

# On the Yuan: The Choice between Adjustment under a Fixed Exchange Rate and Adjustment under a Flexible Rate

Jeffrey Frankel

Harpel Professor for Capital Formation and Growth  
Kennedy School of Government, Harvard University

An earlier version of this paper, “On the Renminbi: The Choice Between Adjustment Under a Fixed Exchange Rate and Adjustment under a Flexible Rate,” was originally drafted for a seminar held in Dalian, China, May 26-27, 2004, and appeared as NBER Working Paper No. 11274. A more informal and condensed version was published as “On the Renminbi,” in *CESifo Forum*, vol. 6., no. 3, Autumn 2005, Ifo Institute for Economic Research, Munich, pp. 16-21. It is anticipated that the present revised and updated version of the paper will be published in Understanding the Chinese Economy, edited by Gerhard Illing (CESifo Economic Studies, Munich).

The author would like to thank Maral Shamloo for efficient research assistance, the Kuwait Fund at Harvard University for support and Yong Zhang; and to thank for comments two referees and participants at conferences in Dalian, the American Enterprise Institute, the European Central Bank, and the Allied Social Science Association meetings.

## On the Renminbi

**“I have listened to both sides of this debate. Here is what I think. I think those who call for a fixed exchange rate are right in the short run. And those who call for a floating exchange rate are right in the long run. How long is the short run, you ask? You must understand. China is 8000 years old. So when I say, short run, it could be 100 years.”**

**-- Li Ruogu, Deputy Governor, People's Bank of China, Dalian, May 2004, as paraphrased by author.**

**“Certainly we don't want... the US situation of having a trade deficit of 6 percent of GDP”**

**-- Li Ruogu, Deputy Governor, People's Bank of China, as reported by the *Financial Times*, p.1, 12/23/04, under the headline, “China Tells US to Put its House in Order.”**

An exchange rate that is de facto fixed has served China well over the last eight years. Nevertheless, the recommendation of this paper is that the time has probably come to allow the yuan to appreciate. This judgment is reached for four major reasons. First, calculations based on the Balassa-Samuelson relationship suggest that the real value of the renminbi is (and has for some time been) low -- not just low compared to the U.S. dollar or other rich countries, but substantially below even the equilibrium value for a country at China's stage of development. Second, although history shows that foreign exchange reserves are a useful shield against currency crises, China's level of balance of payments surplus and reserve acquisition has by now been very high for several years, so that the country is currently giving up a lot when it buys (low-return) US treasury securities with the proceeds it raises from (high-return) inward investments. Third, while the authorities have been remarkably successful at sterilizing the inflow since 2002, and the threat of overheating that existed in 2004 seems to have disappeared by 2006, it is doubtful that they can keep up sterilization on this scale indefinitely. A strategy that continues to exclude appreciation from the policy response mix will become increasingly difficult. Fourth, the experience of other emerging markets suggests that it is better to exit from a peg when times are good and the currency is strong, than to wait until times are bad and the currency is under attack. A country as large as China probably requires an exchange rate regime with some flexibility, and this is a good time to begin moving in that direction.

This need not mean a move to pure floating. An intermediate regime such as a target zone is probably more appropriate for the time being. Indeed the case of China well-illustrates the limitations of the popular “corners hypothesis.”<sup>1</sup>

That the author's recommendation for appreciation happens to coincide with the urgings of American politicians is pure coincidence. Those urgings are often a political response to ill-informed (though understandable) domestic concern about the causes of US trade deficits and job losses.<sup>2</sup> Any country is free to choose to peg its currency if it

---

<sup>1</sup> Among many others urging appreciation of the renminbi are Goldstein (2003), Goldstein and Lardy (2003) and Merrill Lynch (2004), all of whom suggest an initial step appreciation followed by a move to a band around a basket.

<sup>2</sup> The recent US position on the Chinese yuan has a precedent 15 years earlier when US policy urged appreciation and liberalization of the Korean won: Frankel (1993). And before that, the Japanese yen: Frankel (1984). In each case, one could defend the performance of the US Treasury on the grounds that

wishes. Thus allegations of “illegal exchange rate manipulation” are inappropriate. It is not even true that an appreciation of the renminbi against the dollar would have an immediately noticeable effect on the overall US trade deficit, and still less on employment, though the effect on the US trade balance would eventually be moderate if other Asian countries were to respond by letting their currencies appreciate against the dollar as well. But in any case, the first order of business for China should be to determine what policy is in its own interest. It is on those grounds alone that this paper supports increased exchange rate flexibility.

This is not to say that surplus countries have no obligations under the international monetary system,<sup>3</sup> nor that no country can ever be asked to take into account the interests of others, as part of a reciprocal system that carries gains for all. But in the author’s view it is not appropriate to use the language of WTO violations for the question of balancing the pros and cons of fixed exchange rates, which is inherently much less clear-cut than the question of balancing the pros and cons of free trade.

It should be conceded from the outset that a regime of fixed exchange rates has a number of advantages.<sup>4</sup> Probably two advantages of fixing the exchange rate in terms of a particular major currency like the dollar are most important. First is the provision of a nominal anchor to prevent inflationary monetary policies and expectations thereof. But there are other possible alternate candidates for nominal anchor, including nominal GDP, the CPI, and an export price index.<sup>5</sup> Second is the facilitation of trade with those countries that use the dollar, or at least are pegged to the dollar.<sup>6</sup> Other advantages of fixed rates include facilitating financial integration, forestalling competitive appreciation or depreciation, and preventing the sort of speculative bubbles that seem occasionally to afflict floating exchange rates. There is of course a corresponding list of advantages of floating rates.

The paper presents the arguments for exchange rate flexibility in a general context. The freedom to depreciate when the balance of payments is in deficit, or output has fallen below potential, is as important as the freedom to appreciate in the opposite circumstances. But we emphasize the specifics of China’s macroeconomic situation, particularly the features of payments surplus and rapid growth. In the latter part of the

---

public expressions of pressure on the Asian country in question to appreciate its currency are preferable to the alternative political danger of protectionist legislation in Congress.

<sup>3</sup> Goldstein (2003, 2004) argues that there is an obligation not to manipulate the currency to frustrate adjustment, that a fixed exchange rate is not proof against such charges, and that China is guilty as charged.

<sup>4</sup> McKinnon has long argued the advantages of dollar links for Asian countries; e.g., McKinnon and Schnabl (2003). Frankel (2004) is a survey of the pros and cons of exchange rate regimes among emerging market countries.

<sup>5</sup> Of these three candidates for nominal anchor, inflation targeting, by which is usually meant the CPI, has caught on internationally; and the others have not. (Goodfriend and Prasad, 2006, for example, recommend inflation targeting for China, as a substitute for the current exchange rate target.) Setting a target for the CPI, if interpreted literally, suffers an important drawback. In the event of an increase in the world market price of imported commodities such as oil, the rule says to tighten monetary policy enough to appreciate the currency -- so as to leave the price of imports unchanged in local currency -- whereas precisely the opposite response is called for in response to such an adverse shift in the terms of trade. The two old favorite candidates for nominal anchor, price of gold and money supply, have been largely discredited.

<sup>6</sup> Since Rose (2000), we have come to realize that the empirical effect of a fixed exchange rate on the quantity of trade is stronger than had been previously thought, at least in the case of a common currency. Clark, Tamirisa, and Wei (2004) find little effect of variability versus a regular fixed exchange rate.

paper, we consider the long-run implications of the Balassa-Samuelson effect, offering some simple calculations that allow for transitory deviations from the Balassa-Samuelson relationship, which most authors fail to take into account.

## **The Need For Two Policy Instruments: Exchange Rate As Well As Spending**

It is sometimes pointed out that changes in exchange rates are not necessary or sufficient to adjust the trade balance. This proposition is true, so far as it goes, but is much less helpful than at first appears. It is true that other policies, especially those that affect the level of spending, are important. A trade deficit can indeed be viewed as an excess of spending over income, and a trade surplus as the reverse. Thus changes in spending affect the trade balance. But this does not mean that changes in the exchange rate are not important too. We will see that, because any country has other goals in addition to trade balance adjustment, the real exchange rate does have an important role to play. That will mean giving the nominal exchange rate a role to play as well, for a majority of countries – especially countries as large as China.

The claim that the exchange rate is unimportant for adjustment can arise from two – mutually inconsistent – views of trade. One polar view is that trade elasticities, which describe the response of exports and imports to relative prices, are extremely low, and so of little help in adjustment. The other extreme view is that the trade elasticities are extremely high – so high that firms are forced to adjust all prices instantaneously in response to fluctuations in the exchange rate or else face the loss of all their customers. Reality, as so often, lies in between these two extremes. The price level adjusts partially to changes in the exchange rate, especially in the short run. This paper will proceed on that assumption. A simple and standard model focuses on the distinction between goods that are internationally traded and those that are not. It is assumed that the short-run adjustment of prices to exchange rate changes is complete within the traded good sector, so that variability in the real exchange rate arises entirely from the nontraded goods sector. But all the points I wish to make in this paper could as easily be made with other models, so long as elasticities are greater than zero but less than infinite and the price level in the short run adjusts only partially to changes in the exchange rate.

