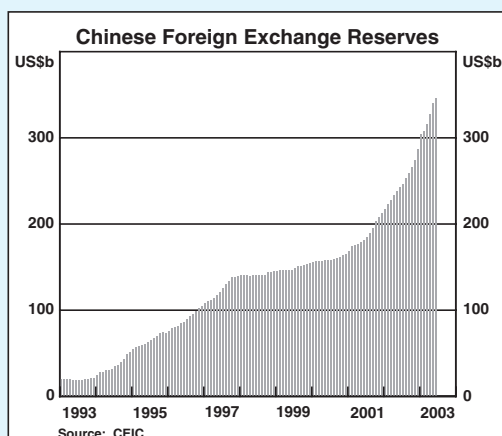
Since the devaluation in 1994, China has maintained its exchange rate within a 0.3 per cent band either side of its target rate¹ (Graph C1). In the context of continuing trade surpluses, strong capital inflows and sharply rising official reserves (Graph C2), there have been calls from time to time from various commentators for China to free up its exchange rate, with the implication that it should appreciate.

Graph C1



Financial markets pricing suggests that market participants see the possibility of a revaluation of renminbi as having increased. This is evident in both implied volatilities from the currency options market and in non-deliverable forward (NDF) rates. The implied volatility from a currency option is a measure of the variability that the market sees in future movements in the exchange rate over the life of the option contract. In the context of a fixed exchange rate, implied volatility largely reflects the expectations of an upward or downward adjustment to the

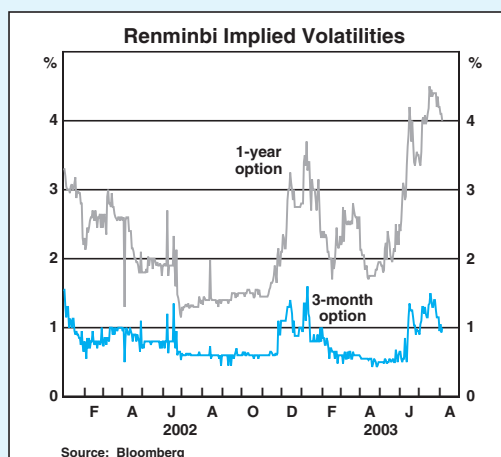
Graph C2



peg. Over the past year, on two occasions when US officials have talked about the possibility of China adopting a more flexible exchange rate, there has been a significant reaction in the options market. In June 2003, for example, implied volatilities on options to buy or sell renminbi rose sharply from around 2.5 per cent to 4 per cent for 1-year contracts, and from 0.5 per cent to 1.3 per cent for 3-month contracts (Graph C3). Also implied volatilities were larger for 'out of the money' options to buy renminbi, than for equally 'out of the money' options to sell the currency, thereby suggesting that the balance of expectations was skewed towards an appreciation of the Chinese currency against the US dollar.

Another gauge of the anticipated direction of a change in the value of renminbi is the NDF rates relative to the spot exchange rate. NDFs are forward contracts in which, at the expiry of the contract, the difference between the prevailing spot exchange rate and the contract rate is settled in cash.

1. China's currency is generally known as renminbi, or 'People's currency', but the unit of measurement is the yuan (the terms are parallels of 'sterling' and 'pound' in the UK).

Graph C3

Given that China has higher interest rates than the US, in the absence of expectations of a change in the target exchange rate one would expect the forward exchange rate (expressed as yuan per US dollar) to be higher than the spot exchange rate so as to eliminate the possibility of earning a risk-free profit over the term of the contract. However, since November 2002, NDF rates have typically been below the prevailing spot

exchange rate. The discrepancy between NDF rates and the spot exchange rate was particularly pronounced in June 2003, when NDF rates temporarily fell 2 per cent below the spot exchange rate for one year contracts, and 0.4 per cent below the spot exchange rate for 3-month contracts (Graph C4). This suggests that investors had attached a higher probability to an upward revaluation of renminbi, with expectations being more pronounced at longer horizons. ♣

Graph C4