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NEW BOOK CALLS FOR FURTHER CHINESE CURRENCY REFORMS

WASHINGTON—In an important new study of China’s currency practices, two senior fellows at the Peterson Institute for International Economics conclude that China’s currency, the renminbi, remains significantly undervalued and that China should continue its currency reforms even in the face of a global economic slowdown. Morris Goldstein and Nicholas Lardy, in their new book *The Future of China’s Exchange Rate Policy*, also recommend that China disavow any future strategy of “competitive undervaluation” of the renminbi that might be aimed at dealing with reduced global demand for Chinese exports. They call for a further appreciation of the renminbi, although at a slower pace than in 2008, and for rejection of export promotion measures, even if such steps are technically consistent with China’s World Trade Organization (WTO) obligations.

The authors say that when the global economy begins to recover, the Chinese authorities should increase the pace of appreciation. They call for China to reach a goal of substantially reducing, within three to four years, its slightly diminished—but still large—current account surplus. When this has been achieved, the authors conclude, the Chinese authorities should further curtail their intervention in the foreign exchange market and remove the daily fluctuation limit on the renminbi (so that the currency would essentially be floating). The Chinese authorities should also further liberalize restrictions on international capital flows, the authors say. This policy trajectory, they assert, would demonstrate that China is working cooperatively and constructively to address the global recession, reduce overinvestment in tradable goods industries, provide increased room to maneuver in the implementation of monetary policy, and put China on the path toward capital account convertibility.

The Peterson Institute’s new study comes at a time when China’s policies and practices have been at the center of worldwide debate and controversy. In much of this period, the United States, the International Monetary Fund, and others have called on China to let the value of its currency rise. The new book is the latest in a series of studies and warnings on the subject by the Peterson Institute, which first voiced many of these concerns in 2003, some years ahead of the major international leaders and policymakers.

Four years ago, partly in response to some of this global criticism, China initiated a reform of its exchange rate policy. It remains unclear, however, how the Obama administration will handle the issue. Publication of *The Future of China's Exchange Rate Policy* comes at a pivotal moment, only one week before first session of the Strategic and Economic Dialogue between high-level administration officials—led by Treasury Secretary Timothy Geithner and Secretary of State Hillary Rodham Clinton—and their Chinese counterparts, scheduled July 27–28 in Washington.

Mr. Goldstein and Mr. Lardy conclude, in their book, that China has taken some significant strides to let the renminbi rise in value but that some of this rise is attributable to the appreciation in the value of the dollar against other currencies resulting from the global economic turmoil and the “flight to safety” of investors seeking dollar-denominated securities. The book provides a comprehensive review of the steps by China since its 2005 announcement of financial and currency reforms, and it examines the difficult challenges and policy choices that China faces in the future.

Beyond these major conclusions, the book traces the recent history of Chinese practices and policies, reaching several conclusions. First, the origins of China's undervalued currency of the past 5–6 years lie in the decision of the authorities in the mid-1990s to fix the nominal value of the renminbi to the dollar. This policy was a great success for the first five years because the value of the dollar was appreciating and the nominal peg of the renminbi to the dollar meant that the Chinese currency was appreciating steadily on a real, trade-weighted basis. The pace of this appreciation, more than 3 percent per year, roughly offset the growth of productivity in China's tradable goods sector. Thus Chinese goods did not gain in international competitiveness, and China's external surplus from the mid-1990s through the early years of this decade averaged only 1–2 percent of gross domestic product.

But beginning in 2002 the dollar began to depreciate and China's nominal peg to the dollar meant that its currency began to depreciate in real effective terms. Productivity growth in the tradable goods sector continued, so the gap between China's equilibrium exchange rate and its real effective exchange rate began to widen. By mid-2005, when the currency reform was announced and China abandoned the renminbi:dollar peg, the gap between these two rates (one measure of undervaluation) was about 25 percent.

A second conclusion is that two years after the new currency policy came into force, the degree of undervaluation of the renminbi was actually greater than in mid-2005. Through late 2007 the cumulative real, trade-weighted appreciation of the renminbi was less than productivity growth in the tradable goods sector, so the degree of undervaluation deepened. In the process, the current account surplus soared from 1.3 percent of gross domestic product in 2001 to an astonishing 11 percent in 2007.

From November 2007 through the end of 2008, however, the pace of appreciation increased substantially. According to three alternative measures of the real effective exchange rate analyzed in the study, half to three-quarters of the cumulative appreciation of the renminbi between July 2005 and the end of 2008 occurred in the period of November 2007–December 2008. The central feature of this conclusion is that the degree of undervaluation of the renminbi is still 15 to 25 percent on a real, effective basis. The currency is less undervalued than it was in late 2007, however.

Third, the study concludes that in Chinese past two years the authorities have taken more forceful action to rebalance the sources of China's economic growth. They seek to encourage increased domestic consumption and to reduce the reliance on an expanding trade surplus to generate that growth. The acceleration of the pace of appreciation of the renminbi from late 2007 onward is one example of this. Another is the dramatic increase in government outlays for social programs, including education, health, and social security. Budget outlays on these programs increased by more than three-fifths between 2006 and 2008. Most noticeably, government outlays on health doubled, facilitating a substantial expansion of health insurance coverage and a reduction in the share of healthcare costs paid out of pocket by Chinese households. This accelerated rebuilding of China's social safety net will eventually reduce the precautionary demand for savings and increase household consumption, Goldstein and Lardy say. Chinese authorities recently have also introduced important reforms that have increased the prices of fuels and electricity, effectively reducing the subsidies that have primarily benefited the production of tradable goods.

The Future of Chinese Exchange Rate Policy
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Morris Goldstein and Nicholas R. Lardy
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ABOUT THE AUTHORS

Morris Goldstein, Dennis Weatherstone Senior Fellow since 1994, has held several senior staff positions at the International Monetary Fund (1970–94), including deputy director of its Research Department (1987–94). He is the author of *Managed Floating Plus* (2002), *The Asian Financial Crisis: Causes, Cures, and Systemic Implications* (1998), *The Case for an International Banking Standard* (1997), and *The Exchange Rate System and the IMF: A Modest Agenda* (1995), coeditor of *Debating China's Exchange Rate Policy* (2008), and *Private Capital Flows to Emerging Markets after the Mexican Crisis* (1996), coauthor of *Controlling Currency Mismatches in Emerging Markets* (2004) and *Assessing Financial Vulnerability: An Early Warning System for Emerging Market* (2000), and project director of *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (1999).

Nicholas R. Lardy, senior fellow at the Peterson Institute for International Economics since 2003, was a senior fellow in the Foreign Policy Studies Program at the Brookings Institution from 1995 to 2003. He was the director of the Henry M. Jackson School of International Studies at the University of Washington from 1991 to 1995. From 1997 through the spring of 2000, he was the Frederick Frank Adjunct Professor of International Trade and Finance at the Yale University School of Management. His publications include *Debating China's Exchange Rate Policy* (2008), *China's Rise: Challenges and Opportunities* (2008), *China: The Balance Sheet* (2006), *Prospects for a US-Taiwan Free Trade Agreement* (2004), *Integrating China into the Global Economy* (Brookings Institution Press, 2002), *China's Unfinished Economic Revolution* (Brookings Institution Press, 1998), *China in the World Economy* (Institute for International Economics, 1994), and *Foreign Trade and Economic Reform in China, 1978–1990* (Cambridge University Press, 1992).

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