The more general point is the classic framework of targets and instruments.<sup>7</sup> The framework might appear “static” and old-fashioned, and not applicable to a dynamic economy like China’s; but this is an illusion. The point where the two lines cross, signifying the equilibrium real exchange rate and potential output, should be viewed as shifting gradually over time. In a country of rapid productivity growth, such as China, the intersection gradually shifts to the right, as potential output rises, and also gradually shifts downward, as the Balassa-Samuelson effect leads to real appreciation. Unfortunately most analysis either considers *only* the evolution of the equilibrium point -- the Balassa-Samuelson relationship – or *only* short-term deviations of the economy from the equilibrium – the Swan Diagram. This paper seeks to consider both, as both are important. We start with the short run deviations.

---

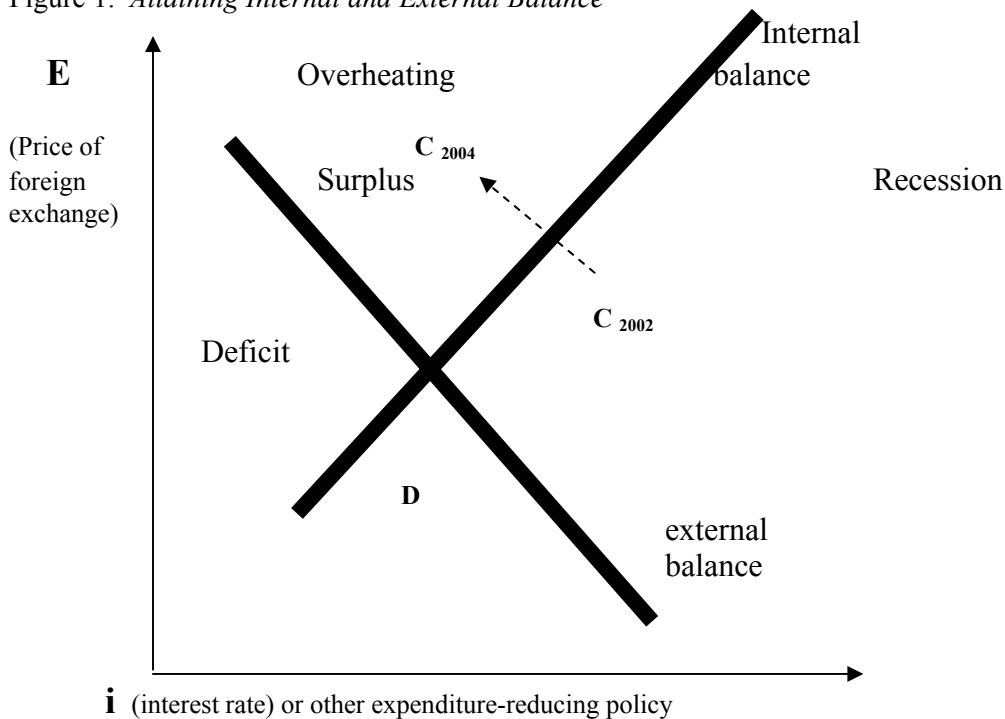
<sup>7</sup> The targets and instruments framework goes back to Tinbergen, Meade and Mundell (1968). Our version will be based on the diagram of Swan (1963).

The government has two kinds of policy instruments: expenditure switching (the real exchange rate) and expenditure reducing (monetary and fiscal policy). Assume for concreteness that the People's Bank of China has at its disposal two policy instruments: the exchange rate, and the interest rate. The interest rate is used as shorthand here for all of monetary policy including domestic credit, reserve requirements placed on banks, etc., and indeed for other policies that affect the level of domestic spending. Figure 1 shows the two instruments on the two axes. If we were only interested in one policy goal or target, then life would be simple. Consider as the first target the trade balance, as a criterion for external balance. For simplicity, let us say the target for the trade balance is zero. In fact, it may be appropriate for a rapidly growing country with a low capital/labor ratio and a high return to investment to run a trade deficit and finance it by borrowing from abroad. But whether the target level is zero or some other number does not matter for the analysis.

### *Trade balance equilibrium schedule*

There are different combinations of the real exchange rate and the real interest rate that are consistent with a zero trade balance, and they are represented by the downward-sloping TB line in Figure 1. (We are defining the nominal and real exchange rates as the domestic price of foreign currency or goods, respectively; so an increase is a depreciation.) To see that the line slopes down, consider a deficit country at point *D*, e.g., Asian crises victims Thailand or Korea in 1997 (or the U.S. today!) At point *D*, the country can eliminate the trade deficit either by real appreciation -- a movement upward - - or by expenditure reduction, a movement rightward.

Figure 1. *Attaining Internal and External Balance*



Imagine now that the country finds itself with too large a trade surplus. Then it is located above or to the right of the external balance schedule, at a point like *C*. It can get back to equilibrium either by lowering the real exchange rate or by lowering the interest rate. Lowering the interest rate would operate by stimulating domestic spending, some of which would spill abroad as increased imports (or as increased consumption of goods that might otherwise be exported), thereby reducing the trade balance. Lowering the real exchange rate could, in turn, be achieved either by appreciating the currency or allowing prices to rise; either way, domestic goods lose competitiveness on world markets and the goal of reducing the trade balance is again achieved. Thus the authorities can either lower the interest rate or lower *E*; the more of one, the less of the other. An inverse tradeoff between *i* and *E* characterizes the combination of points that give equilibrium in the trade balance. That is the external balance relationship.

Which way of achieving a change in the real exchange rate is to be preferred, a reduction in the nominal exchange rate or an increase in the price level? The choice between flexible and fixed exchange rates depends on a number of further factors, which vary from case to case. Many of these criteria fall within the general title of Optimum Currency Area theory. A very small, very open, economy -- such as Hong Kong [S.A.R.] -- will find it relatively more costly to give up an exchange rate peg, and would find it easier to let the price level adjust instead. China is a large country with a large internal market, indicating that adjustment via the exchange rate is relatively more attractive.<sup>8</sup>

If the trade balance were the sole objective, then perhaps there would be no need to adjust the real exchange rate. The nominal exchange rate could be fixed – with all the advantages that entails. There would also no be need to undergo changes in the price level either. Adjustment could take place in the level of expenditure, rather than through expenditure-switching. In terms of central bank instruments, monetary policy could do all the work.

### ***Internal balance schedule***

The big problem with the attitude that one needs only a single kind of policy instrument, such as those instruments that work through the level of spending, is that the trade balance is not the sole objective. Governments should and do have other macroeconomic objectives. We consider now internal balance. Because the country has more than one policy objective, it will need more than one category of policy instrument to achieve them. The interest rate alone is not enough. (Subsequently we will turn to a third objective: the capital account or overall balance of payments.)

---

<sup>8</sup> The emphasis on the share of traded goods in the economy as an optimum currency area criterion dates from McKinnon (1963). The term “optimum currency area” itself dates from Mundell (1961), who focused on a high level of cross-border labor mobility as his criterion for giving up a monetary independence. A referee for this paper has pointed out a reason to think of wages and prices in China as flexible, despite its large size and Communist historical path: because the economy is so dynamic, wages are fluid, in the sense that they are growing rapidly in nominal terms, regardless of price inflation, because of productivity growth, so there is less reason to fear nominal stickiness.

The target for internal balance can be defined as output equal to potential output, or as employment equal to the natural rate of employment, or as an absence of inflationary or deflationary pressures. Let us say that the country in question finds itself with output above potential,  $Y > \bar{Y}$ , i.e., there is excess demand for goods. As a result the economy is overheating. To cool off the economy, the government can either raise interest rates or undergo a real appreciation. In terms of Figure 1, we are talking about an economy that finds itself to the left of the upward-sloping  $Y = \bar{Y}$  line; it can get back to internal balance either by moving to the right in Figure 1, or by moving down. Not long ago, in 2002, it was possible to argue that China was to the right of the  $Y = \bar{Y}$  curve, in the zone of Excess Supply of Goods. At that point, some easing of monetary policy was called for, to increase spending and restore internal balance. By 2004, however, China had moved to the other side of the line, to a point like  $C_{2004}$ . As a result, some combination of an increase in interest rates or a real appreciation was called for. By 2006, the overheating danger had abated, and China had moved back closer to the internal balance line. This may be as much due to increases in US interest rates and in the value of the dollar in 2004-05 than to monetary tightening in China over and above the world level.

