

RENMINBI CONTROVERSIES

Morris Goldstein

No topic in international monetary economics has probably been more debated over the past three years than what should be done about China's currency regime and about the exchange rate for the renminbi (RMB). In this article, I take up three questions that are at the center of the current debate, namely: (1) Is the RMB undervalued and, if so, by how much? (2) Would an RMB appreciation of 20–25 percent be particularly harmful for China's economic growth and development, as well as for its domestic financial stability? (3) Was the July 21, 2005, currency reform a large or tiny step forward?¹

Is the RMB Undervalued?

Among the many approaches available for estimating equilibrium exchange rates, I prefer two: the “underlying balance” approach and the “global payments” approach. In both cases, I am going to assume that no wholesale change occurs in China's capital-account regime over say, the next three years.²

Under the *underlying balance approach*, one asks what level of the real effective exchange rate—that is, the trade-weighted average of nominal exchange rates adjusted for inflation differentials between the home country and its trading partners—would produce

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¹Another controversial issue is whether China has been “manipulating” the value of the RMB counter to its obligations as a member of the International Monetary Fund. In Goldstein (2006a), I answer that question in the affirmative.

²On April 14, 2006, the Chinese authorities announced a set of foreign exchange liberalization measures, including an easing of restrictions on portfolio capital outflows. Like Anderson (2006), I expect the initial impact of this liberalization on China's balance of payments to be quite small. The effect over the next few years is likely to be moderate but not enough to invalidate the conclusion that China's overall balance of payments is apt to be still in substantial disequilibrium.

equilibrium in the home country's balance of payments, where equilibrium means an "underlying" current account position that is approximately equal (and opposite in sign) to "normal" net capital flows.

Suppose we take the average of China's capital account balance over the 1999–2002 period—a surplus equal to 1.5 percent of gross domestic product (GDP)—as a rough estimate of its normal net capital flows.³ China's capital account surplus in 2003 and 2004 was much larger than that—on the order of 7–8 percent of GDP—but much of that appears to have been driven by speculative capital inflows, induced primarily by an expected appreciation of the RMB.

If normal net capital flows are in surplus by 1.5 percent of GDP, equilibrium then calls for an underlying current account *deficit* equal to 1.5 percent of GDP. The "underlying current account" can be defined as the actual current account balance adjusted for two factors: cyclical movements in the economy that make the demand for imports unusually high or low, and the lagged trade effects of earlier exchange rate changes that are not yet visible in the published statistics. China's actual, overall current account surpluses in 2003 and 2004 were 3.3 and 4.2 percent of GDP, respectively. The underlying current account surplus was undoubtedly higher than the actual ones in those two years because the overheated state of the Chinese economy was pushing the demand for imports way up and because the real, trade-weighted value of the RMB depreciated during that period, suggesting positive trade-balance effects in the pipeline (see Goldstein 2004). Without pretending to undue precision, the underlying current account surplus in 2003–2004 was probably in the neighborhood of 4.5–5 percent of GDP.

China's actual global current account surplus in 2005 was much larger still. Based on official figures just recently released, the actual current account surplus last year was 7.2 percent of GDP. The underlying surplus would be somewhat lower because domestic demand growth slowed in China last year—reducing the growth of imports—and because the RMB appreciated in real, trade-weighted terms in 2005.⁴ Nevertheless, the underlying current account surplus in 2005 was likely on the order of 5–6 percent of GDP.

³Using the revised GDP series released in January 2006, the figure for normal net capital flows would be a surplus equal to 1.4 percent of GDP.

⁴According to J. P. Morgan's index of real effective exchange rates, the RMB appreciated about 9 percent in 2005—reducing its cumulative depreciation since the dollar peak in February 2002 to about 2 percent. In contrast, Citigroup's index of real effective exchange rates has the RMB appreciating about 6 percent in 2005—leaving the cumulative depreciation since February 2002 at a still substantial 11 percent.

