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How does real exchange rate influence income inequality between urban and rural areas in China?

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Abstract

The channels through which the real exchange rate influences urban/rural per capita real income inequality are analyzed using yearly data for 28 Chinese provinces. Due to the higher share of tradable goods produced in urban than rural areas, the real depreciation of the Chinese currency raised the urban bias, contrary to the effect usually expected. This rise was, however, mitigated because of the impact of the exchange rate on the urban/rural consumer price ratio, real public wages, and the ratio of industrial/agricultural protection rates. It disappeared for coastal provinces due to the strong development of outward-oriented rural industrial activities. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

It has often been argued that overvaluation of domestic currencies in developing countries tends to penalize farmers, and that real depreciation should therefore be beneficial to the latter.[1] The devaluation which accompanied stabilization and

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[1] See, for instance, the World Bank analysis on the reasons for agricultural stagnation in Africa in the early 1980s (World Bank, 1981), and more generally the contributions of Morrisson (1991), Bourguignon and Morrisson (1992), Guillaumont (1993) and Minot (1998).

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liberalization programs pursued by developing countries since the beginning of the 1980s aimed primarily at restoring the balance of payments equilibrium. A complementary motive for devaluation has sometimes been to reduce the "urban bias" inherent to development strategies of many developing countries.

Studies on the effects of the exchange rate policy of developing countries principally focus on the general price level, production or the balance of payments, or consider only a particular aspect of income distribution, such as the evolution of real wages or profit–wage sharing.[2] However, only a few studies have investigated the issue of the relationship between the evolution of the exchange rate and the distribution of urban and rural incomes.

Since the beginning of the 1980s, the exchange rate policy of China has been very active, which has resulted in a substantial real depreciation of the Chinese currency (e.g., Guillaumont Jeanneney and Hua, 1996). The fact that China publishes annual series of urban and rural incomes at provincial level provides an especially relevant case for assessing the relationship between the real exchange rate and the geographical distribution of incomes. This study is all the more interesting as both urban/rural and provincial income disparities are the main source of China's income inequality (e.g., World Bank, 1997).

This paper comprises two sections. The following section examines the different phases of the exchange rate policy of China and the corresponding evolution of the ratio of urban/rural incomes per capita. It appears that the income inequality between urban and rural areas does not move identically in the two geographical zones, namely inland and coastal areas, and therefore that the real depreciation of the Chinese currency might have raised the urban bias more in the former than in the latter. This divergence is in keeping with the ambiguous theoretical predictions of the impact of exchange rate variation on income distribution. Several assumptions are then presented to analyze certain channels through which exchange rate variations may have influenced urban/rural per capita income inequality in China, and so to explain the divergence between inland and coastal provinces. The last section presents the econometric results obtained from a panel analysis.

2. Relationship between the real exchange rate and the geographical distribution of income: stylized facts and main assumptions

2.1. The various phases of China's exchange rate policy

The exchange rate policy pursued by China since the beginning of the liberalization program has been quite complex, as, from 1981 to 1993, it involved a double exchange rate regime, whose nature has, moreover, changed over time.

[2] See for instance Alejandro (1963), Twomey (1983), Edwards (1989), Agenor and Montiel (1996). See also the contributions of Knight (1976) and Morrisson (1991) which are closer to our analysis.