There is only one point on the graph that achieves the desired settings for both objectives, and that is where the two lines intersect. The key lesson is that, in general, one must use two sorts of policies -- expenditure-reduction and expenditure-switching, as represented by the two axes -- to attain both goals simultaneously. China's economy has recently occupied the upper quadrant of the graph: a combination of trade surplus and excess demand. Without more precise information it is not possible to know what direction of movement in the interest rate is entailed by the optimal combination of adjustment in the two instruments. It depends exactly where in that quadrant China lies. But it is possible to know what direction of movement is called for in the real exchange rate: downward, i.e., real appreciation. (Below we will consider another argument why a move to equilibrium for China today would imply real appreciation: the Balassa-Samuelson relationship, which can be thought of as determining the equilibrium intersection in the long run.)

Some real appreciation took place in the 1990s, in the form of inflation. But it is probably not desirable that the real appreciation take this form. Inflation is not good. Especially if one of the leading arguments for a fixed exchange rate is as an anti-inflationary anchor for monetary policy, the argument for abandoning the peg is reinforced if economic circumstances imply high inflation even under a peg. Those circumstances in China are increases in the international reserve component of the monetary base as opposed to the net domestic asset component. Such increases work to drive up inflation. Hence the argument for nominal appreciation instead.

### ***Target for the overall balance of payments***

There are three components of the large balance of payments surplus that China has run since 2002. First, the trade balance has usually been in surplus (except for a brief period in early 2004). One might argue that China should, if anything, be running a

trade deficit (not just because a rapidly growing country like China is traditionally expected to run a trade deficit, financed by borrowing from abroad, but also because phasing in of WTO commitments.) But even aside from the trade balance, there is the question of the overall balance of payments, the sum of the current account and the private capital account.

Second, inward Foreign Direct Investment is substantial. This has long been a deliberate and successful feature of China's development strategy, often explained by the need to import managerial and technical know-how and good corporate governance to complement the cheap manufacturing labor force.<sup>9</sup>

Third, although portfolio capital inflows are still heavily restricted by the government of China, and one must look at errors and omissions to see them, they are nevertheless finding their way in through one route or another. (In large part, Chinese citizens who squirreled dollar earnings away overseas in the past have now been bringing them back into the country, in anticipation of a revaluation of the currency.<sup>10</sup>) Which measure of external balance is the right one? One cannot definitively assert that it is correct to have an objective for the current account but not for the overall balance of payments, or vice versa. Both measures are of interest to policymakers.

Why does the balance of payments matter? One disadvantage of a balance of payments deficit, for any country, is that the central bank is running down its reserves. If this process continues indefinitely, it will eventually have to adjust course. Under conditions of open capital markets, if reserves reach a critical level (which need not be as low as zero), a sudden speculative attack could force the adjustment to take place rapidly, and under unpleasant conditions.<sup>11</sup> In the East Asian crisis of 1997-98, for example, the economies that had run down their reserves suffered sharp crises (Thailand, Korea, etc.), while the economies with high levels of reserve holdings were the ones able to ride out the storm (China, Hong Kong SAR, and Taiwan Province of China).

One disadvantage of a balance of payments *surplus*, on the other hand, is that the reserves, which are typically held in the form of US Treasury bills and bonds and other dollar securities, pay a low rate of return. Interest rates on US treasury bills are low because the market is so liquid and because default is assumed to be very unlikely -- and also, during the period 2001-2004, because the Federal Reserve has held short-term interest rates well below normal historical levels. The Chinese authorities have evidently already diversified out of Treasury bills, into agency bonds and other longer term securities, which should help the yield somewhat. But it is more likely than not that the dollar will depreciate over the next ten years -- not necessarily in the short run -- in light of the large US trade deficit, which would reduce even further the return to holding dollar securities. (Diversification into the euro or other currencies has evidently not yet gone far.) Meanwhile, China is paying to foreign investors on their inward investment a higher return than it is earning, which means that the arrangement is a losing deal for the country in the aggregate.

---

<sup>9</sup> On this Dooley and Garber (2003, 2005) and Huang (2003) agree, although the former regard the strategy as clever on China's part, while the latter regards it as a sorry commentary on the inadequacy of home-grown firms.

<sup>10</sup> E.g., Prasad and Wei (2005).

<sup>11</sup> This is predicted by most theories of speculative attacks. Chapter 23 of Caves, Frankel and Jones (2002) is a brief survey of crises in emerging markets.



The author's feeling is that China has not been irrational -- in light of the observed volatility of the preceding decade -- to want to accumulate reserves. Thus one can rationalize a balance of payments surplus above and beyond the trade surplus, though I would guess that exports and employment are the more important motivations in the minds of Chinese policy-makers when they intervene to maintain the de facto peg.<sup>12</sup> In any case, by now the level of reserves is so high -- on a track soon to cross the \$ one trillion mark before Japan does -- that further accumulation would seem to accomplish very little by way of increased security. So I will assume in the analysis that the target for the overall balance of payments is now zero.

Another consideration in selecting the desired level of the overall balance of payments is the implication of reserve flows for the monetary base. If reserves are flowing in through a balance of payments surplus, that puts upward pressure on the monetary base. Conversely, if reserves are flowing out through a balance of payments deficit, that puts downward pressure on the monetary base. If the central bank wishes to make its domestic monetary policy decisions unencumbered by changes in foreign exchange reserves, that may be a further argument for a zero target in the balance of payments. (We return to this issue shortly.)

### ***Balance of payments equilibrium schedule***

Regardless what numerical target is selected for the overall balance of payments, the combinations of  $i$  and  $E$  in Figure 1 that correspond to that target are, as for the trade balance, downward sloping. We have already seen that the real exchange rate and the interest rate have the same direction of effects on the trade balance (via competitiveness and spending, respectively); so if one goes up the other must go down to maintain equilibrium. But in addition, they probably also have the same direction of effects on the capital account: an increase in interest rates attracts a capital inflow, other things equal, while an increase in the exchange rate also makes domestic assets more attractive (cheaper) to foreign residents. Again, if one goes up the other must go down, if the capital account is to remain equal to some particular number. Thus the relationship governing the overall balance of payments has the same negative slope as the relationship governing the trade balance.<sup>13</sup>

If we substitute the balance of payments objective for the trade balance objective, then we again find China today in the upper right half of the Figure, at one of the C points. Again, an appreciation of the currency is called for.

### ***Sterilization***

---

<sup>12</sup> Dooley, Folkerts-Landau, and Garber (2003) surmise on these grounds that Asian central banks will happily absorb ever-more dollars indefinitely.

<sup>13</sup> One might choose to draw the  $BP=0$  curve more steeply than the  $TB=0$  curve. This is somewhat arbitrary, but is motivated by the thought that currency depreciation can sometimes engender expectations of further depreciation and/or inflation, which might work to discourage capital inflows, rather than the reverse.

We have already mentioned that a balance of payments surplus implies that the reserve component of the monetary base is increasing. Some expansion in the monetary policy is entirely appropriate, especially in an economy with strong long-term growth on the order of 10 percent. But in an economy that is in danger of excessive monetary ease, the central bank may wish to sterilize the inflow, so as to slow expansion in the overall money supply. Sterilization could be defined narrowly, as reduction in the net domestic assets of the central bank, e.g., by selling bonds, so as to keep the monetary base from rising. Or sterilization could be defined more broadly, as reduction in domestic credit of the consolidated banking system, e.g., by raising reserve requirements on banks, so as to keep M1 from rising.

Sterilization can be a good response to an inflow, for a period of time. It can help the country maintain its exchange rate target without abandoning a target for the money supply or interest rate. But it can become increasingly difficult over time, especially if traditional barriers to capital flows have been gradually eroded. One problem is that it just prolongs the balance of payments disequilibrium, because it by-passes the automatic mechanism of adjustment that reserve flows provide under the monetary approach to the balance of payments. Another potential problem is the quasi-fiscal deficit: if the central bank has to pay high interest rates to get domestic residents voluntarily to absorb “sterilization bonds,” while receiving low interest rates on its reserves of US treasury securities, then it is running a deficit. So far, the PBoC seems to have had little difficulty sterilizing; it has not had to pay high interest rates domestically. But this happy situation could change. To the extent the government is achieving this feat by forcing its sterilization bonds down the throats of its banks without paying market interest rates -- a form of financial repression -- this just weakens the balance sheets of banks and raises the odds of a banking crisis somewhere down the road.

### *Avoiding currency crises*

Asian countries are understandably anxious to avoid crises such as those that afflicted much of the continent in 1997-98. Many areas of policy are relevant for trying to minimize the probability and severity of crises. Some decisions, such as the speed of liberalization of the capital account, are highly controversial. Others are more widely agreed upon, such as the desirability of strong banking regulation, holding adequate reserves, and tilting the composition of capital inflows away from short-term dollar-denominated bank loans and toward Foreign Direct Investment and longer-term securities.