The foregoing implies that China's current account balance needs to deteriorate by a whopping 6.5–7.5 percent of GDP to restore equilibrium to its overall balance of payments. If one does some simulations with a small trade model to calculate what size real appreciation of the RMB would generate such a large negative swing in China's current account—using a range of plausible price elasticities, giving due consideration to how the high import content of China's exports affects its export prices, and making alternative assumptions about the second-round feedback effects of income changes on the demand for imports—the answers tend to congregate in the 20–35 percent range.⁵ Note again that this estimate of undervaluation of the RMB is not dependent either on the large speculative capital inflows of recent years or on China's large and rising bilateral trade surplus with the United States.

A second complementary approach, the *global payments approach*, asks what role RMB adjustment should play in the correction of large existing payments imbalances around the world—not just in China. Here, the elephant in the room is the large U.S. current account deficit—running at about 6.5 percent of GDP in 2005 and threatening to go higher over the medium term (see Cline 2005). An analysis of U.S. external debt dynamics suggests that a deficit only about half that size is likely to be sustainable. As argued by Mussa (2005) and others, one key element in any effective strategy to correct the U.S. external imbalance, while simultaneously sustaining healthy global economic growth, is a further depreciation in the real trade-weighted dollar from its current level—on the order of 15–25 percent.⁶

Emerging Asia plus Japan account for about a 40 percent weight in the trade-weighted dollar index. Whereas the euro, the Canadian dollar, and the Australian dollar, among other market-determined exchange rates, have shown strong (real effective) appreciations during the first wave of dollar depreciation (since February 2002), the Asian currencies—with the notable exceptions of the Korean won and Indonesian rupiah—have either appreciated only slightly (e.g., Thai

⁵Even for a given set of elasticities, estimates of the degree of undervaluation change over time, reflecting changes in trade balances, exchange rates, the cyclical position of the economy, and other factors.

⁶Other key elements include: a credible medium-term plan of fiscal consolidation in the United States that, in concert with a steady tightening of U.S. monetary conditions, would slow domestic demand growth relative to output growth; and policy measures in Europe and Japan that would increase the growth of domestic demand relative to the growth of output. According to J. P. Morgan's indexes of real, trade-weighted exchange rates, the dollar has fallen about 19 percent since the dollar peak in February 2002; Citigroup's index places the dollar depreciation since the February 2002 peak at a smaller 14 percent.

baht and the Indian rupee) or have actually depreciated.⁷ In some cases (the Malaysian ringgit, the Japanese yen, and the Taiwanese dollar), the depreciation has been large despite sizable current account surpluses. If the Asian currencies do not lead the way in the needed second wave of dollar depreciation, either the resulting overall depreciation of the dollar will be too small, or the burden of appreciation will fall heavily on economies where a further large appreciation would not be warranted by their economic circumstances (see Goldstein 2005).⁸

Under the global payments approach, China is a prime candidate for significant real currency appreciation: it has experienced massive reserve accumulation equal to 10 percent of GDP over each of the past three years; its real, trade-weighted exchange rate has depreciated over this period; and it has now recorded 10 successive quarters of 9 percent plus economic growth. Moreover, an appreciation of the RMB would likely induce some appreciation in some other Asian currencies.

To sum up, the message I take away from these approaches to assessing the equilibrium value of the RMB is that it remains significantly undervalued on a real, trade-weighted basis—on the order of 20–35 percent.⁹ A wholesale liberalization of controls on capital outflows could wipe out most of this undervaluation, but the fragile state of China's banking system makes this policy neither desirable nor likely for the next several years. True, there are other approaches to valuing the RMB (e.g., purchasing-power-parity calculations, structural models of the RMB, and VAR models), and there are other ad hoc adjustments one could make to obtain estimates of underlying current accounts and normal capital flows. None of those approaches, however, yields results persuasive enough and different enough to overturn the large undervaluation verdict.¹⁰

⁷The J. P. Morgan and Citigroup indexes of real effective exchange rates differ substantially from each other on the recent movements of the Singapore dollar and Philippine peso.

⁸Truman (2005) considers various scenarios for reducing the U.S. current account deficit to 3 percent of GDP, including one where Asian currencies lead the second wave of appreciation against the U.S. dollar. In that latter scenario, the RMB appreciates in real trade-weighted terms by 17 percent and by 41 percent against the dollar.

