Vertical Trade and China's Export Dynamics

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Summary

This paper examines how China's exports are affected by exchange rate shocks from countries who supply intermediate inputs to China. We build a simple small open economy model with intermediate goods trade to show that due to the intraregional trade in intermediate goods, a devaluation of other Asian currencies does not necessarily damage China's exports, as imported intermediate goods could become cheaper. This channel through the cost of intermediate goods depends critically on the share of intermediate goods used in China's export goods production and the degree of exchange rate pass-through in imported intermediate goods prices. If prices for intermediate goods are not very sticky, the effect through this channel could be large and China's exports could even benefit. We find the above findings do not depend on China's choice of currency invoicing between RMB and the US dollar or the choice between fixed and flexible exchange rate regimes.