China’s currency needs to rise further

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

The under-valuation 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 characterised the renminbi as “substantially under-valued”.

Nor has China’s new exchange rate policy been helpful in “rebalancing” economic growth towards consumption and away from investment and net exports, or in alleviating the repression in the banking system, both of which are strongly in China’s own interest.

Last year, for the first time in more than five years, the government slightly increased its own outlays on health, education and other social programmes 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 36 per cent 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 sterilisation 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 sterilisation 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 globalisation 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 sterilisation 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.

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