⁹Using an approach that focused on restoring medium-term equilibrium to the “basic balance” in China's balance of payments, Anderson (2005b) calculated that the RMB was undervalued (on a real effective basis) by about 25 percent. Cline (2005) finds that the RMB is undervalued by 21 percent on a real trade-weighted basis from its March 2005 level and is undervalued by 46 percent in real terms against the U.S. dollar relative to a 2002 base.

¹⁰Many of these studies are reviewed in Cheung, Chinn, and Fujii (2005).

Would an RMB Revaluation Be Bad for China's Growth and Financial Stability?

Many have argued that even if the RMB is undervalued, it would be most unwise to undertake a large revaluation since this could be catastrophic for China's growth and economic development, as well as its social and financial stability. In this context, some opponents of RMB revaluation emphasize the large-scale and continuing migration out of agriculture, the sizable employment losses in state-owned industries, and the large annual flow of graduates looking for work. Taken together, these labor force trends are said to create irresistible social pressures for rapid economic growth that can only be accommodated with the high export growth emanating from a highly undervalued exchange rate. Still others opposed to revaluation assert that the rigid link of the RMB to the dollar—along with its undervaluation—has served as an essential pillar of China's domestic financial stability and as a way of encouraging large inflows of foreign direct investment that can compensate for the weaknesses of China's domestic banking system.

I find these arguments against a significant RMB revaluation unpersuasive. Getting the arguments right about the benefits and costs of an RMB revaluation is important because China cannot be expected to undertake an exchange rate policy that is perceived to be counter to its self-interest. Let me offer three observations.

First, it is an exaggeration both to equate any significant real appreciation of the RMB with very slow growth and to regard exports as the main driver of China's growth.

Between 1994 and early 2002 the real, trade-weighted exchange rate of the RMB appreciated by almost 30 percent (see Figure 1), yet the Chinese economy grew at an average annual rate of 9 percent and growth never dipped below 7 percent in any single year (see Figure 2). True, this large real appreciation of the RMB did not come all at once, but there were individual years in which the appreciation was 8 percent or more (13 percent in 1997 and 8 percent in 2000).¹¹ Also, the record over this eight-year period demonstrates that the Chinese economy is capable of growing at a robust pace when the real exchange rate is following strong trend appreciation.

The export-to-GDP ratio in China is now approaching 35 percent. But as Anderson (2005a) has recently argued, this does not

¹¹Note also from Figure 2 that the strong trend appreciation of the RMB really took place over the first four years of this period.

FIGURE 1
 REAL EFFECTIVE EXCHANGE RATE OF THE RMB,
 1994–MARCH 2006

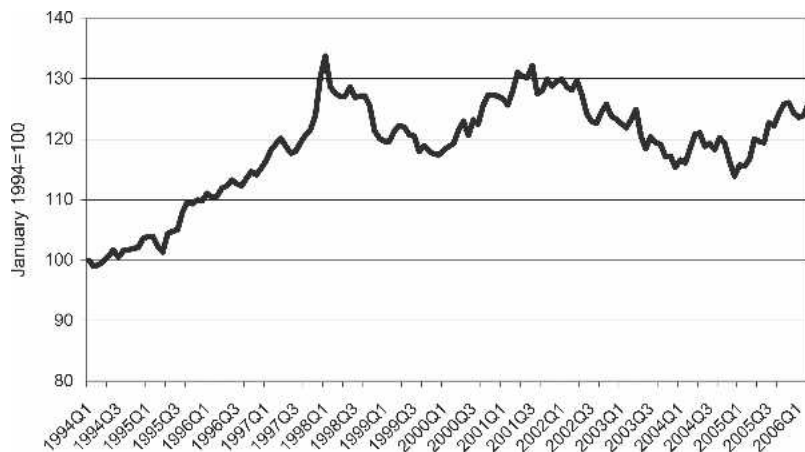
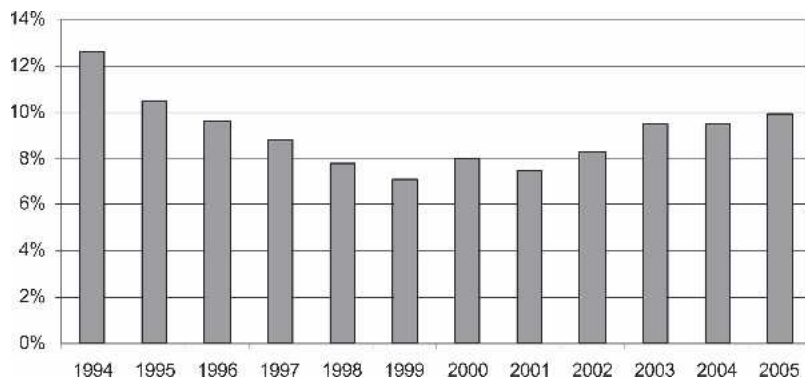


