



China's Undervalued Currency

Nicholas R. Lardy, coauthor of a new book with Morris Goldstein, says China's exchange rate practices have improved but could benefit from more reform.

Recorded July 21, 2009. © Peterson Institute for International Economics.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Nicholas R. Lardy, our guest today, is the co-author with Morris Goldstein of the new Peterson Institute book entitled, *The Future of China's Exchange Rate Policy*. Thanks for joining us, Nick.

Nicholas R. Lardy: Thank you, Steve.

Steve Weisman: This book is the latest in a series of studies that you and Morris and others at the Institute have done on aspects of China's economic growth and exchange rate policy. What is the most important conclusion that one takes away from this new book?

Nicholas R. Lardy: Perhaps the most important conclusion is that the new policy that China adopted with respect to its exchange rate in the middle of 1995 has probably brought them closer to what we would call an equilibrium situation—that is, one in which their current account, or their trade surplus, is not so huge. But that they still have a way to go.

Steve Weisman: And how much further do they have to go, in your judgment?

Nicholas R. Lardy: There are uncertainties of a variety of types of any estimate of magnitude of remaining appreciation that would be appropriate. But in the study, we conclude that it's something in the neighborhood of 15 percent to 25 percent. Of course we look at that on a trade-weighted basis, that is across a broad range of currencies. We're not looking at it just with respect to the US dollar.

Steve Weisman: The exchange rate policy has been at the center of irritation that's ebbed and flowed between the US and China over the last several years, and also as you pointed out today, between Europe and China. How tense is the discussion on this issue right now between the United States and China?

Nicholas R. Lardy: It's perhaps less tense than it was two to three years ago. The appetite in the Congress for trying to address this issue through what was referred to as currency legislation seems to have waned a little bit. And I think that's a function of a couple of things.

First, the United States, which has had in recent years a very large deficit in its external trade with the rest of the world, that deficit has shrunk dramatically since it peaked in 2006. So we are in a more comfortable kind of external position than we were two or three years ago.

The second factor is of course that the Chinese, over the course of 2008, did allow their currency to appreciate much more rapidly than it had in earlier years. So there is at least now some suggestion that the Chinese are moving strongly in the right direction. And their trade surplus in the second quarter of this year is actually about 10 percent less than in the same period of 2008. This is really the first time in more than a decade or in about a decade, in which China's trade surplus has not been growing at a very, very rapid pace.

So both sides seem to be moving a little bit closer to a more sustainable external position—the United States a little more strongly and China with a bit of a lag and a long way to go, but the direction of change [that] is more promising than it was a couple of years ago.

Steve Weisman: How much of a factor has been simply the global economic slowdown?

Nicholas R. Lardy: Obviously there are a number of factors that have contributed to the changes that I just described. Exchange rates are part of it. The overall macroeconomic situation is certainly another part.

And it is true that the United States has slowed down more on average than the rest of the world, which means the demand for imports by the United States has slowed more than the rest of the world's demand for US products. And that would be a contributing factor to making our trade deficit somewhat smaller. But the United States currency had depreciated from February 2002 really all the way through roughly the end of 2007. So currency changes have been an important part of the adjustment process as well.

Steve Weisman: Is the United States engaged on this issue at a sufficient level? We're talking about a week away from the Obama administration's inauguration of its new dialogue with China, which it calls the Strategic and Economic Dialogue (as opposed to the Strategic Economic Dialogue that the Bush administration had). How central to that dialogue is this issue as they meet next week?

Nicholas R. Lardy: I think one way of putting it is the exchange rate issue is not really quite the headline issue that it was in the earlier dialogue under the Bush administration. The Obama administration, under Secretary Geithner, is focusing more on financial imbalances. That allows him to kind of back into the exchange rate issue.

Steve Weisman: What do you mean by financial imbalances?

Nicholas R. Lardy: The very large surplus that China has, the somewhat smaller but still large deficit that the United States has. I'm really referring to the external imbalances.

So the issue will be addressed but it's in the framework of the external imbalances rather than kind of a frontal approach taking on the exchange rate directly. And part of the argument, of course, is that these global imbalances were a contributory factor to the onset of the global financial crisis.

The China supply of large amounts of money to the United States and the rest of the world made interest rates much lower than they otherwise would have been. That

allowed the creation of more leverage, the undertaking of more risk on the part of financial institutions that led to the difficulties that emerged so strongly beginning in the fall of 2008.

Steve Weisman: Let me ask you about American pronouncements that seem on the surface contradictory.

On the one hand, you have Treasury Secretary Geithner saying, I believe when he was in the Persian Gulf a couple weeks ago, that a strong dollar is the ultimate objective of American policy, or is in American interests. That was kind of a repetition of a mantra going back to the 1990s.

