JOURNAL ARTICLE

Assessing China's exchange rate regime

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Abstract

The IMF Articles of Agreement forbid a country from manipulating its currency for unfair advantage. The US Treasury has been legally required since 1988 to report to Congress biannually regarding whether individual trading partners are guilty of manipulation. One part of this paper tests econometrically two competing sets of hypothesized determinants of the Treasury decisions: (1) legitimate economic variables consistent with the IMF definition of manipulation – the partners' overall current account/GDP, its reserve changes and the real overvaluation of its currency, and (2) variables suggestive of domestic American political expediency – the bilateral trade balance, US unemployment and an election year dummy. The econometric results suggest that the Treasury verdicts are driven heavily by the US bilateral deficit, though other variables also turn out to be quite important.

In 2005 China announced a switch to a new exchange rate regime. The exchange rate would be set with reference to a basket of other currencies, with numerical weights unannounced, allowing a movement of up to ± 0.3% within any given day. Although this step was originally accepted at face value in public policy circles, scepticism is in order. The second econometric part of the paper evaluates what exchange rate regime China has actually been following. We use the technique introduced byFrankel and Wei (1994)): one regresses changes in the value of the local currency, in this case the RMB, against changes in the values of the dollar, euro, yen and other currencies that may be in the basket. We find that within 2005, the de facto regime remained a peg to a basket that put virtually all weight on the dollar. Subsequently there has been a modest but steady increase in flexibility with some weight shifted to a few non-dollar currencies – but not those one might expect. In any case, the weight on the dollar was still fairly heavy in 2006. The paper tests whether the decline in the implicit

suggest the likelihood of some genuine flexibility in the not-so-distant future.

— Jeffrey A. Frankel and Shang-Jin Wei

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