Although much ink has been spilled over the question of exchange rate regime, there is no clear verdict. The late-1990s saw the development of a surprisingly wide consensus in favor of the corners hypothesis: hard pegs or pure floats, in preference over intermediate regimes. But the author has been skeptical of this view all along. China, for one, is too large a country to dollarize or adopt a currency board, but is probably not ready for pure floating yet either. That leaves intermediate regimes: either the current adjustable peg, on the one hand, or alternatives such as a target zone, centered either on the dollar or on a basket, on the other hand.<sup>14</sup>

Baskets tend to be less transparent and less credible than defining a parity in terms of a single existing currency. Asia currently lacks a currency in use that is a suitable

---

<sup>14</sup> Williamson (2000) has been a consistent defender of the intermediate regimes, particularly for Asia, even when the corners were most in fashion (which was just before the collapse of Argentina's currency board).

anchor for individual countries. China does not yet have the necessary developed and open financial markets to make the renminbi a regional anchor currency, while Japan's yen fluctuates too much versus the dollar and euro. As a possible pathway to Asian monetary integration, I have proposed that Singapore unilaterally adopt a firm and transparent basket peg (with weights on the dollar, euro, yen and renminbi), and that other countries in the region then use the Singapore dollar as their anchor to whatever extent they wish to target their own exchange rates.<sup>15</sup>

Some have argued that if China wants to minimize the probability of crisis, it should avoid appreciation, so as to keep the current account as strong as possible. It is true that overvalued currencies played a role in the East Asia crisis of 1997, even though some westerners had urged appreciation for surplus countries in the past. It is also true that real appreciation is likely to lead to trade deficits and net borrowing from abroad, and that countries that borrow from abroad are more likely to have crises. But there is another respect in which moving to a regime of increased flexibility now might reduce the chance of future crises rather than increase it.

If and when inflow turns to outflow, as part of the cycle that so many developing countries have gone through so many times before, it is important not to cling to a peg for too long. Many countries procrastinate, postponing adjustment either through devaluation or expenditure reduction. The crisis comes when reserves have been run down to low levels. By then the national balance sheet is so weak (lots of short-term and dollar-denominated debt) that the adjustment options are no longer attractive: the result is often a sharp recession regardless of the mix of devaluation and expenditure-reduction.<sup>16</sup> The lesson is not to procrastinate.

There is an understandable temptation to cling to an exchange rate peg that has worked well for some years, economically and politically. Mexico in 1994 is one of many examples. One lesson from past experience is that of the exit strategy. If an eventual exit from a peg, to a regime with greater flexibility, is likely to occur eventually anyway, it is better to do it at time when the balance of payments is strong and the initial movement is likely to be appreciation. The alternative of waiting for a time of balance of payments deficit often turns out to mean exiting the peg under strong downward speculative pressure, with the result that confidence is undermined and the national balance sheet is weak.<sup>17</sup> Hence the argument for being safe, and increasing flexibility before any cut-off in capital flows.

These points are drawn largely from the experience of emerging markets such as Colombia and Korea in the early 1990s. Those countries were able to sterilize capital inflows only for a year or two, before it became too difficult, due to high interest rates on the sterilization bonds and the prolongation of strong capital inflows (as in standard macro models). Chinese officials may be correct that their case is somewhat different, due to a financial system that is less open and less market-oriented. The capital inflow

---

<sup>15</sup> At the end of Frankel (2004).

<sup>16</sup> Why can't the authorities maintain internal balance even after a "sudden stop" of capital inflows has shifted the external balance line adversely, in terms of Figure 1, by the right mix of devaluation and increase in the interest rate? The problem is that in the presence of a lot of dollar-denominated debt, devaluation is contractionary. This balance sheet effect makes the internal balance line slope down rather than up. As a result, it may be hard to find a sensible intersection between the two lines.

<sup>17</sup> Eichengreen and Masson (1998).

has consisted largely of Chinese citizens bringing capital flight money back home, speculating on a revaluation,<sup>18</sup> and so far the authorities have not had to pay high interest rates locally to sterilize it. But they find it increasingly difficult to sterilize further inflows.

## The Balassa-Samuelson relationship

Purchasing Power Parity (PPP) is often calculated as a guide for what the exchange rate should be, for China as for other countries. The overwhelming majority are estimates of *relative* PPP, that is, based on price indices. They do not necessarily show the yuan to be strongly undervalued. But that may be because they use the past as the benchmark, and the yuan may have been undervalued in the past.<sup>19</sup>

Comparisons of price levels across countries are difficult, because such *absolute* PPP data are much less available than *relative* PPP data (for which one only needs price indices and exchange rates). But some data are available. As of 1990, China's price level was reported as only .119 of the US price level, according to the Penn World Tables, Mark 5.6.<sup>20</sup> That prices are lower in China is not in itself a surprise. Even if we thought that markets in internationally traded goods were perfectly integrated, there is no mechanism to arbitrage disparities in prices of nontraded goods. There is abundant empirical evidence, along both the cross-section and time-series dimensions, that prices of non-traded goods, and thereby of general price levels, rise with levels of productivity, real wages and real income. This robust empirical regularity is called the Balassa-Samuelson effect, and is most often explained by the assumption that productivity growth is more rapid in traded goods than non-traded goods.<sup>21</sup>

### *Estimation for 1990*

The news is that China's prices have been, not just low, but well below the level that one would predict from the country's per capita income and the cross-country empirical relationship between the real exchange rate and real income. According to the same source, China's real per capita income in 1990 was .125 of the US level. Rogoff's (1996) regression estimates that for every 1 percent increase in a country's real per capita income (in a cross-section), its real exchange rate is stronger by 0.366 per cent. Notwithstanding the relatively good fit of this univariate regression ( $R^2=.42$ ) there are some substantial outliers. China is one of them, though far from the most egregious.

We have re-run the Rogoff regression for 1990 (with data from the year 2000 Penn World Table), as reported in the Econometrics Appendix. The estimate is a highly significant .317: every one percent increase in income is associated with a real

---

<sup>18</sup> E.g., Prasad and Wei (2005).

<sup>19</sup> Bosworth (2004) takes an absolute PPP approach like the present paper. Ceglowski and Golub (2005) compare Chinese and international unit labor costs. Other studies attempting to estimate econometrically where the yuan exchange rate should be include Cheung, Chinn, and Fujii (2005) and Funke and Rahan (2005).

<sup>20</sup> China's prices showed up as the lowest of 31 countries; the next lowest was Bangladesh at .154. Summers and Heston (1991) describe the data. See Rogoff (1996, p. 659-660).

<sup>21</sup> Useful references include Balassa (1964), De Gregorio, Giovannini, and Wolf (1994) and Kravis and Lipsey (1988).

appreciation of .317 percent. We confirm that China is an outlier: apparently undervalued by 42 % in logarithmic terms, or by 34% in absolute terms.<sup>22</sup>

Few economists would seriously recommend a revaluation over a short period of time of the yuan on the order of magnitude suggested by this interpretation of the Balassa-Samuelson equation. In the first place, a sudden revaluation of the currency of this magnitude would be disruptive.<sup>23</sup> In the second place, other considerations matter in addition to the Balassa-Samuelson regression, including current monetary conditions. In the third place, one would first have to investigate the reliability of the Chinese price data. It is possible that the numbers in the Penn World Table have been extrapolated extensively from a slender base.<sup>24</sup> The possibility of measurement errors in the level and growth of real GDP has also been widely discussed. If China is indeed lagging far behind other countries in the extent to which it has allowed or encouraged the sort of detailed gathering of good price data that is necessary for international comparisons of China's absolute price level and real income, then this should be rectified.

Nevertheless, the numbers are suggestive of a disequilibrium that in the very long run may have to be corrected one way or another. Even if the adjustment is drawn out over a long period of time, to correct the disparity with no change in the nominal exchange rate would imply substantial inflation, not desirable as a long-term trend. Thus the Balassa-Samuelson calculation seems another reason to plan on a transition to a more flexible exchange rate regime.

The yuan appreciated in real terms during the course of the 1990s. In nominal terms, the currency depreciated substantially, particularly in 1994 when the official rate was unified with the already-depreciated parallel rate, as reported in Table 1 of the Data Appendix. In 2000 the nominal exchange rate was 8.28 (the level at which it has been pegged since 1998), as compared to an official rate of 4.78 in 1990. But the cumulation of inflation during the 1990s has been greater than the depreciation, implying a real appreciation.<sup>25</sup> China has also experienced rapid growth in real income, as reported in Data Appendix Table 1. Thus the real exchange rate predicted by the Balassa-Samuelson equation has changed. The gap between the current real exchange rate and the level predicted by Rogoff's equation appears to have been (very roughly) as big at the end of the decade as it was at the beginning.

---

<sup>22</sup> The word "undervaluation" or "overvaluation" has no single agreed upon definition among economists. But the renminbi seems now to qualify for most of the various possible definitions of undervalued.

<sup>23</sup> It is hard to think of precedents of discrete upward revaluation of this magnitude. Perhaps the closest parallel is the 16% revaluation of the Japanese yen in 1971. Eichengreen and Hatase (2005) argue from that experience that a gradual increase in flexibility would be better for China today than a sudden large adjustment. But McKinnon (2006) argues from the Japanese precedent that a predictable path of currency appreciation for China could put it into an undesirable low-interest-rate trap.

