



## Op-eds

### China's Currency Needs to Rise Further

by [Morris Goldstein](#), Peterson Institute  
and [Nicholas R. Lardy](#), Peterson Institute

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The currency regime China adopted three years ago this week is faltering. Official reserves grew by a massive \$280 billion (£140 billion, €177 billion) in the first half of 2008. The central bank has strengthened controls on capital inflows. Consumer price inflation has risen to 8 percent. The currency has become more flexible and appreciated about 20 percent against the dollar. But on a real trade-weighted basis the appreciation has been only 15 percent. China's current account surplus has soared, from 3.6 percent of gross domestic product in 2004 to 11.3 percent last year.

The undervaluation of the renminbi has in fact increased in the past three years because the equilibrium value of the currency, the value consistent with economic fundamentals, has risen even faster, as its external surplus has mushroomed and as rapid productivity growth in export industries has enhanced China's competitiveness. The appreciation in China's real trade-weighted exchange rate is only about a third to a half of what is needed. Dominique Strauss-Kahn, managing director of the International Monetary Fund, recently characterized the renminbi as "substantially undervalued."

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Last year, for the first time in more than five years, the government slightly increased its own outlays on health, education, and other social programs as a share of GDP. But this was not enough to offset the multi-year decline in household consumption, which slumped to a new low of only 35 percent of GDP. As a result, the contribution of consumption to growth remains depressed. Investment, on the other hand, exceeded two-fifths of GDP last year for the fifth

consecutive year. In short, China has remained heavily dependent on investment and growing trade surpluses to sustain its double-digit growth rate. Rebalancing the sources of growth will require more rapid appreciation of the renminbi as well as other policy adjustments.

One cause of China's elevated investment rate is that interest rates remain low. Indeed, they are now negative in real terms, in part because the authorities are reluctant to adjust upward for fear of attracting even more speculative capital inflows. Low lending rates contribute to an excess demand for loans and thus the high share of investment in GDP. Low deposit rates have depressed the growth of household income far below the levels that would have been achieved with less financial repression. China will find it hard to change to more consumption-driven growth as long as household income continues to decline as a share of GDP.

Bank profitability has suffered, as the authorities engage in massive sterilization to prevent increases in international reserves from spilling over into an undesirably rapid increase in bank lending. The central bank has raised the level of required reserves, which pay a negative real return, 19 times since mid-2005. The authorities have also "sold" banks huge volumes of sterilization bonds that bear negative real yields. They have more than offset these implicit taxes on banks by maintaining a large spread between lending and deposit interest rates, but this spread will erode as further domestic financial reform and globalization expand the alternatives available to Chinese savers and borrowers.

Progress on China's currency regime should not be evaluated by focusing exclusively on movements in the renminbi/dollar exchange rate. China is still suffering from serious misalignments in two crucial relative prices: the real exchange rate and the real interest rate. Unless China narrows markedly the gap between the real and equilibrium exchange rate of the renminbi by reducing the scale of intervention and sterilization and sharply accelerating the pace of renminbi appreciation, it will find it ever harder to prevent speculative capital inflows from undermining its pursuit of independent monetary policy. A step revaluation of the renminbi would be helpful. Likewise, unless China increases interest rates significantly, it will continue to face strong headwinds in rebalancing the sources of its economic growth. Bolder reforms in these two areas would increase the odds of a more positive verdict from future currency reform anniversaries.