FIGURE 2
 CHINA'S GDP GROWTH, 1994–2005



mean that the Chinese economy is “export led.” Adjusting for the relatively low domestic content of exports makes China’s “true” export exposure lower than suggested by the headline export-to-GDP ratio. Anderson (2005a) goes on to argue that one salient characteristic of an export-led economy is that fluctuations in trade growth should be similar to those in broader GDP growth—whereas an economy that relies more on domestic demand for growth would display fluctuations in GDP growth that were considerably smaller

than those for trade growth. On this count, Anderson (2005a) finds that while the standard deviation of trade growth has been very similar to the standard deviation of GDP growth for a group of seven Asian economies, the standard deviation of GDP growth has been only about a third as high as that for trade growth in China. In fact, the relationship between GDP growth and trade growth in China looks much closer to that in the United States than it does to China's Asian neighbors.

In my work with Nicholas Lardy (Goldstein and Lardy 2004) on China's growth prospects, we have underlined that it is investment and consumption that have the dominant weights (40 percent or more each) in China's GDP and that it is their behavior that typically drives GDP growth in China—not net exports. In 2004, the weight of net exports in China's GDP was just under 3 percent. Net exports can thus have a major influence (positive or negative) on China's growth performance only in those years in which the percentage change in net exports is very large (say 75–100 percent or more). It turns out that 2005 was just such a year.¹² But this cannot go on indefinitely—as the rest of the world would surely resist a serial doubling of China's net export surplus.

Second, discussions of the impact of exchange rate revaluation should not proceed as if the exchange rate were the sole instrument of macroeconomic policy. In 2003 and much of 2004, an RMB revaluation would have simultaneously moved the economy closer to both internal and external balance. In the classic terminology of James Meade (1951), China was then in a “non-dilemma” situation for exchange rate revaluation because the domestic economy was strongly overheated at the same time that China was running a sizable global balance-of-payments surplus. But such non-dilemma situations do not last forever. In fact, China's domestic final demand growth slowed in 2005—the near 10 percent growth in real GDP notwithstanding. This may have created a dilemma for the authorities: a large, one-step revaluation would dramatically shrink the current account surplus but it could also slow economic growth more than desired.

Preliminary data for the first quarter of 2006 suggest that domestic demand growth is strengthening in China. But even if this strengthening were to prove short-lived, this does not mean that a significant revaluation of the RMB would then have to be abandoned. One

¹²China's goods trade surplus, as measured by Chinese Customs, was roughly three times larger in 2005 than in 2004.

option is to combine a sizable RMB revaluation with an expansionary fiscal policy directed at pressing social needs (e.g., pension, health, and education programs). In this way, the expenditure-switching role of revaluation can be retained while fiscal policy reduces the contractionary effect of revaluation on aggregate demand. This could be accomplished without exacerbating China's already excessively large share of fixed asset investment in GDP by focusing increased government expenditure on remedying deficiencies in China's social safety net. Once China's external imbalance declines to an appropriate level, fiscal policy can revert to a more normal, longer-term stance. A second (not mutually exclusive) option is to reduce somewhat the size of the initial revaluation so that it is still substantial enough (say, 10–15 percent) to make a credible down payment on reducing external imbalances but not so large as to depress economic growth unduly. The second stage of revaluation could then take place when domestic demand growth was more buoyant.

