FEERs Update: China's Persistently Undervalued Currency

In the light of PIIE's latest update of estimates of fundamental equilibrium exchange rates (FEERs), John Williamson discusses China's currency practices, its undervalued renminbi, and the impact on US-China trade.

Edited transcript, recorded January 29, 2010.

Steve Weisman: The issue of China's currency and its value is, again, in the news. This is Steve Weisman at the Peterson Institute for International Economics with John Williamson, senior fellow at the Institute, to discuss that and his new policy brief this month written with William Cline on the issue of equilibrium exchange rates.

Thank you, John, for joining us.

John Williamson: It's a pleasure.

Steve Weisman: John, what was the main finding of this policy brief on equilibrium exchange rates?

John Williamson: The main finding as of the beginning of this year was that the dollar wasn't generally overvalued, that it was more or less in equilibrium vis-à-vis most currencies with the exception of a small group in East Asia who are still very much undervalued relative to the dollar and relative to, therefore, all other currencies; China, most conspicuously, but also countries like Singapore, Malaysia, Taiwan, and Hong Kong.

Steve Weisman: Is that because those other smaller Asian countries are more or less pegging their currency to China for competitive reasons?

John Williamson: I think that's one factor, as it would be very embarrassing for them to fall out of line with China and become greatly overvalued in effective average terms, even as they would do if they established equilibrium exchange rates vis-à-vis the dollar.

Steve Weisman: How much in your view and analysis is China's currency, the renminbi, undervalued?

John Williamson: The estimate that we had was based on the International Monetary Fund's forecasts as of last spring, and that was an indication then that the renminbi was about 25 percent undervalued in effective terms and about 40 percent in bilateral terms vis-à-vis the US dollar, so very substantially undervalued. Now, there have been more recent forecasts that suggest that at that time, the IMF overestimated the size of the Chinese surplus and therefore, the implication would be that the renminbi was less undervalued than that. But personally, my guess is that we shall revert close to previous figures when the dust clears.

Steve Weisman: How does a currency become undervalued? A large body of critics in the United States accused China of manipulating—in their words—its currency by buying dollars or by whatever other techniques.

John Williamson: Well, there are two mechanisms by which you can get a seriously disequilibrium exchange rate. It can be produced by the market, and from all examples where the market has been way off base—think of the euro in the early 2000, when the euro was worth like 80 something US cents. It was just absurdly undervalued at that time but nevertheless, that happened even though Europe was floating the euro and not intervening with exchange markets at all. The second way in which under-evaluation can come about is by a deliberate policy or policies on the part of the government; for example, holding the exchange rate constant in bilateral terms. And that's exactly what the Chinese government has been doing. It's been holding a constant dollar exchange rate, and it started off being undervalued. It's become even more undervalued as the dollar drove it down in the last few months, taking the renminbi with it. Then the renminbi has indeed become very much undervalued.

Steve Weisman: And there's been so much pressure on China to cease and desist in these practices, but political and other pressure doesn't seem to have worked.

John Williamson: No. I think that's right. There's been a lot of pressure, and the Chinese are being extremely obstinate about it; they regard the exchange rates of the renminbi as their own business and nobody else's. I think that's an untenable position when exchange rates inherently are the relationship between two currencies, and so no one country has the right to regard its exchange rate as only its business. It's inherently an international question, and the Chinese are not accepting that. But nobody is prepared to warn them to change.

Steve Weisman: Now, conventional economic theory, as it's taught in college, is that these exchange rates do have an impact on trade, and of course that's probably at least one motive for China. But if you look closely, how much in your view is the exchange rate issue related to the trade balance? If China allowed its currency to appreciate, how much would that impede exports and encourage imports from, let's say, the United States?

John Williamson: I think that there's no question that exchange rates are an important influence on trade, by no means the only influence. It is also as comparably important an influence as that of the level of demand in a particular country. The question becomes whether allowing Chinese appreciation would encourage the Chinese to also allow their internal demand to expand further, which I take the view that it would do, that it would be government policy on the part of China. But the basic question, do exchange rates influence trade? Yes, of course, they do. There's overwhelming evidence that they do.

Steve Weisman: What is your sense of the emerging consensus, not only in the United States but in other parts of the world, especially Europe, on what strategy they will try now to encourage China to allow its exchange rate to float more freely?

John Williamson: I don't know that there has been any agreement to follow a particular strategy. I think it's presumed we shall see in due course some resumption of pressure for protection as a trade measure. But I don't think that there has yet been any agreement on whether China should be subjected to additional pressure.

Steve Weisman: Do you and Bill Cline and others at the Institute speak to Chinese economists? What do they say?

John Williamson: There are some differences of views even among Chinese economists. But most of them take the view that their government is right and that it's very important to expand exports, and they are just following a fixed exchange rate policy, and so this is a consequence of that, which is not in line to social policy. It just happens to work out this way. That's the dominant view among Chinese economists.

Steve Weisman: John Williamson, thank you. This is a very hot issue, but it really helps that you and Bill have brought your scholarship to it and studied it so carefully. Thanks very much for joining me today.

John Williamson: It's a pleasure.