

## MASTER'S THESIS

### The exchange rate system of China: an empirical study with institutional factors

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*Date of Award:*  
2006

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The Exchange Rate System of China: An Empirical Study with  
Institutional Factors

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A thesis submitted in partial fulfillment of the requirements

for the degree of

Master of Philosophy

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Hong Kong Baptist University

August 2006

## Abstract

In this thesis, I take a close look to the institution of the foreign exchange system of China. I study how the Chinese government made use of the existing foreign exchange framework to stabilize the value of Renminbi after the 1994 reform; and assess their effects on the efficiency of fiscal and monetary policy. To complete capital account full convertibility of Renminbi, an optimal sequencing was proposed based on the experience of other countries and the existing literature. Two empirical tests are done to clarify the general misunderstandings to Renminbi. First, the value of Renminbi is not the cause of US rocketing trade deficits; and second, the increasing export from China to US does not hurt US manufacturing workers.

The thesis consists of five chapters. In the first chapter, it gives out a summary of the foreign exchange reforms since 1979. The reforms were a gradual transformation of “exchange allocation mechanism” from one that was governed by central planning to one in which market forces play a higher role. The entire

process is characterized by trade liberalization, official exchange rate adjustments, foreign exchange market development, easing of regulations on current account transactions and establishment of control framework on capital flows. The summary allows readers to have a deeper understanding on the background of the foreign exchange system in China, as well as its evolvement to the current status. It is important for the further studies related to the foreign exchange system, which studied in Chapter II, III, IV & V.

The second chapter finds out how the Chinese government utilizes the institutional framework to stabilize the exchange rate of Renminbi at the 8.28 level for more than 8 years. It can be said that it was a miracle for a currency to be such stable and the stability had a significant contribution to the fantastic economic development of China in the last decade. It is worthy for us to study it and learn the experience from it for future reforms. The experience is useful to prevent any potential crisis occurred during the future reforms. Besides, it accesses the effects of the current foreign exchange mechanism on fiscal policy, monetary policy, as well as the reaction to economic shocks. Based on existing macroeconomic

models (Rodseth), it tries to apply the theoretical model into the China context.

The third chapter discusses what the optimal sequencing should be if China further reforms its foreign exchange system in the future. Based on the experiences learned in other countries and the existing literature, it is expected the reform process should consist of the following four steps: Step 1: Open currency exchange to domestic residents → Step 2: Liberalizing long-term capital inflows → Step 3: Open domestic capital to invest abroad & limited open on foreign short-term capital inflows → Step 4: Complete capital account full convertibility.

The fourth and fifth chapters are the empirical works. Two hot issues of Renminbi are discussed. First, “Is Renminbi a significant factor to huge trade deficits in US?” is discussed in chapter VI. Based on my studies, the conclusion is negative. According to the arguments and the empirical results, we cannot find any significant evidence to show that Renminbi should be blamed for causing the huge trade deficits to US. In contrast, to a large extent, the trade deficit can be regarded to be produced by the US itself. The expansionary monetary policy

adopted in US in the past few years has boosted the US economy, as well as the consumption and the volume of import. Thus, the expansionary monetary policy, instead of the value of Renminbi should be the main cause of the problem.

Second, “Has the increasing weighting of US import from China hurt the employment in US?” is discussed in chapter V. Based on our studies, the conclusion is also negative. No significant evidence is found to prove that the increasing weighting of US import from China has hurt the US employment.

At last, all the studies are up to July 2005 and thus the recent de-link of Renminbi to US was not covered in the thesis.

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