I want to stress that these two options are advisable only when there is a conflict between achieving internal and external balance and when the scale of the external imbalance has grown so large that a very big revaluation would be needed to eliminate it fully in one go. If the Chinese economy were to return to the overheating days of 2003–2004 and if China's current account surplus were to return to the 3–4 percent of GDP range of that period, a one-shot revaluation along with a widening of the band (followed a few years later by a floating of the RMB)—without fiscal expansion—would remain as my first choice.

Third, it should be recognized that continuing the present policy of maintaining a much undervalued RMB by engaging in large-scale, prolonged, one-way intervention in exchange markets risks inducing a protectionist response in China's major export markets.¹³ This cannot be good for China's growth prospects. On April 6, 2005, 67 U.S. senators voted for the Schumer-Graham amendment that called for imposing an across-the-board tariff of 27.5 percent on China's exports to the United States if negotiations between the United States and China on the value of the RMB proved unsuccessful. In its May 2005 "Report to Congress on International Economic and Exchange Rate Policies," the U.S. Treasury (2005a) warned that "if the current trends continue without substantial alteration, China's policies will likely meet the statute's technical requirements for designation (as an

¹³See Goldstein (2006b) on the links between perceived "unfairness" in exchange rate policies and protectionism.

economy that manipulates its currency).”¹⁴ On September 23, 2005, Under Secretary of the U.S. Treasury, Tim Adams (2005), urged the IMF to be more ambitious in its exchange rate surveillance. On March 28, 2006, Senators Grassley and Baucus introduced legislation (“The United States Trade Enhancement Act of 2006”) that, among other provisions, would disallow nonmarket economy countries with harmful, fundamentally misaligned currencies from achieving market economy status under U.S. antidumping laws.¹⁵

Over half of China’s exports go to the United States, the European Union, and Japan (with over 30 percent going to the United States alone). If China’s rapidly rising current account surplus, huge accumulation of reserves, and limited appreciation of the RMB persuade legislators and policymakers in the major industrial countries that China is blocking effective balance-of-payments adjustment and running afoul of IMF exchange-rate manipulation guidelines, China may well find its access to these markets constrained by new protectionist barriers. That could put a serious dent in China’s exports as well as damage the global economy. Indeed, the protectionist dent could well be larger than the dent associated with a 20 percent revaluation of the RMB. Put in other words, in thinking about the export and growth effects of an RMB revaluation, one should compare those with a reasonable counterfactual—and not to indefinite continuation of the present exchange rate policy and of present market access.

Just as the adverse growth effects of an RMB revaluation have been overstated, so too have the positive effects that a highly undervalued and quasi-fixed exchange rate are said to generate for China’s domestic financial stability.

It is widely agreed that China needs to improve the functioning of its banking system if it is to increase the efficiency with which capital is used in the economy (see Lardy 1998). A necessary element in any meaningful banking reform is better credit decisions based on an

¹⁴In the November 2005 “Report to Congress on International Economic and Exchange Rate Policies,” the U.S. Treasury (2005b) failed to name China as a “currency manipulator.” Nevertheless, that report noted that the actual operation of China’s post July 21, 2005, currency regime was “highly constricted” and that “future reports will intensely scrutinize whether and to what degree China is practicing what officials have previously committed to undertake.” That report also went on to indicate that Chinese President Hu told President Bush in October 2005 that China would unswervingly press ahead with reform of its exchange rate mechanism and that “the Chinese authorities should do so by the time this report is next issued.”

¹⁵The Grassley–Baucus legislation would also prevent the U.S. Executive Director at the IMF from voting for a quota increase for any country found to have a fundamentally misaligned currency that adversely affected the U.S. economy.

objective, forward-looking assessment of the borrower's creditworthiness. This objective is not well served by a substantially undervalued RMB.