<sup>24</sup> As a rough check MacPPP suggests that Chinese prices are about .56 of US prices. Parsley and Wei (2004).

<sup>25</sup> If the base is the real exchange rate in the 1990 Penn World Tables, adding the cumulative changes in price levels and the exchange rate from 1990 to 2002 produces an estimate that China's prices are now up to .181 of US prices: He (2004). But it makes more sense to work off of the 2000 PWT.

### ***Estimation for 2000***

We can do better at updating the calculation than simple extrapolation. The Penn World Tables, Version 6.1, report absolute PPP data for 2000. China's absolute price level in 2000 was .23, relative to the U.S., and its real income per capita was \$3747.3, which was .11 relative to the US.

We have run a new regression for the year 2000 on a cross-section of 118 countries. (Details are available in the Econometrics Appendix.) The regression yields a highly significant coefficient of 0.382 on the log of relative income. In other words, every one percent increase in real per capita income is associated with 0.38 percent in real appreciation. The price level (relative to the United States) that is predicted for China by the equation is 0.362 (derived from -1.015 in logs). China's actual price level is 0.231 relative to the US (derived from -1.464 in logs). The residual of the log was -0.448. In other words the regression suggests that the yuan was undervalued by 44.8 % in logarithmic terms (36.1% undervalued in absolute terms) in 2000.

To fine-tune this calculation, we should allow for whatever movement in the real exchange rate has taken place since 2000, the year of the last Penn World Table. The cumulative change over the last four years turns out to have been relatively small, as reported in Tables 2 and 4. The nominal exchange rate is virtually unchanged vis-à-vis the dollar, due to the peg, and the Chinese price level is evidently not far from where it was in 2000, because deflation in 2002 offset inflation in 2000-01 (and 2003). Thus, amazingly, that leaves as the dominant component of the change in the real exchange rate: US inflation, which cumulated to 5 % from 2000 to 2002. It would be foolish to rely too much on the precision of these numbers. On the one hand, official statistics suggest that Chinese inflation has by now pulled ahead of US inflation (in the last quarter of 2003 and the first quarter of 2004), which would imply that the 5% has begun to reverse a bit. On the other hand, Chinese real growth has again zoomed ahead, so the target is receding even farther away. The important point is that the "undervaluation" in the sense of the Balassa-Samuelson equation has, if anything, widened since the calculation of the gap on 2000 data.

### ***Regression toward the mean***

To characterize the empirical literature on the Balassa-Samuelson effect, the relationship between the real exchange rate and real income is fairly robust on a cross-section basis, but is more uncertain on a time series basis, even when changes are observed over intervals as long as ten years. This raises the question of the predictive power of the relationship for a given country over time. But a plausible interpretation is readily at hand. Most economists believe that real exchange rates are influenced not solely by the long-term trend of the Balassa-Samuelson effect nor solely by the short-term fluctuations of monetary policy and nominal exchange rate changes, but rather are influenced by both.<sup>26</sup> A reasonable characterization is that in the long run Balassa-

---

<sup>26</sup> One does not necessarily need prices of non-traded goods to be sticky – let alone prices of traded goods – to get the result that devaluations or changes in monetary policy can have transitory effects on the real exchange rate in the short run. Dornbusch (1973).

Samuelson factors dominate, but in the short run monetary factors can pull the real exchange rate away from the Balassa-Samuelson equation. This framework contains the powerful prediction that if a country lies substantially off the Balassa-Samuelson regression line in one year, it can be expected to return part way – not necessarily all the way – to the regression line over the subsequent decade. This claim has important implications for our ability to make predictions, and furthermore is testable with data from the last decade.

We have tested whether residuals from the 1990 regression have explanatory power for the year 2000. On a cross-section (of countries with data available for both years), we regressed the 2000 real exchange rate against the fitted values from the 2000 regression (which is also equivalent to regressing them against 2000 income levels, as before) *together with the residuals from the 1990 regression*. The results are also reported in the Econometrics Appendix. The coefficient on the predictions from 2000 incomes is .98, insignificantly different from 1, as expected. The coefficient on the 1990 residual is .48, which is not only highly significantly greater than zero, but is also highly significantly less than 1. This provides confirmation for the theory, and also provides the useful prediction that, in expected value terms, approximately half of any deviation from the Balassa-Samuelson regression line is corrected over the subsequent decade. For the case of China, it says that even if the big differential in productivity growth between China and its trading partners were to disappear tomorrow, Balassa-Samuelson factors nonetheless would predict that by 2010 the yuan should undergo an expected real appreciation of about half of the year-2000 gap, which is half of 44.8 percent, or 22.4%.

A real appreciation toward long-run equilibrium could be accomplished with no change in exchange rate regime, by an inflation rate of 2.24% per year in excess of the US level, which is not especially large compared to recent swings in China's inflation rate. Nevertheless, the theory predicts that more movement in the same direction would have to continue over the subsequent decade, and, more importantly for present purposes, that an allowance for Chinese growth to continue on the order of 6 % greater than US growth would require adding another 2.3 % of real appreciation per year (.38 times the relative growth rate). Adding together the correction of the past undervaluation and the continued trend gives a real appreciation in excess of 4% per year. A 4% differential above the US inflation rate seems too high to be desirable as a long-term inflationary bias. Again, the implication is that the yuan should appreciate in coming years.

This idea of gradual “regression toward the regression line” bridges the gap between the first half of this paper and the second half. The Balassa-Samuelson calculation suggests real appreciation on the order of 4% a year averaged over the next decade or more, better achieved through nominal appreciation than through inflation. The targets and instruments framework of the first half of the paper suggests that appreciation is needed to curtail excessive build-up of reserves through the current balance of payments and the dangers of excessive monetary expansion. Perhaps past devaluations (or deflation, as recently as 2002) help explain how the yuan got so far off the equilibrium line in the first place. At least as important is that China's rapid productivity growth and increased trade integration mean that levels of the nominal

exchange rate that might have been consistent with long-run equilibrium in the past have now become undervalued. In terms of Figure 1, the external and internal balance lines have been shifting down, so that a decline in the real exchange rate (i.e., real appreciation) is necessary just to keep up with the point of intersection. This could explain how China in 2004 found itself at a point like C in Figure 1, despite having already undergone some real appreciation in the 1990s. Either way, if this gap is real, better to address it through appreciation than inflation.

## Conclusion

Where does this leave Chinese exchange rate policy?

### *The announcement of July 2005*

On July 21, 2005, the government of China finally revalued the RMB against the dollar -- though by only 2.1% -- and announced the implementation of a new “managed floating system,” where the exchange rate was to be determined more flexibly “with reference to a basket of currencies.”<sup>27</sup> The regime was to maintain the limit of plus-or-minus 0.3% on daily changes against the dollar, but also adopt ranges of 1.5 percent against the yen and euro.<sup>28</sup> As is common, the weights in the basket were not announced, but the basket was said to feature four currencies prominently -- the dollar, yen, euro, and won -- and to include with lesser weights the currencies of Australia, Canada, Malaysia, Russia, Singapore, Thailand and the United Kingdom

The announcement was tactically well-timed to head off rising protectionist movement in the U.S. Congress, in that it succeeded in deflecting the Schumer Amendment, for the time being, while yet minimizing loss of face for the Chinese leaders domestically. But public coverage to date, by largely taking the announcement at face value, has failed to notice that very little change has yet happened. China has not de facto adopted the BBC regime (basket/band/crawl) that many assumed, nor the regime it announced. In the first place, the 2.1% appreciation was trivial compared to the annual fluctuations of the dollar itself (which happened to be upward in 2005). Second, it came nowhere close in 2005 to using cumulatively the full 0.3% limit on daily changes allowed by the system, and implied by the language of basing the exchange rate on “market supply and demand” (although it may start to do so in 2006). Third, well within the tradition of other Asian countries that have announced de jure basket pegs in the past<sup>29</sup>,

---

<sup>27</sup> “Text – China Central Bank Statement on Yuan,” Reuters, 7/21/05.

<sup>28</sup> If this regime were interpreted literally, it would imply a new global target zone (as has long been urged by the Institute for International Economics) because it implies margins of 3 percent among the yen, dollar and euro, along with the RMB. One should forego the temptation to dismiss this implication on the grounds that China cannot influence the major currencies, in light of the level of the countries’ foreign exchange reserves (far in excess of the U.S. level, and set to overtake Japan for the number one position in 2006). Instead, one should dismiss this implication on the grounds that the Chinese leaders could not have understood what they were saying.

<sup>29</sup> Frankel and Wei (1994).