On the other hand, former Treasury Secretary Summers, who spoke here at the Peterson Institute, warned as the Obama administration has done before that future economic growth in the United States must be, to some degree anyway, export-led. And many listeners interpret that to mean that the US wants a weaker dollar, which is also implied by the request for China to let its currency appreciate.

Are we seeing contradictory signals here?

Nicholas R. Lardy: As your question suggests, I think Treasury secretaries always repeat the mantra that a strong dollar is in the US interest. They never want to be seen as so-called talking the dollar down. I think that's a well-established tradition that has certain advantages.

But yet, I think Larry Summers' point [was] that the United States cannot be kind of the sole engine of economic growth by having excessively large consumption expenditures financed by going into debt to the rest of the world, that that's not a viable model going forward, that households need to rebuild their financial wealth and that's going to mean that US consumption demand is substantially weaker than it was in the recent past.

So if the United States is going to grow at anything close to its long-term potential rate of maybe 2.5 percent to 3.25 percent, we're going to have to have a bigger contribution from the external sector, which is just another way of saying that US exports are going to have to grow more rapidly relative to imports than they have in the past. And I think inevitably, this process would be facilitated if some of the currencies that are currently undervalued, appreciated. And China would certainly [be] on that list, if not at the top of that list, although there are a number of other currencies that should strengthen. Obviously, that means on a trade-weighted basis, the dollar would become somewhat weaker.

Steve Weisman: There is some talk at the event that you and Morris did at the Institute today to launch your book, about China trying to have it both ways, fearing that the value of its dollar reserves will go down but intervening in the markets to keep the dollar high related to the renminbi. Walk me through how you see that.

Nicholas R. Lardy: I think we need to go back over a period. The last several years, the Chinese have allowed their currency to appreciate to some extent but their surplus has been very, very large. And if the authorities had not been buying up the extra foreign exchange

that comes into the market as a result of that surplus, their currency would have appreciated much, much more rapidly. So the attempt to hold down the rate of appreciation, has led to these large reserves, they are now far and away the largest of any country in the world. They're about US\$2.1 trillion. Maybe about 75 percent of those reserves are held in dollar-denominated assets.

So they have a huge exposure to the dollar and now, they're worried about it. And they've even talked about, wouldn't it be nice if the United States government would guarantee the value of their dollar holdings, so in case of deflation that might erode the value of the dollar, the United States would have to make up the difference? Really, they're trying to have it both ways. It's inevitable if you have massive currency intervention to keep a currency from appreciating more rapidly, you build up huge reserves and inevitably, you will have what is referred to as currency risk. You'll be at risk that the dollar would lose value or if you put your reserves into euros, you would be at the risk that the value of the euro would go down. So the currency risk is an inevitable part of the process of intervention and keeping a currency undervalued.

In a sense, the Chinese are trying to have it both ways. They want to have the undervalued currency and they want to have no currency risk. And that's really an impossible combination for the simple reason that the United States government would never guarantee the value of China's dollar-denominated assets, or those of any other country for that matter.

Steve Weisman: How could the United States do that even if it wanted to?

Nicholas R. Lardy: Well, in theory, it could say to the Chinese, okay, you hold, let's say for the point of discussion, a trillion dollars in US assets, and if inflation in the United States over the next year or two years or whatever period of time is 10 percent more than inflation is in China, because we're running such a big deficit and our fiscal management isn't quite as sound as some of us hope it would be, then we'd have to give them an extra \$100 billion to compensate for the 10 percent loss that they suffered on their initial trillion dollars' worth of assets.

Steve Weisman: That's not exactly realistic, is it?

Nicholas R. Lardy: No, it's not realistic. For one thing, the Congress would never go along with it. And this would have to be financed by a congressional appropriation. And the Chinese know that it's not in the cards, but they bring it up as a debating point really, to put the United States on notice that fiscal rectitude is highly valued by the Chinese.

Steve Weisman: Finally, though I've asked you this before, but we're only a week away from that SED meeting. How are Secretaries Geithner and Clinton doing in their relations with China, in your judgment?

Nicholas R. Lardy: I think the relations with China are going reasonably well. They each have made a trip to China: Secretary Clinton early in the administration; Secretary Geithner more recently. I think that has paved the way for making these meetings as productive as possible, establishing the personal relationships.

I mean, one of the big differences between this Strategic and Economic Dialogue and the dialogue we had under the Bush administration is that Secretary Paulson had a long longstanding prior relationship with his counterpart in China as a result of his work on Wall Street over the decades.

Secretary Geithner has not had that previous relationship with the Chinese vice premier that will be leading on the economic side. And Secretary Clinton has not had that relationship with the state councilor that will be leading the Chinese delegation on the geopolitical issue. So I think the fact that they've invested in making these trips, is a promising sign that the dialogue would be successful.

Steve Weisman: Nick Lardy, thank you very much for talking about this today. And we'll see you on the next round.

Nicholas R. Lardy: Thank you, Steve.

