Asian currencies

Hot air

HONG KONG

The world's bounciest economies have its most undervalued currencies

THE leaders of the world's biggest economies agreed at the G20 meeting in Pittsburgh last month to work to prevent global imbalances of the sort that exacerbated the financial crisis. But talk is cheap, not least because the bigwigs did not even discuss exchange rates.

One of the biggest inconsistencies in the global economy today is the fact that emerging Asian economies have rebounded faster than any other region (the gap between their average growth rate and that of developed economies is likely to hit a record high this year), yet most of their currencies have fallen since 2008 in real trade-weighted terms. By many measures—from *The Economist*'s Big Mac index to more sophisticated gauges—Asian currencies are among the world's most undervalued.

Take China, the fastest-sprinting economy. In the three years to July 2008 the yuan climbed by 21% against the dollar. But for the past 14 months it has, in effect, been repegged to the dollar. As a result the slide in the greenback has dragged down the yuan's trade-weighted value by almost 10% since the start of this year (see chart). Morris Goldstein and Nicholas Lardy of the Peterson Institute for International Economics estimated in July that the yuan was undervalued by 15-25%. Some smaller Asian currencies may be even more undervalued. The IMF calculated in March that by one measure South Korea's won was 41% below its fair value (its trade-weighted value has since gained about 10%).

The fact that Japan's new government has allowed the yen to climb against the dollar, even though its economy is weaker, may seem to buck the regional trend. The yen is up by 18% over the past year and touched an eight-month high on September 28th, after comments from Hirohisa Fujii, the new finance minister, appeared to suggest that the government would not intervene to stem the rise. But squeals from Japanese exporters, as well as claims that the government has adopted a new "strong yen" policy, can mislead. Mr Fujii has since denied that he favours a stronger currency, and the yen still looks relatively weak by past standards: its real trade-weighted value has fallen by 7% since January and is below its 15-year average.

A cheap trick

The yuan, January 2005=100

Sources: JPMorgan; Thomson Reuters

Outside Japan, Asian governments have been forced to step up their intervention to hold down currencies as foreign-capital inflows have surged on optimism about recovery. China's foreign-exchange reserves rose by a record $178 billion in the second quarter, compared with an increase of only $8 billion in the first quarter.

China's motive for halting the yuan's rise against the dollar is to stem the collapse in its exports. Its trade surplus in the three months to August was less than half its level a year ago (though its current-account surplus is still likely to amount to a hefty 6% of GDP this year, maintaining upward pressure on the currency). The Chinese government is unlikely to let the yuan start rising again against the dollar until three conditions are met: exports show a year-on-year increase, GDP growth hits 10% and inflation turns firmly positive. All three are possible by the end of the year, and there are good reasons to think that the government in Beijing will then relax its exchange-rate policy.

One reason to do so is to curb asset-price bubbles and prevent excessive inflation. Measured by the gap between current interest rates and expected nominal GDP growth in 2010, China has the world's loosest monetary policy—too loose for its booming economy. But the cost of raising interest rates would be a stronger currency as foreign capital flows in.

A second reason why China may allow a stronger yuan is its desire to increase use of its currency in international trade and finance. In recent months China has allowed cross-border trade with some economies to be settled in yuan; it has raised quotas on share purchases by foreign institutional investors; and on September 28th it sold yuan-denominated government bonds in Hong Kong for the first time. If China wants to make the yuan a global currency this will require further loosening of foreign-exchange controls, and hence revaluation.

Last, but not least, the crisis painfully underlined the limits of export-led growth. China's proclaimed goal of boosting household spending requires a stronger currency, which would lift consumers' real purchasing power. If China allows the yuan to rise, other Asian countries are likely to follow suit. Only then will Asia play its full part in global rebalancing. ■