

China's Equilibrium Exchange Rate and Trade Balance: A Tale of Apples and Pirates

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Abstract

China has been widely accused of deliberately maintaining an undervalued currency to fuel its exports. In this paper we argue that one of the most popular measures of equilibrium exchange rates, the Big Mac index, should make way for an Apple index; a theoretically more appealing index where purchasing power parity exchange rates are calculated based on the prices of globally available Apple Inc. products such as the iMac and iPod. Our Apple index also embodies a technique that can account for the value share of non-tradeable inputs, a bias that has plagued the Big Mac index. In contrast to the Big Mac index, the Apple index concludes that the RMB is not undervalued. An alternative explanation for the rapid growth in China's exports is offered and we note that after accounting for intellectual property right (IPR) piracy, there is nothing in China's overall trade balance to suggest an undervalued exchange rate. Piracy means that China may well be unfairly benefiting from trade, but the salient policy implication is better IPR enforcement, not distorting the exchange rate in a bid to compensate.

JEL classifications: F31, F36

Keywords: Big Mac Index, Purchasing Power Parity, Renminbi, intellectual property rights

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