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KEY ASIAN CURRENCIES STILL SUBSTANTIALLY UNDERVALUED WITH RESPECT TO DOLLAR

Washington—A new study from the Peterson Institute for International Economics concludes that the dollar is still significantly overvalued against a number of Asian currencies, most prominently the Chinese renminbi and the Japanese yen. The renminbi needs to rise by about 30 percent against the dollar and the yen should strengthen by about 20 percent. A number of other Asian currencies (and a few elsewhere) also need to appreciate substantially so the desired increases amount to much less on a trade-weighted average basis: under 20 percent for the renminbi and only about 5 percent for the yen.

The study also concludes that the euro and the pound are now overvalued on average. They have not overshot greatly against the dollar, however, and the depreciation in their effective exchange rates should come largely from the appreciations of a number of Asian currencies.

On average, the dollar is now overvalued by less than 10 percent. It has declined by almost 25 percent since early 2002 and, partly as a result, the US current account deficit has improved by about \$80 billion (falling from about 6 percent of GDP to about 5 percent). This gain would have been larger without the sharp rise in the price of oil imports, and the reduction in the “real” deficit (as incorporated in the GDP accounts) has been considerably larger.

These are among the conclusions of *New Estimates of Fundamental Equilibrium Exchange Rates*, a Policy Brief by Senior Fellows William R. Cline and John Williamson that estimates the FEERs of all the leading advanced and emerging-market economies. They derive the present misalignment of each currency and find the set of exchange rates against the dollar needed to correct all these misalignments simultaneously. The estimates are based on a set of current account targets that in general do not exceed 3 percent of GDP, whether deficits or surpluses. Adjustments needed to reach these targets are translated into needed exchange rate realignments.¹ The Institute will be releasing estimates of this type periodically.

1. The model used for the calculations in this study is set forth in an associated Working Paper by Cline, entitled *Estimating Consistent Fundamental Equilibrium Exchange Rates*.

The principal results of the study are shown in table 1. It concludes that there remain significant undervaluations of a number of Asian currencies against the dollar and against several other advanced-country currencies including the euro, the pound, and the Canadian dollar. The long-standing overvaluation of the dollar in terms of those three currencies has now ended, however, and may even have mildly overshot.

The Asian currencies that should appreciate most are the Singapore dollar, the Chinese renminbi, the Malaysian ringgit, the New Taiwan dollar, and the Japanese yen. The Korean won is the only Asian currency estimated to be overvalued, despite which it would need to appreciate against the dollar (but not on a trade-weighted average basis) as part of the needed multilateral realignment.

Table 1 Currency realignments needed to reach fundamental equilibrium exchange rates (FEERs)

Country/ Region	Percent change from base ^a		Currency level against the dollar		
	Trade-weighted average	Bilateral vs. the dollar	FEER equivalent	July 1–15, 2008	Percent change needed
Industrial countries					
Canada	-4.1	-1.5	1.02	1.01	-0.6
Euro area ^b	-7.2	-0.2	1.47	1.58	-7.0
Japan	5.7	19.0	90.1	106.5	18.2
Switzerland	21.4	23.9	0.88	1.02	16.3
United Kingdom ^b	-6.6	-2.5	1.91	1.98	-3.7
United States	-8.6	0.0	1.00	1.00	0.0
Developing Asia					
China	18.4	31.5	5.45	6.85	25.7
Korea	-3.5	11.2	850	1,024	20.5
Malaysia	12.3	30.7	2.47	3.25	31.8
Singapore	24.7	41.2	1.00	1.36	36.2
Taiwan	9.0	26.0	25.1	30.4	21.2
Other developing					
Mexico	-0.4	2.0	10.6	10.3	-2.5
Poland	-8.6	-6.1	2.59	2.10	-19.1
South Africa	-14.6	-6.7	8.21	7.73	-5.9
Turkey	-13.0	-8.5	1.32	1.23	-7.0

a. February 2008

b. Dollars per currency unit

In the case of the Asian currencies in particular, the needed appreciations against the dollar are much larger than their appreciations against the averages of their trading partners. This is because the Asian countries trade a great deal with each other so that, if they all appreciate simultaneously, they lose much less competitiveness on average than they would against the United States and other dollar-linked countries.

Several other currencies besides the dollar, pound, euro, Canadian dollar, and won are estimated to be overvalued. The largest overvaluations at present are those of the South African rand, the Turkish lira, and the Polish zloty.

The biggest undervaluations are estimated to be those of the Singapore dollar and the Swiss franc. These currencies are severely undervalued even though their current account surpluses are in part rationally motivated and hence their appropriate current account targets are twice as large as those of other countries (6 percent of GDP rather than the standard 3 percent).

Both of the countries bordering on the United States, Canada and Mexico, are estimated to have exchange rates that are currently very close to equilibrium both on average and against the dollar.

Although one of the simulations performed in the study assumed that oil-exporting countries should be subject to the same considerations as other countries, the central simulations that generated the results reported above did not attempt to estimate equilibrium exchange rates of oil-exporting countries. Forecasts of both the future oil price and how much these countries would save on a long-term basis are too tenuous to place such estimates on a solid footing.

Factors other than exchange rates of course influence the actual adjustment of current account imbalances. The most critical additional factor is economic growth rates. An assumption underlying this analysis is that governments will expand or contract domestic demand to maintain noninflationary full employment (i.e., they will offset the demand impact of a change in the foreign balance) when the foreign value of their domestic currency increases or decreases.

About the Authors

William R. Cline is a senior fellow jointly at the Peterson Institute for International Economics and the Center for Global Development. He has been a senior fellow at the Institute since its inception in 1981. During 1996–2001, while on leave from the Institute, he was deputy managing director and chief economist at the Institute of International Finance. He was a senior fellow at the Brookings Institution (1973–81); deputy director of development and trade research, office of the assistant secretary for international affairs, US Treasury Department (1971–73); Ford Foundation visiting professor in Brazil (1970–71); and lecturer and assistant professor of economics at Princeton University (1967–70). His publications include *Global Warming and Agriculture: Impact Estimates by Country* (2007), *The United States as a Debtor Nation* (2005), *Trade Policy and Global Poverty* (2004), *Trade and Income Distribution* (1997), *International Debt Reexamined* (1995), *International Economic Policy in the 1990s* (1994), and *The Economics of Global Warming* (1992).

John Williamson, senior fellow at the Peterson Institute, has been associated with the Institute since 1981. He was project director for the UN High-Level Panel on Financing for Development (the Zedillo Report) in 2001; on leave as chief economist for South Asia at the World Bank during 1996–99; economics professor at Pontificia Universidade Católica do Rio de Janeiro (1978–81), University of Warwick (1970–77), Massachusetts Institute of Technology (1967, 1980), University of York (1963–68), and Princeton University (1962–63); adviser to the International Monetary Fund (1972–74); and economic consultant to the UK Treasury (1968–70). He is author, coauthor, editor, or coeditor of numerous studies on international monetary and development issues, including *Reference Rates and the International Monetary System* (2007), *Curbing the Boom-Bust Cycle: Stabilizing Capital Flows to Emerging Markets* (2005), *Dollar Adjustment: How Far? Against What?* (2004), and *After the Washington Consensus: Restarting Growth and Reform in Latin America* (2003).

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