An undervalued RMB induces both speculative capital inflows (chasing expected exchange rate appreciation) and a large trade surplus. It therefore leads, as has been amply demonstrated over the past three years, to a large accumulation of international reserves. This reserve accumulation in turn—if not countered by specific policy measures—can spill over into an excessively rapid expansion of bank credit (and of the monetary aggregates). And when bank credit expands too fast, the quality of loan decisions almost always suffers, with serious fiscal consequences. China experienced just such a bank credit “blowout” in 2003 and the first part of 2004, when bank credit growth expanded at a 20 percent plus clip and when the ratio of the increase in bank credit to GDP hit a historic high.¹⁶ While the main driver of that excessive credit expansion may well have been domestic rather than external factors, the external imbalance undeniably made the task of financial policy much more difficult.

The Chinese authorities were able to regain control over the growth rate of bank credit in 2004–2005—and bank lending growth returned to a more sustainable pre-blowout pace (about 13 percent). But the final tab for the lending excesses of 2003–2004 is likely to be large. Moreover, it was only through the use of both strong administrative controls (on bank lending, investment projects, and land use) and of large-scale sterilization operations that runaway credit growth was contained. Each of these measures carries its own costs. Bank managers and loan officers do not learn much about how to make better credit decisions if the central government steps in to direct the credit allocation process. Moreover, the controls are not well suited to responding in a timely way to changing financing and cyclical conditions. Indeed, in the first quarter of 2006 (after the controls had been eased), the growth of bank credit surged again, with that quarter's increase accounting for approximately half the targeted increase in bank lending for 2006 as a whole.¹⁷ In a similar vein, although the interest rate on sterilization bonds is relatively low and although the stock of reserves is high relative to the stock of sterilization liabilities,

¹⁶Simultaneously, inflation rates (for consumer and producer prices) also soared. Those too have since come down significantly. The decline in the growth rate of broad money has been less marked (since it accelerated in 2005).

¹⁷In a sign that the People's Bank of China (PBC) has begun to worry again about excessive credit growth, the PBC raised based lending rates by 27 basis points in late April (2006), while leaving deposit interest rates unchanged.

the full cost of sterilization is higher than meets the eye. It should include any subsequent capital loss on China's reserves if the RMB later appreciates strongly relative to reserve currencies, as well as any (shadow) costs imposed on the banking system by inducing state-owned banks to hold government bonds at less than an arms-length rate of return. If reserve accumulation and the scale of sterilization operations increase in the future, these costs will only become larger.

The contention that an undervalued RMB makes it possible for China to attract large amounts of incoming foreign direct investment (FDI) and that such large FDI inflows, in turn, permit Chinese firms to circumvent the weaknesses of the domestic banking system is equally fallacious. As pointed out in Goldstein and Lardy (2005b), FDI has financed less than 10 percent of China's total investment in recent years—far too small a figure to obviate the need for serious bank reform.

Turning from the level of the exchange rate to the currency regime, the “fixed” nature of China's regime has likewise increasingly become the enemy—not the ally—of domestic financial stability. As illustrated in Figure 1, long-term stability of the RMB against the U.S. dollar has not translated into stability in China's real effective exchange rate (since the dollar has moved markedly against the currencies of China's other trading partners)—and it is the real effective exchange rate that matters most for China's trade and competitiveness. Just as important, the rigid link of the RMB to the dollar has meant that China has had much less monetary policy independence than would be desirable—its controls on capital flows notwithstanding. For example, while it made good sense for the U.S. Federal Reserve to be reducing short-term policy interest rates in 2003 to deal with conditions in the U.S. economy, the overheating of the Chinese economy during that period called for the opposite stance of monetary policy. Yet the Chinese authorities may well have been discouraged from making timely upward adjustments in interest rates by the worry that, given the rigid link to the dollar, this would exacerbate their problems with large capital inflows. Such constraints on the use of monetary policy related to the currency regime continue. For example, the People's Bank of China (PBC) allowed (in the latter part of 2005) base money to grow more rapidly than would otherwise be called for on domestic stabilization grounds—perhaps out of concern that lower levels of liquidity and higher short-term interest rates would, in concert with the July 21 currency reform, stoke higher capital inflows.

