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Foreign exchange markets in transition economies: China

Kate Phylaktis [a,*], Eric Girardin [b]

[a] *City University Business School, Frobisher Crescent, Barbican Centre, London EC2Y 8HB, UK*
[b] *CEDERS Université de la Méditerranée, 14 Avenue Jules Ferry, 13621 Aix ey, Provence Cedex, France*

Abstract

The purpose of the paper is to examine the behaviour of exchange rates in China during the recent period of trade and exchange system reforms. A simple theoretical model based on the monetary approach is developed to explain the exchange rate in the parallel or black market, given the official and substantially controlled rate. The model is tested on quarterly data using the cointegration technique, error correction modeling and impulse response analysis. The results confirm the main features of the model and have policy implications concerning the use of devaluation and monetary policy for stimulating the economy, and the adoption of policies, which encourage black market activities.

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1. Introduction

One striking feature of the Chinese economy since 1978 has been the co-existence of planned and market prices in many areas of the economy. In the foreign

* Corresponding author. Fax: +44-171-477-8881.
E-mail addresses: k.phylaktis@city.ac.uk (K. Phylaktis), egegirardiu@yahoo.com (E. Girardin).

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exchange market, three types of exchange rates have co-existed. The official rate, which was fixed and rarely changed; the swap rate, which was used by Chinese enterprises to swap their foreign exchange quotas and/or foreign currencies at a state determined rate by the Bank of China in selected cities, and which was less managed since 1988; and the black or parallel market rate, which was market-determined. The black market emerged because of the government's attempts to set the exchange rate and to monopolise access to and use of foreign currencies.

In this paper, we concentrate on the behaviour of the black market rate since 1988. We develop a simple theoretical framework for a country, like China, with an underdeveloped financial system and where access to credit has been largely controlled by the state, limiting the possibilities for interest rate arbitrage. The model is within the class of monetary models to exchange rate determination, which have been initially developed for the official exchange rate.[1] In our model the money market is what has been driving the black market rate. Such a framework is more suitable than the portfolio balance models, which emphasize amongst other factors portfolio considerations based on the interest rate differential.[2] It is also considered more appropriate than the "smuggling and real trade models", which emphasize the transactions demand for foreign exchange and analyse the impact of trade restrictions assuming away the portfolio motive completely.[3] Although import tariffs existed in China, the average tariff rate was reduced substantially during the period of examination, from 29.2% in 1988 to 19.8% in 1996 (see World Bank, 1997). In contrast to the relaxation of tariffs, capital account inconvertibility has remained throughout the period of examination, encouraging agents to participate in the black market. The monetary approach framework applied in this study has the additional advantage of allowing one to examine the effects of monetary policy on the economy and the financial markets, which is a useful exercise in view of the emphasis on financial policies in post reform period.

The paper contributes to the literature as follows. First, it is the first study of its kind which attempts to examine the interaction between the black market rate and the swap rate in China in recent times following the drastic economic and financial reforms. The swap rate was a more representative state rate for the period 1988 to 1993 than the official rate, since an increasing amount of transactions were channeled through that market. In 1994 the official rate and the swap rate were unified. Previous studies, such as that by Yin and Stoever (1994), have looked at the black market premium, defined as the spread between the black market rate over the official rate. They applied a version of the portfolio approach using

[1] For a review of the various models, see Phylaktis (1996).
[2] For an exposition of the portfolio balance models, see e.g. Phylaktis (1991).
[3] See e.g. McDermott (1989).