

China's exchange rate debate **

James Laurenceson* & Fengming Qin, China's exchange rate debate. East Asia Economic Research Group† Discussion Paper No. 1, August 2005 (revised September 2005), School of Economics, The University of Queensland. Queensland.

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Abstract

This paper reviews and critically comments on the policy debate surrounding China's exchange rate regime. There are presently two key issues – firstly, whether the RMB has become significantly undervalued, and secondly, whether China would benefit from adopting a flexible exchange rate regime. We find little rigorous evidence in support of the first proposition. With respect to the second, the consensus view is that a flexible exchange rate is desirable as it would support macroeconomic stability by providing greater monetary independence. Most absent in this position is convincing evidence that exchange rate stability is associated with macroeconomic instability, either in the context of China or broader international experience. The consensus position also appears to understate many of the benefits that accrue to China as a result of having a stable exchange rate, as well as many of the costs associated with moving to greater flexibility. We conclude that while adopting a flexible exchange rate regime may pass the cost/benefit test sometime in the future, for now the focus ought to firmly be on domestic financial reform.

Key words – exchange rate, China

JEL Codes – E58, F31

James Laurenceson *
The School of Economics
The University of Queensland
Brisbane Queensland 4072
Australia
Ph – (+617) 3365 6085
j.laurenceson@economics.uq.edu.au

Fengming Qin
School of Economics
Shandong University
China

* Corresponding author

** This paper was originally presented at the 17th annual conference of the Association for Chinese Economic Studies (Australia) held at the University of Western Australia, Perth, July 7-8th 2005. The authors are particularly grateful for helpful comments received from Guonan Ma and Michael Thorpe. The paper is currently in press in Wu, Y. (ed.). 2006. *Economic transition, growth and globalization in China*, Edward Elgar Publishing, Cheltenham.

† The East Asia Economic Research Group was established in July 2005, providing a focal point for East Asia-related research of an economic nature, conducted by academic staff of the School of Economics at The University of Queensland, their research collaborators and other interested contributors.