China's decision to keep the component currencies and weights secret appears to be a smokescreen for continuing the de facto peg to the dollar. In the months since July 2005, according to econometric estimates by a number of authors, the de facto weight on the dollar remains at 100%.<sup>30</sup>

The wider importance of the July 2005 move is that it was probably the first of a series of more serious, if gradual, steps to come. In that light, early 2006 would be a good time for China switch to a true basket peg, before the currently-strong dollar resumes its depreciation against the euro and yen. Of course, if China were ever to give American politicians what they say they want, and especially if this included a shift in reserves to match a switch in basket weights away from the dollar, the United States would probably come to regret it. Not only would the effect on the US trade balance and employment be small-to-negligible, but US interest rates would probably rise.

### *Summary of conclusions*

The conclusions of this paper are easily summarized.

1. A fixed exchange rate and a flexible exchange rate each have its own advantages.
2. A country should have the right to choose the regime best suited to its circumstances.
3. Nevertheless, the de facto dollar peg may now have outlived its usefulness for China.
4. One reason to allow appreciation and thereby reduce the balance of payments surplus is that, although foreign exchange reserves are a useful shield against currency crises, by now China's current level is fully adequate, and US treasury securities do not pay a high return.
5. Another reason is that it becomes increasingly difficult to sterilize the inflow over time so as to prevent excessive monetary expansion.
6. Although external balance could be achieved by expenditure reduction, as Professors McKinnon, Mundell, and others sometimes point out, the existence of two policy goals (external balance and internal balance) in general requires the use of two independent policy instruments (e.g., the real exchange rate and the interest rate).
7. While a very small open economy might be able to rely on adjustment in the price level, and thus to keep the exchange rate fixed, a large economy like China is better off achieving adjustment in the real exchange rate via flexibility in the nominal exchange rate.
8. There are other arguments for flexibility as well. The experience of other emerging markets suggests that it is better to exit from a peg when times are good and the currency is strong, than to wait until times are bad and the currency is under attack.
9. From a longer-run perspective, prices of goods and services in China are low -- not just low relative to the United States (.23), but also low by the standards of a Balassa-Samuelson relationship estimated across countries (which predicts .36).

---

<sup>30</sup> E.g., Shah, Zeileis and Patnaik (2005). ShangJin Wei has found the same thing -- a highly significant weight of .98 on the dollar and nothing significant on other currencies.

In this specific sense, the yuan was undervalued by approximately 35% in 2000, and is by at least as much today.

10. Typically across countries, such gaps are corrected halfway, on average, over the subsequent decade.
11. The correction could take the form of either inflation or nominal appreciation, but the latter is preferable.
12. These arguments for increased exchange rate flexibility need not imply a free float. China is a good example where, contrary to the popular “corners hypothesis,” an intermediate exchange rate regime like a target zone is more appropriate.
13. Although the Chinese authorities announced a new regime in July 2005, supposedly a move to a “managed floating system,” where the exchange rate was to be determined more flexibly “with reference to a basket of currencies,” in reality the yuan remained de facto pegged to the dollar in 2005 . Thus the arguments of this paper, as of early 2006, remain as relevant as before.

\* \*

## References

- Balassa, Bella, 1964, "The Purchasing Power Parity Doctrine: A Reappraisal," J. Political Economy, 72, 584-596.
- Bosworth, Barry, 2004, "Valuing the Renminbi," presented at the Tokyo Club Research Meeting, February.
- Caves, Richard, Jeffrey Frankel and Ronald Jones, 2002, World Trade and Payments: An Introduction (Addison Wesley Longman: Boston MA). Chinese translation, 2005.
- Ceglowski, Janet, and Stephen Golub, 2005, "Just How Low are China's Labor Costs?" Bryn Mawr and Swarthmore Colleges, November.
- Cheung, Yin-Wong, Menzie Chinn, and Eiji Fujii, "Why the Renminbi Might be Overvalued (But Probably Isn't)," Federal Reserve Bank of San Francisco conference, September, 2005.
- De Gregorio, Jose, Alberto Giovannini, and Holger Wolf, 1994, "International Evidence on Tradables and Nontradables Inflation," NBER WP no. 4438; European Economic Review, 38, no.6, June 1994, 1225-44.
- Dooley, Michael, and Peter Garber, "Is it 1958 or 1968? Three Notes on the Longevity of the Revived Bretton Woods System," *Brookings Panel on Economic Activity*, 1, 2005, 19-204.
- Dooley, Michael, David Folkerts-Landau, and Peter Garber, 2003, "An Essay on the Revived Bretton Woods System," NBER Working Paper No. 9971.
- Dornbusch, Rudiger, 1973, "Devaluation, Money and Nontraded Goods," American Economic Review December, 871-880.
- Eichengreen, Barry, and Mariko Hatase, 2005, "Can a Rapidly-Growing Export-Oriented Economy Smoothly Exit an Exchange Rate Peg? Lessons from China from Japan's High-Growth Era," NBER working Paper 11625, September.
- Eichengreen, Barry, and Paul Masson, 1998, "Exit Strategies: Policy Options for Countries Seeking Greater Exchange Rate Flexibility," Occasional Paper No. 168, International Monetary Fund, Washington DC.
- Frankel, 1984, "The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets," Policy Analyses In International Economics No.9, M.I.T. Press for *Institute for International Economics*: Washington, D.C..
- Frankel, Jeffrey, 1993, "Liberalization of Korea's Foreign Exchange Markets, and the Role of Trade Relations with the United States," in Shaping a New Economic

Relationship: The Republic of Korea and the United States, edited by Jongryn Mo and Ramon Myers, Hoover Institution Press, Stanford, CA, 1993: 120-142.

Frankel, Jeffrey, 2004, "Experience of and Lessons from Exchange Rate Regimes in Emerging Economies," NBER WP No. 10032. In *Monetary and Financial Integration in East Asia: The Way Ahead*, edited by Asian Development Bank, (Palgrave Macmillan Press, New York ) vol. 2, 91-138.

Frankel, Jeffrey, and ShangJin Wei, "Yen Bloc or Dollar Bloc? Exchange Rate Policies of the East Asian Economies," in Macroeconomic Linkages: Savings, Exchange Rates, and Capital Flows, NBER - *East Asia Seminar on Economics, Volume 3*, Takatoshi Ito and Anne Krueger, editors, University of Chicago Press, 1994.

Funke, Michael, and Jorg and Rahan (2005) "Just How Undervalued is the Chinese Renminbi?" World Economy, 28, 465-89.

Goldstein, Morris, 2003, "China's Exchange Rate Regime," Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, Committee on Financial Services, US House of Representatives, Washington, DC, October 1.

Goldstein, Morris, 2003, "Currency Manipulation," *JoongAng Daily*, Korea, Dec. 11.

Goldstein, Morris, 2004, "Adjusting China's Exchange Rate Policies," High-Level Seminar, Dalian, China, May 26-27, 2004.

Goldstein, Morris, and Nicholas Lardy, "Two-Stage Currency Reform for China," *Wall Street Journal*, September 12, 2003.

Goodfriend, Marvin, and Eswar Prasad, 2006, "A Framework for Independent Monetary in China," Carnegie Mellon and IMF, respectively, Feb. 7.

Huang, Yasheng, 2003, Selling China (Cambridge University Press).

Kravis, Irving, and Richard Lipsey, 1988, "National Price Levels and the Prices of Tradables and Nontradables," American Economic Review, Papers and Proceedings, 78, 2, May, 474-78.

McKinnon, Ronald. 1963. "Optimum Currency Areas," *American Economic Review*, 53:17-724.

McKinnon, Ronald, 2006, "China's Exchange Rate Trap: Japan Redux?" American Economic Association Meetings, Boston, 7 January 2006.

McKinnon, Ronald, and Gunther Schnabl, 2003, "The East Asian Dollar Standard, Fear of Floating, and Original Sin," Stanford University, September.

- Merrill Lynch, "China's FX Regime: Moving the Great Wall," March 3, 2004.
- Mundell, Robert. 1961. "A Theory of Optimum Currency Areas," *American Economic Review* vol. 51 (November): 509-517.
- Mundell, Robert, 1968, International Economics (MacMillan: New York).
- Parsley, David, and Shang-Jin Wei, 2003, "A Prism into the PPP Puzzles: The Micro-Foundations of Big Mac Real Exchange Rates," NBER Working Paper No. 10074, Nov.
- Prasad, Eswar, and Shangjin Wei, 2005, "The Chinese Approach to Capital Inflows: Patterns and Possible Explanations," NBER Working Paper no. 11306, April.
- Rogoff, Kenneth, 1996, "The Purchasing Power Parity Puzzle, J. Economic Literature, 34: (2) June 1996, 647-68.
- Rose, Andrew, 2000. "One Money, One Market? The Effect of Common Currencies on International Trade," *Economic Policy*, 30, April, 9-44.
- Shah, Ajay, Achim Zeileis and Ila Patnaik, "Monitoring the Chinese Currency Regime," November 13, 2005, [www.mayin.org/ajayshah/papers/CNY\\_regime/](http://www.mayin.org/ajayshah/papers/CNY_regime/)
- Summers, Robert, and Alan Heston, 1991, "The Penn World Table (Mark5): An Expanded Set of International Comparisons, 1950-1988," *Quarterly Journal of Economics*, May, 106, no 2, 327-68.
- Swan, Trevor, 1963, "Longer Run Problems of the Balance of Payments," in H.W. Arndt and W.M. Corden, eds., The Australian Economy, Cheshire, Melbourne.
- Williamson, John, 2001, "The Case for a Basket, Band and Crawl (BBC) Regime for East Asia," in David Gruen and John Simon, eds., Future Directions for Monetary Policies in East Asia, Reserve Bank of Australia, July, 97-109.

