

The Illusion of Precision and the Role of the Renminbi in Regional Integration

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Summary

The debate on renminbi (RMB) revaluation has not subsided, despite the policy change announced by the Chinese authorities in July 2005. The key rationale for undertaking this study was our strongly held conviction that many strong policy recommendations were being made on the basis of weak empirical evidence or vague theoretical underpinnings. Specifically, we show that the evidence of RMB undervaluation may not be as strong as it appears. Depending on the method used, the evidence ranges from slight overvaluation to undervaluation. Even in the case of undervaluation, the results are not significant in the statistical sense. Contrary to the standard approach, we have documented the extent of our ignorance regarding the appropriate model and the true nature of the relevant data.

We also note that China is playing an important economic role in Asia and has established a complex production and trade network with its neighboring economies, which complicates the calculation of the equilibrium exchange rate. Thus, a hasty decision on RMB policy based on not well-founded evidence can do more harm than benefit to China and to its trading partners, especially the developing economies in the region. That being said, we do believe that China should pursue a policy of gradually allowing the RMB to appreciate as both the macroeconomic balance and real exchange rate-income models suggest some undervaluation.