

Exchange Rate

HOW SIGNIFICANTLY IS THE RENMINBI UNDERVALUED?

CHINA BALANCE SHEET

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Background

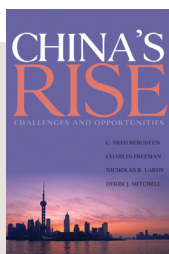
- The Chinese renminbi is significantly undervalued on both a trade weighted basis and against the dollar. In July 2005, in response to international pressure to let its currency appreciate in value, the Chinese government ended the fixed nominal exchange rate of the renminbi vis-à-vis the dollar. The government revalued the renminbi by 2.1 percent and introduced a managed floating exchange rate system. Since then, the currency has appreciated cumulatively, both against the dollar and on a trade-weighted average, by about 20 percent.
- The extent of appreciation of the renminbi has been significantly limited by official intervention in the foreign exchange market, as reflected in the \$1.2 trillion increase in China's foreign exchange reserves, from \$733 billion in July 2005 to \$1,906 billion in September 2008. China's reserves at \$2 trillion are now far and away the world's largest. Intervention continues to run at about \$30 billion per month.
- The continued significant undervaluation of the renminbi is demonstrated not only by the massive accumulation of official reserves, but also by the increase in China's external trade imbalance. Prior to the policy change of intervening to keep the renminbi's value low, in 2004 China's current account surplus was \$69 billion (3.6 percent of GDP). By 2007, this surplus had more than quadrupled to \$372 billion (11.3 percent of GDP), far and away the world's largest surplus. This explosion in surplus suggests that Chinese exports have become even more competitively priced. Thus the undervaluation of the renminbi, in fact, has increased over this period.

Current Situation

- China's current account surplus in 2008 probably increased by about a fifth to reach \$450 billion. As a result, China's role in global economic imbalances is no longer growing at the breakneck pace of earlier years, but it remains large in absolute terms. The slowdown in the growth of the surplus appears to derive mainly from reduced demand for Chinese exports because of slower growth in China's major export markets rather than a change in relative prices of Chinese and foreign goods stemming from appreciation of the renminbi. In the absence of further appreciation, it is likely that China's external surplus would resume expanding when global growth returns to its long-term potential rate.
- China's resistance to a more rapid movement toward an equilibrium rate for its currency stems from its fears of job losses in its export sector. These fears are understandable. In fact, however, undervaluation of the renminbi has distorted investment in a way that has actually produced fewer jobs than might otherwise have been generated by more sound currency policies. This has happened because undervaluation has tilted investment into manufacturing, where most of China's export goods originate. But that tilt has also reduced investment in services, a sector that is more labor intensive than manufacturing. As a result, warped investment priorities driven by currency undervaluation slow the pace of job creation.

Implications

- Further substantial appreciation of the renminbi is essential for three reasons. First, it would moderate China's global surplus and thus contribute constructively to the reduction of global economic imbalances. Second, by moderating Chinese export growth, it would tend to head off protectionist pressures against China in both the United States and Europe, which are already quite high. Third, further appreciation is essential to achieving China's goal of more balanced economic growth—growth that relies more on the expansion of private consumption expenditures and less on investment and net exports.
- To sustain rapid economic growth as the contribution of the external sector shrinks, China should also adjust its fiscal, financial, and pricing policies to encourage more efficiency in its domestic economy and more consumer spending.



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