Economics focus | Burger-thy-neighbour policies

Attacks on China's cheap currency are overdone

CHINA has been accused of "manipulating" its currency by Tim Geithner, America's new treasury secretary, and this week Dominique Strauss-Kahn, the managing director of the IMF, said that it was "common knowledge" that the yuan was undervalued. You would assume that such strong claims were backed by solid proof, but the evidence is, in fact, mixed.

Of course China manipulates its exchange rate—in the sense that the level of the yuan is not set by the market, but influenced by foreign-exchange intervention. The real issue is whether Beijing is deliberately keeping the yuan cheap to give exporters an unfair advantage. From July 2005, when it abandoned its fixed peg to the dollar, Beijing allowed the yuan to rise steadily, but since last July it has again been virtually pegged to the greenback. And there are concerns that China may allow the yuan to depreciate to help its exporters—with worrying echoes of the beggar-thy-neighbour policies that exacerbated the Depression. But American politicians are wrong to focus only on the yuan's dollar exchange rate. Since July the yuan has gained 10% in trade-weighted terms. It is up 23% against the euro, and 30% or more against the currencies of many other emerging economies.

In early 2005 two American senators brought a bill to Congress that threatened a tariff of 27.5% on all Chinese imports unless the yuan was revalued by that amount. This curiously precise figure was the midpoint of a range of estimates (15-40%) of the yuan's undervaluation. The bill was dropped, but the yuan has since risen by that magic amount in real trade-weighted terms (see left-hand chart). So how much further should it rise?

Those who argue that the yuan is still too cheap point to three factors: China's foreign-exchange reserves have surged; it has a huge current-account surplus; and prices are much cheaper in China than in America. Start with official reserves. If China had not bought lots of dollars over the past few years, the yuan's exchange rate would have risen by more. So does the yuan's fixed level against the dollar in recent months mean that intervention has risen? On the contrary, in the fourth quarter of 2008, China's reserves barely rose, despite a record current-account surplus. This suggests that private capital is now flowing out of China.

Charles Dumas, an economist at Lombard Street Research, argues that outflows of hot money could become a flood if China did not have capital controls. Currency "manipulation" amounts to more than foreign-exchange intervention; China also has strict capital controls which, although leaky, keep private savings at home. If Beijing scrapped those controls, firms and households would want to invest abroad to diversify their assets. In other words, if the value of the yuan was not "manipulated" and instead was set entirely by the free market, it might fall, not rise.

Some argue that China's large current-account surplus is incontrovertible proof that the yuan is too cheap. Morris Goldstein and Nicholas Lardy, at the Peterson Institute for International Economics in Washington, DC, estimate that the yuan's real trade-weighted value needs to rise by another 10-20% to eliminate the surplus. But other economists say it is wrong to define the yuan's fair value by the revaluation required to eliminate the current-account surplus. Trade does not have to be perfectly balanced to be fair. And China's surplus partly reflects its high saving rate. A stronger yuan will help to shift growth away from exports towards domestic consumption, but is unlikely to do so on its own. In 2005 Messrs Goldstein and Lardy reckoned that the yuan was 20-25% undervalued; it has since risen by that, yet the surplus has doubled. To reduce China's external gap, policies to boost domestic spending will be more important than its exchange rate.

Beefing up the argument

An alternative way of defining the "fair" value of a currency is purchasing-power parity (PPP): the idea that, in the long run, exchange rates should equalise prices across countries. *The Economist*'s Big Mac index offers a crude estimate of how far exchange rates are from PPP. Our January update found that a Big Mac cost 48% less in China than in America, which might suggest that the yuan is 48% undervalued against the dollar. But by this gauge, the currencies of virtually all low-income countries are undervalued, since prices are generally lower in these countries than in rich ones (see right-hand chart). This is the basis of the Balassa-Samuelson theory which holds that average prices will be higher in countries with higher productivity (ie, high GDP per head), because higher wages will push up prices in labour-intensive goods and services. This implies that it is natural for China's exchange rate to be below its PPP, but as it gets richer and productivity rises, its real exchange rate should rise.

PPP is a long-term concept. However, the relationship between prices and GDP per head can be used to estimate the short-term fair value of a currency relative to others. Using a simple model, which adjusts the Big Mac index for differences in countries' GDP per head and relative labour costs, gives the result that the yuan is now less than 5% undervalued.

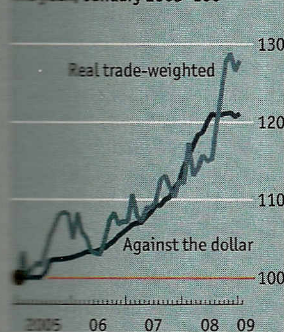
A new study* by Yin-Wong Cheung, Menzie Chinn and Eiji Fujii arrives at a similar result using World Bank price data across the whole economy. Previous assessments of such data had found that the yuan was around 40% undervalued. But the latest price surveys have raised the estimated price level in China (and so reduced GDP per head measured at PPP). The authors conclude that the yuan was 10% undervalued against the dollar in 2006, which means that it might now be close to parity.

The evidence that the yuan is significantly undervalued is hardly rock-solid. It probably is still a bit too cheap, and it would certainly be a mistake for Beijing to allow it to fall, not least because this would risk a protectionist backlash from abroad. In the longer term, the yuan needs to keep rising against a basket of currencies. But for now, some of the accusations being thrown at China are wide of the mark. ■

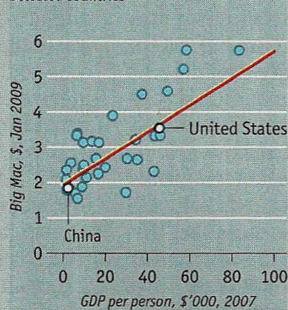
*"China's current account and exchange rate". NBER working paper 14673.

Food for thought

The yuan, January 2005=100



Big Mac prices v GDP per person
Selected countries



Sources: BIS; Thomson Datastream; *The Economist*; IMF