China's Currency: Modest Appreciation but Still Undervalued

William R. Cline explains the implications of China's undervalued renminbi, the overvalued dollar, and a euro that could face depreciation in the future.

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Steve Weisman: President Obama has been in Asia, suggesting again that China is not playing by the rules, especially on exchange rates. As it happens, William Cline and John Williamson have just issued their latest evaluation of the currency situation. This is Steve Weisman at the Peterson Institute with Bill Cline. Bill, the President has suggested that China's currency is undervalued. To what extent, in your estimation?

William Cline: Our new estimates are that China's currency is about 11 percent undervalued in terms of what it would take to keep their current account surplus within bounds. We say a three percent of GDP surplus is about as high as it should get. They're headed instead to a 7 percent surplus, according to the IMF, by 2016. Now, that estimate is somewhat narrower than our April estimate, which was 16 percent.

Steve Weisman: So it went from 16 to 11?

William Cline: It went from 16 to 11, and that was because there's been some move of the renminbi against the dollar. In addition, the real value of the renminbi has been moving faster than that, because they have more inflation than we do. They're inflating at about five and a half percent. We're inflating at about three percent per year. That means that they are essentially giving us renminbi that aren't worth as much, and therefore they are becoming stronger relative to us for the inflation component.

It continues to be an imbalance. I think the Chinese case is particularly problematic because it's not just the exchange rate in the current account. It's also that they continue to pile up huge reserves. After all, they went back to what they call "floating" in June of 2010. But since that time, their reserves have gone up from $2.4 trillion to $3.2 trillion, so clearly they're not floating in the sense that they're keeping their hands off the market. And it's a combination of the undervaluation, with pretty obvious thwarting the market on the exchange rate, that makes it particularly contentious.

Steve Weisman: Your paper though says that the bilateral undervaluation of the renminbi against the dollar is 24 percent. Explain the difference between why you say it's 24 percent bilaterally, but 11 percent…

William Cline: …on the effective rate.

Steve Weisman: Yes, on the effective rate. This is a little technical, but I think people interested in this subject will bear with us.

William Cline: All right, here's the concept: the bilateral rate that comes out of this exercise is what the dollar rate against each currency would be if all countries at the same time were to realign to equilibrium rates. And an equilibrium rate again is, if the huge current account surplus in Singapore would come down; the current account surplus in Switzerland would come down, because they depreciated.

When you have all of these other economies – and there are a lot of them are undervalued that trade heavily with China: Malaysia, Singapore, Hong Kong, Taiwan – then the fact that those currencies are also moving up would mean that in order to achieve an 11 percent real effective appreciation, the renminbi would need to move up considerably more against the dollar individually, because it would be not moving up against these other currencies.

If you think about what the country itself should be responsible for – its own action, nobody else in the world changes an iota – then you can say, "Well, it's 11 percent." But the reality is that if China were in fact to move its exchange rate, the neighboring countries [would] tend to move along with it. They've done that in the past, [and there is] every reason to expect them to do it.

Steve Weisman: I think Fred Bergsten [director of the Peterson Institute] refers to that as the "satellite effect."

William Cline: Satellite effect, right, So, in practical terms, at the end of the day, the right notion to think about against the dollar would be somewhere in the range of 11 percent, at least up to as much as 24 percent.

Steve Weisman: Depending on how you look at it, China's record is improving or not?

William Cline: It improves even on the bilateral one, in the sense that that was 28 percent in our estimate. Now it's down to 24 percent.

Steve Weisman: You don't, I'm sure, want to get into the tactics of which policy is most effective, but is there grounds for thinking that whatever tactic the administration is using, it's working a little bit?

William Cline: I think it would be generous to the Chinese to say that they're adopting their own announced policy. Because their own announced policy, it's right there in the five-year plan, is that they're going to move toward greater international balance. They don't want to be quite as dependent on foreign shocks as in the past.

So, if they were to keep up the current pace of the real appreciation of their currency for a prolonged period, it would certainly eventually move them a lot closer to where they need to be. I'm not sure you can count on that. The last time that the international crisis got worse, they suddenly put the brakes on their currency movement. After all, they had appreciated their currency quite a bit from 2005 to 2008. But as soon as the world economy got dicey, they basically froze it against the dollar.

Steve Weisman: Because they were worried about their export record.

William Cline: They were worried about export prospects, and didn't want to rock the boat further by continuing to appreciate their currency. So if the European crisis gets further out of control, who knows? Maybe they would decide it's time once again to put the brakes on. But there is some improvement, yes.

Steve Weisman: You also say that the dollar is about the same as it was before, overvalued. Is that because people are buying dollars because of the safe haven effect?

William Cline: The dollar has been overvalued for some long time. It is less overvalued now than it was at certain points in time. After all, at one point the US current account deficit was about twice as large relative to GDP as it's been recently. But it has taken a long time for it to bring down the degree of overvaluation. Getting it [the overvalutation] down to nine percent is encouraging in some sense. As I say, there's not much change from April in the extent of the dollar overvaluation. And yes, one of the things that's preventing a continued gradual elimination of that overvaluation is the safe haven effect from the euro.

Steve Weisman: What has been the effect, if any, of the quantitative easing policies of the Fed?

William Cline: That, in principle, causes the dollar to be weaker than it otherwise would be. Indeed a year ago at this time, there was this big hue and cry about the currency war. I mean, the Brazilian finance minister accused the United States of causing a currency war by artificially depressing the dollar by quantitative easing. That kind of talk has died down quite a bit, certainly from a lot of emerging market economies, who no longer see a flood of too much capital coming in. Their currencies have gone down in this new environment of return to the safe haven effect. But the interest rate policy, the quantitative easing has, in fact, helped reduce the overvaluation of the dollar.

Steve Weisman: Finally, on the euro, you mention in the Policy Brief that there is a possible danger of an undervaluation or a depreciation of the euro as a way of boosting European exports.

William Cline: I think the point we were trying to make is that some advocates say, "Well, the euro should be sharply devalued because that would be a way for Europe to regain growth." The problem is that that would make the dollar more overvalued. It would not contribute to global stability and avoidance of global imbalances.

Steve Weisman: But do you see any signs of the Europeans doing that?

William Cline: I don't think that they are consciously trying to cause the currency to decline. What is going to be interesting to watch is whether the markets make a run at the euro because of the seeming notching up of contagion to Italy, to Spain.

Steve Weisman: A run at the euro?

William Cline: Well, an attack on the euro.

Steve Weisman: Right.

William Cline: And, so far, it's gone down from $1.42 right after the October 26 package, to $1.35 today. So there's some erosion. It hasn't exactly fallen through the floor. We have to wait and see how it holds up.

Steve Weisman: Thank you, Bill.

William Cline: Thank you, Steve.