

# **An Investigation into the Chinese Exchange Rate Regime and its Implications for International Financial and Trading Relations**

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This study is important as it aims to investigate China's exchange rate regime, find out whether or not the yuan is undervalued, and identify the major causes of the big bilateral trade deficit between China and its trading partners, particularly the United States. Specifically, the objectives of this project are

1. Measuring the misalignment of the Chinese currency.
2. Verifying the Chinese exchange rate regime.
3. Investigating the causal link between the bilateral exchange rate and the bilateral trade balance between China and its main trading partners

The first objective pertains to the claim that China has consistently kept its currency undervalued in order to remain competitive. This proposition is normally used to explain China's success in selling its products and attracting foreign direct investment. Most OECD countries, including Australia, are witnessing the migration of industrial firms to China, seeking lower costs of production resulting from several factors, including the alleged undervaluation of the currency. Whether or not the Chinese currency is undervalued is a matter that must be investigated, and this is the first objective of the project. The procedure used for this purpose is to define an equilibrium or a fair level of the exchange rate between the Chinese currency and other currencies, then if the actual level of the exchange rate is different from the equilibrium level, we say that the Chinese currency is misaligned (undervalued if the actual exchange rate is below the equilibrium level, and vice versa). Several methods will be used to measure the equilibrium exchange rate, including the theory of purchasing power parity and the concept of long-term equilibrium effective exchange rate.

The second objective is to verify the Chinese exchange rate regime because countries often do not practice what they declare. It has been known that some countries that declare the use of floating exchange rates try to control these rates (the so called fear of floating), whereas others may declare fixed exchange rates but they allow them to fluctuate with market forces. This has led to the emergence of the distinction between the so-called de facto (actual) and de jure (declared) exchange rate regimes. China presumably changed its exchange rate regime on 21 July 2005, from a system of pegging to the U.S. dollar to a system of basket peg. This is what is declared, but is it what is practiced? This is the question that the project will find an answer to by addressing the second objective.

The third objective relates to the question of whether or not the alleged undervaluation of the Chinese currency is the reason for its current account surplus and the corresponding deficits of its trading partners, most notably the U.S. The international deficit in good and services trade of the U.S. reached a record level of \$726 billion in 2005, increasing by 18% relative to 2004, and representing around 5.8% of total GDP. Although this deficit has reached a new record, most analysts forecast an even wider trade gap in the years to come. On the other hand, China currently has the largest bilateral trade surplus with the U.S., increasing by 24.5% in 2005 to \$202 billion. This is creating a lot of trade friction, and a number of U.S. politicians have called for restrictions to be imposed on trade with China. Again, this is a matter that requires investigation. The project will test the hypothesis that there is a causal effect from the exchange rate to the bilateral trade between China and its trading partners.

The project, therefore, deals with some interesting ideas that are of interest not only to academics and policy makers but also to the public at large. These are effectively issues that we read about in the press on a regular basis.