## Data Appendix

MS 5/19/04

### Real exchange rate and real income for China, 1990-2000

Nominal Ex Rate Nominal Exchange rate in RMB /\$  
P (US=1) Price Level of Gross Domestic Product relative to US  
Real GDP/capita (\$ chain) Real GDP per capita (Constant price: Chain series)

**Table 1 -Real exchange rate and Real Income for China, 1990-2000**

year	Nominal ExRate	p	Real GDP/Capita	US Real GDP/Capita	Real GDP/Capita rel. to the US
1990	4.7832	0.2351	1786.5474	26457.82	0.0675
1991	5.3234	0.2112	1975.3807	25897.92	0.0763
1992	5.5146	0.2154	2202.6613	26488.70	0.0832
1993	5.7620	0.2380	2455.4704	26956.07	0.0911
1994	8.6187	0.1925	2644.9477	27877.94	0.0949
1995	8.3514	0.2282	2818.1204	28408.86	0.0992
1996	8.3142	0.2433	2968.5394	29193.91	0.1017
1997	8.2898	0.2454	3109.6103	30190.34	0.1030
1998	8.2790	0.2396	3275.9917	31090.66	0.1054
1999	8.2782	0.2351	3414.9809	32127.90	0.1063
2000	8.2785	0.2314	3747.2977	33292.99	0.1126
averg.	7.2539	0.2287	2763.5953	28907.6	0.0946

<sup>1</sup> Data Source: Alan Heston, Robert Summers and Bettina Aten, Penn World Table Version 6.1

**Table 2 - Real Exchange Rates for China, 2001-2003**

USA			China			Change in LogRER rel 2000	RER
Inflation	Pu		Inflation	Pc	NomEx		
2001	2.8	119.458	0.5	128.18	8.277	0.050	0.243
2002	1.6	121.353	-0.8	127.20	8.277	0.027	0.238
2003	1.2	122.809	1.2	128.73	8.277	0.027	0.238

<sup>1</sup> Data Source: IMF – International Financial Statistics, Country Tables: <http://imfstatistics.org/>

**Table 3 – Chinese Real Exchange Rates - Log Form, 1990-2000**

year		Log RER		Log GDP		Log relative real GDP
1990		-1.4477		7.4880		-2.6953
1991		-1.5547		7.5885		-2.5734
1992		-1.5354		7.6974		-2.4871
1993		-1.4354		7.8061		-2.3959
1994		-1.6475		7.8804		-2.3552
1995		-1.4774		7.9438		-2.3106
1996		-1.4134		7.9958		-2.2859
1997		-1.4051		8.0423		-2.2730
1998		-1.4290		8.0944		-2.2503
1999		-1.4478		8.1359		-2.2416
2000		-1.4637		8.2288		-2.1843
average		-1.4779		7.9001		-2.3684

<sup>1</sup> Data Source: Alan Heston, Robert Summers and Bettina Aten, Penn World Table Version 6.1

**Table 4 - Real Exchange Rates for China-Log Form, 2001-2003**

USA			China					
						Log (NomEx)	Change in LogRER rel 2000	Log RER
	LogPu		LogPc					
2001	4.783		4.853			2.113	0.050	-1.413
2002	4.799		4.846			2.114	0.027	-1.437
2003	4.811		4.858			2.113	0.027	-1.437

<sup>1</sup> Data Source: IMF – International Financial Statistics, Country Tables: <http://imfstatistics.org/>

# Econometric Appendix: Estimates of Balassa-Samuelson Effect

## Cross-Country Regression for Year 2000

### Data Definitions:

**Q**  $\equiv$  **RER**  $\equiv$  Real Exchange Rate is obtained by dividing *Price Level of Gross Domestic Product* for each country by that of the US (normalized to 100).

**q**  $\equiv$  **LogRER**  $\equiv$  Log of Real Exchange Rate

**rgdpch**  $\equiv$  Real GDP per capita (Constant price: Chain series)

**y**  $\equiv$  **Loginc**  $\equiv$  Log of real GDP per capita

Data source: Alan Heston, Robert Summers and Bettina Aten, Penn World Table Version 6.1, Centre for International Comparisons at the University of Pennsylvania (CICUP), October 2002.

We first ran the regression  $q$  vs.  $y$  for 118 countries, based on their year 2000 data for RER and Real GDP per capita. It yields:

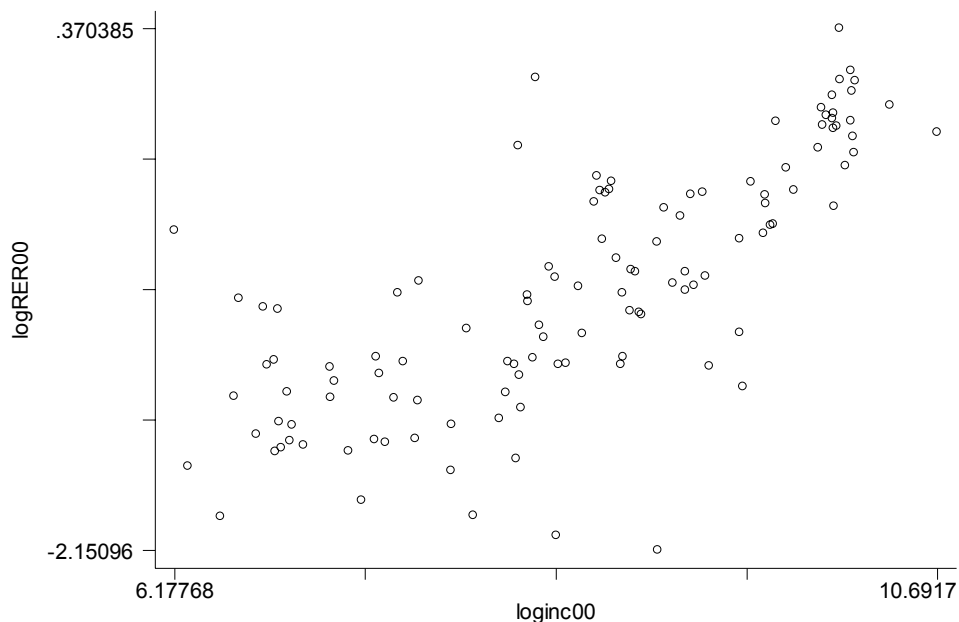
$$q = -4.15 + 0.382 y$$

The coefficient on log of per capita income is statistically significant, and similar to that estimated by Rogoff and others.

```
. reg logRER00 loginc00
```

```
Number of obs =      118
F( 1, 116) =    151.14      Prob > F      =    0.000
R-squared      =    0.566      Adj R-squared =    0.562
Root MSE      =    .393
```

$q$ 2000	Coef.	Std. Err.	t
y 2000	.3821	.0311	12.29
constant	-4.159	.2686	-15.48





The residual for each country was calculated.  
 Particularly interesting is the residual for China: -44.8 per cent.

