China's Currency Continues to be Undervalued

William R. Cline discusses his latest study with John Williamson on fundamental equilibrium exchanges rates (FEERs) and its conclusion that the renminbi remains undervalued.

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Steve Weisman: William Cline, senior fellow at the Peterson Institute for International Economics, has been studying exchange rates of currencies with John Williamson, also at the institute, for a few years now. Bill and John have issued a new report evaluating the undervaluation, overvaluation. This is Steve Weisman to talk to Bill Cline about it today. Bill, summarize please the major new findings in your report.

William Cline: The new finding in a sense is that the same major disequilibriums continue in the international economy. The Chinese renminbi and a group of sort of satellite currencies are substantially undervalued, leading to current account surpluses that are excessive. The U.S. dollar, despite the narrowing of the current account deficit in the last couple of years, is again a bit overvalued. Its current account deficit is headed back up. That's sort of the big picture.

The main imbalances: China on the one hand; the U.S. on the other. And so in some sense, this is a story that we have heard before. And in a sense, what's new is that the seeming efforts of China to start moving some direction toward correction with some flexibility--the rmb has actually risen by all of 5 percent against the dollar over the last year--doesn't get the job done, because the dollar's gone down against other currencies and there's been virtually no change in the trade-weighted strength of the rmb. The other parts of the story again are sort of more of the same. The last time we did this essay we called it Currency Wars? That was the period when the so-called Quantitative Easing II, otherwise known as QE2, was being blamed for increasing the strength of currencies like the Brazilian real and the Korean won and there was a lot of concern about currency wars.

Steve Weisman: Increasing their strength against the dollar.

William Cline: Against the dollar.

Steve Weisman: With Europeans and others accusing the Fed of deliberately driving the value of the dollar down.

William Cline: Right. And some of those distortions continue. The countries we identify as being overvalued include some of those already at that time: Brazil in particular, Turkey, South Africa. And the countries undervalued as I say include the same suspects: Hong Kong, Malaysia, Singapore, Taiwan in addition to China, also to some extent Sweden and Switzerland.

Steve Weisman: In a world where economic growth rates in different parts of the world are wildly divergent, as you point out in the paper, the United States and Europe struggling to recover still from the recession, but Asia and other countries showing terrific growth rates, wouldn't one expect fluctuations in currency anyway?

William Cline: You do expect fluctuations in currency. What we do is to use the IMF's projections of current accounts through 2016. So in some sense, the best estimate of where these current accounts are headed is already in the data that we're working with. That's, in principle, captured the principal changes. Now, one of the new elements we do have in this particular report is tracking these equilibrium exchange rates over the four years that we've been doing it.

And we see what we projected was an equilibrium before, and where we say it is now. And we find that over 90 percent of the world economy, at least the bloc of major countries that we're looking at, is included in countries that have stayed within plus or minus 15 percent of what we said their equilibrium exchange rates were over this period. So, there's more continuity here than one might necessarily have thought. The equilibrium rate in some sense doesn't radically jump around. Now, what is also true is you've had prolonged departures from this equilibrium rate in terms of China and its bloc being persistently undervalued, U.S. persistently overvalued -- by how much depends a little bit on what period -- but also some other countries like Australia and New Zealand persistently overvalued.

Steve Weisman: To what extent do you attribute these undervaluations and overvaluations to manipulation by China, or to other macro factors like savings and consumption rates in the United States and China?

William Cline: Manipulation is kind of a loaded word.

Steve Weisman: Right.

William Cline: But whether you want to use that kind of a term or another somehow more polite term, it is interference with the market when China says, "OK, this is our exchange rate and if we earn a big surplus of exports or imports, we put that surplus into reserves." That's basically a managed exchange rate. So yes, there is management of the exchange rate by China that prevents it from appreciating as much as would occur if it allowed the market to determine the value. And that tends to make their exports more competitive. It tends to give them a large surplus. Now their surplus has come down. They had a current account surplus of 10 percent of GDP two or three years back, and it was down to more like 4.5 or 5 percent last year. And the debate is where it's headed. The fund, the IMF says it's going back up to 8 percent of GDP by 2016. And that was the benchmark at which we said, "Well, look, we still got this big imbalance." Now some in the private sector say: "Well, wait a minute, the surplus is not going to go up that much." And an important distinction is those folks, to some extent, are saying "Well, the Chinese are going to let the currency appreciate." OK, that's fine. I mean, the exercise we are conducting is what would happen if they don't allow it to appreciate.

Steve Weisman: What would happen as against what would happen if they continue their current policies?

William Cline: Right.

Steve Weisman: I mean your benchmark in judging whether it's under or overvalued is-

William Cline: Our benchmark is the current real exchange rate.

Steve Weisman: Right.

William Cline: Now, you could say that the policy is somewhat different from that because they're planning to let it appreciate. And they had said from time to time, especially the Central Bank tends to say, it should appreciate, "we may do this by allowing wages to increase and therefore prices to increase so that it's partly the real revaluation [that] is accomplished by having higher prices rather than a different exchange rate." They enunciate that. But we are using a snapshot of today's real exchange rates and saying what would happen. That's the exercise that the fund does. It has to adopt some assumption. So it doesn't say that its exchange rate projection is what the government says it might be. It says what they are today and that's maintained in the future.

Steve Weisman: Have you heard from the Chinese on your findings?

William Cline: In the past we've had some dialog with think tanks in China, and I think both sides understand where the others are coming from. Their tendency tends to be, "Well, maybe there is some undervaluation, but these things take time. It's not as severe as the Peterson Institute is saying." So there's sort of a dialog going on. I think it's also true that there are quite different viewpoints among different interest groups within China. The export-tied interest groups are emphatic on maintaining the exchange rate where it is, the macro types have to worry about inflation in particular, or those who want to make the Chinese currency an international currency with status equal to the dollar and the euro someday. Those folks would like to see more appreciation.

Steve Weisman: And more flexibility. Thank you, Bill.

William Cline: Thank you, Steve.