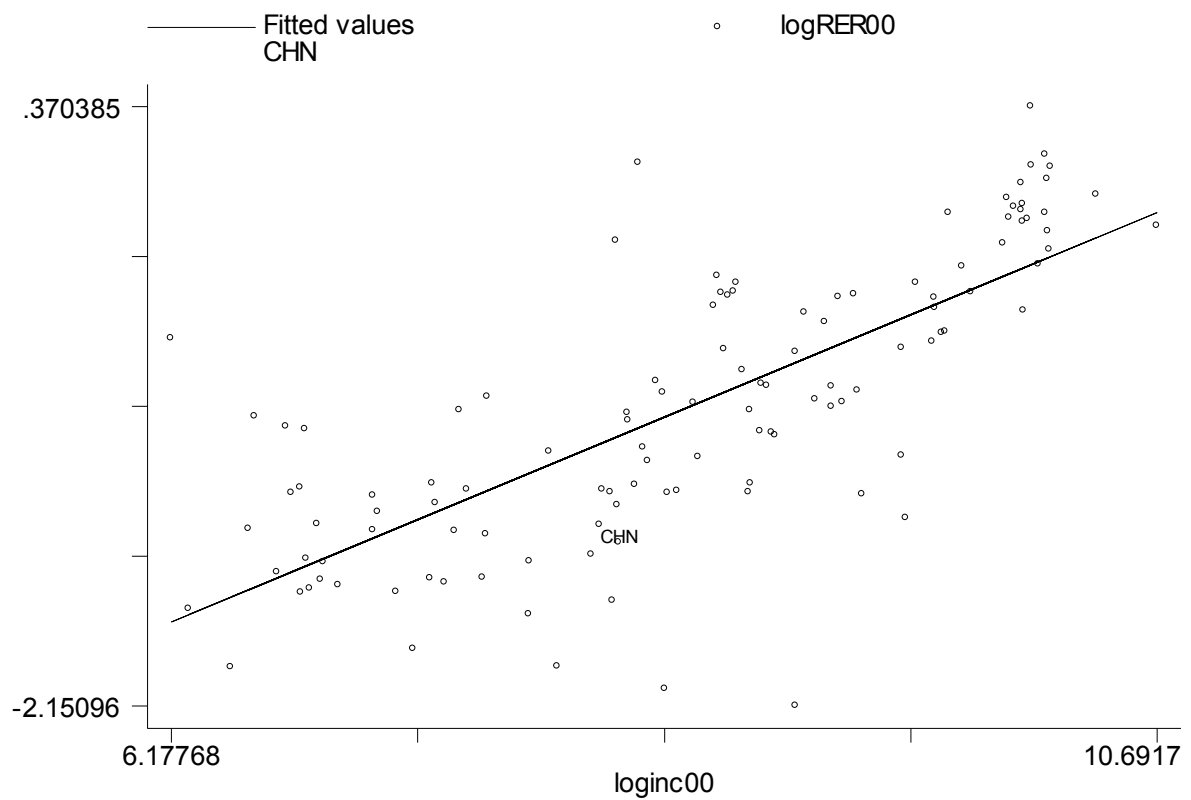
```
. predict loginchat00, residual
di logRERhat[18] = -1.0152
```

This means that

$$(q - \hat{q})_{2000} = -0.448$$

$$(Q/\hat{Q})_{2000} = 0.639$$

In other words, China's real exchange rate is 64% of the value predicted by the regression.



### Cross-Country Regression for Year 1990

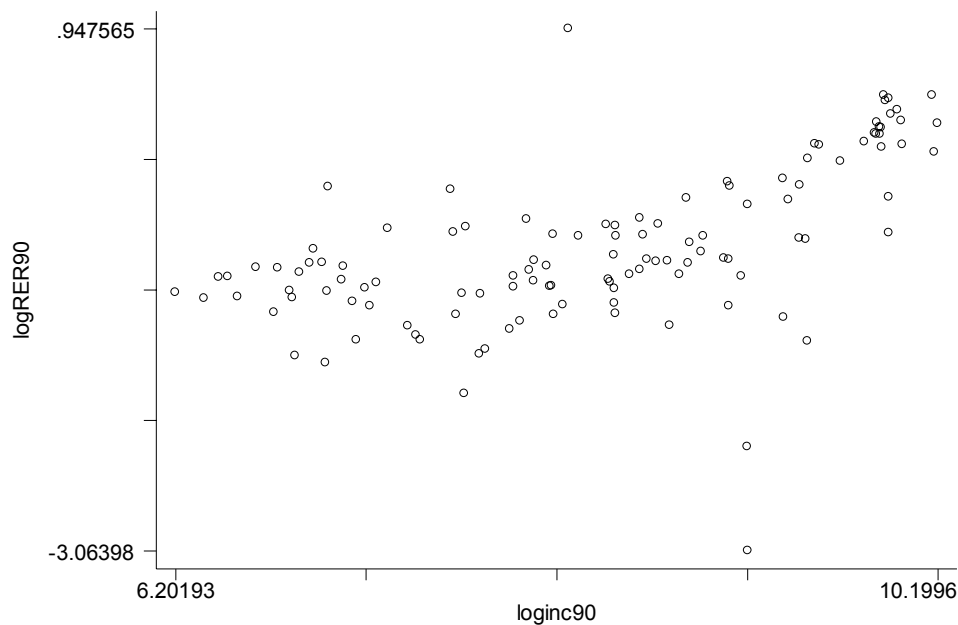
The regression of the log real exchange rate against the log of real income per capita was repeated for the same for 118 countries, based on their year 1990 data for RER and Real GDP per capita. The regression yields:

$$q_{1990} = -3.40 + 0.317 y$$

The coefficient on the log of per capita income is again statistically significant, and similar to others' estimates

```
Number of obs =      118
F( 1, 116) =    55.3      Prob > F      = 0.000
R-squared     = 0.323      Adj R-squared = 0.317
Root MSE     =  .506
```

$q_{1990}$	Coef.	Std. Err.	t
$y_{90}$	.317	.043	7.44
constant	-3.399	.362	-9.39

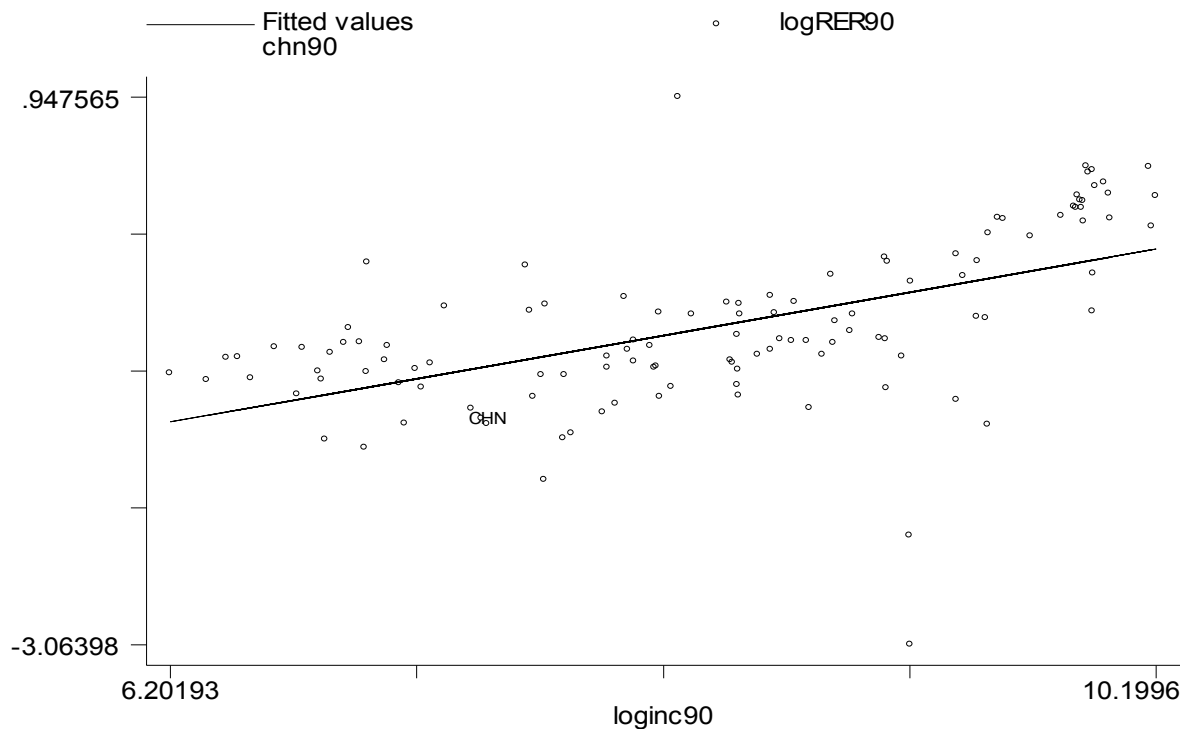


Again, the residual for each country was calculated and this value for China is - 42%:

$$(q - \hat{q})_{90} = -0.422$$

$$Q_{1990} / \hat{Q}_{1990} = 0.656$$

or in other words, the real exchange rate is 66% of its predicted value by the regression, very close to the value found for the 2000 data.



Exchange Rate Deviations for China

	Price level relative to US = 1/RER (in logs)	Predicted Price level by the B-S regression (in logs)	estimated real “undervaluation” (% in logarithmic terms)	implied fall in RER needed for B-S equil. (% in absolute terms)
<b>1990</b>	-1.448	-1.026	42.2%	34%
<b>2000</b>	-1.464	-1.015	44.8%	36%

### Predictive power of deviations from the 1990 regression

To examine whether the deviations from the regression in 1990 have predictive power, we run a regression of  $q \equiv \log(\text{RER})$  in 2000 vs. two variables:

a) deviations from the 1990 regression ( $q - \hat{q}$ ) and b) the fitted values of the 2000 regression ( $\hat{q}$ ).

Number of obs = 118  
 F( 2, 115) = 153.5 Prob > F = 0.000  
 R-squared = 0.728 Adj R-squared = 0.723  
 Root MSE = .313

$q_{2000}$	Coef.	Std. Err.	t	P> t
$\hat{q}_{90}$	.474	.057	8.26	0.000
$(q - \hat{q})_{90}$	.981	.065	15.15	0.000
constant	-.017	.064	-0.26	0.795