Taking a longer-term perspective, while the Chinese economy has continued to deliver impressive average growth performance over the

past decade, there have also been large swings in growth and in inflation rates. Those swings probably could have been reduced had the authorities been able to rely more heavily on domestic interest rates and on a more flexible exchange rate as stabilizers. Imposing administrative controls on bank lending, tweaking controls on capital flows, and engaging in large-scale exchange market intervention and sterilization operations does not constitute a sensible long-term framework for conducting stabilization policy in China—even if bottom-line outcomes have been better than might have been expected. It is time for China to change both its exchange rate and its currency regime.

The Currency Reform of July 21, 2005

Some observers have argued that the needed currency reform in China is already well under way. On July 21, 2005, the PBC announced that China was revaluing immediately the RMB with respect to the U.S. dollar by 2 percent. It also indicated that it would “further strengthen the managed floating exchange rate based on market supply and demand,” and that “the RMB exchange rate will be more flexible based on market condition[s] with reference to a basket of currencies” (People’s Bank of China 2005).

Contrary to what was implied in some news accounts, the previous (daily) fluctuation band with respect to the dollar—no more than a 0.3 percent fluctuation from the previous day’s closing value—was retained, not widened. On September 25, 2005, the daily fluctuation band with respect to nondollar currencies was widened from the previous 1.5 percent to 3 percent. The scope for participation in the foreign exchange market and for instruments of foreign exchange trading have also been expanded somewhat.

It is too soon to evaluate with confidence the longer-term significance of the July 21 currency reform. But it is not too early to offer several observations.

First, those who argued at the time of the July 21 announcement that the 0.3 percent daily fluctuation limit for the RMB vis-à-vis dollar could just be China’s way of implementing a large and relatively rapid appreciation of the RMB with respect to the dollar—e.g., a 0.3 percent appreciation per day continuing over 60 days would produce an 18 percent appreciation of the RMB—have been disappointed. The RMB/dollar rate today is little different (about 1 percent more appreciated) from where it was on July 22, 2005. Also, the appreciation in the real trade-weighted RMB that took place in 2005 reflected primarily an appreciation of the dollar with respect to other

currencies and real trade-weighted depreciations of the euro and the Japanese yen (not a large real appreciation of the RMB with respect to the dollar). But since the real trade-weighted value of the dollar has to go down in the medium-term while the real effective exchange rate of the yen has to go up, these sources of recent (real effective) appreciation of the RMB will likely be reversed.

Second, the revaluation of the RMB that has occurred since July 21, 2005, is clearly way too small to make a meaningful contribution toward reducing either China's now huge external imbalance or large global payments imbalances more generally. If the undervaluation of the real, trade-weighted RMB is on the order of 20–35 percent, then the roughly 3 percent real effective appreciation of the RMB since July 2005 does not get you very far—no matter what sound bites China (or the G7 or IMF) utters about progress toward greater exchange rate flexibility.

Third, with average monthly intervention in the foreign exchange market during the first quarter of 2006 averaging about \$19 billion—about the same as a year earlier—there is little indication that the Chinese authorities are giving “market forces” a greater role in the determination of the RMB. Likewise, there has so far been little evidence that the RMB is being managed against a “basket” of currencies rather than against the U.S. dollar alone.¹⁸

Fourth, the small appreciation of the RMB will also do little to silence strong protectionist pressures in Washington and elsewhere. The July 21 announcement provided China with somewhat of a “honeymoon” from sharp criticism over its exchange rate policies. But that honeymoon is likely to end soon if China's overall current account surplus remains large and if China continues to engage in sizable, protracted, and one-way intervention in the exchange market to keep the RMB from appreciating much vis-à-vis the dollar. In such circumstances, a finding by the U.S. Treasury in May 2006 that China has *not* been acting as a “currency manipulator,” would carry little credibility and might prompt Congress to pass some kind of protectionist legislation. On the other side, a positive finding of manipulation by the Treasury could unsettle foreign exchange markets—as speculators bet on how the rising tensions might be resolved.

What then to do? Since the summer of 2003, Nick Lardy and I (Goldstein and Lardy 2003) have been recommending that China adopt a “two-stage” currency reform. In the first stage, China would adopt a basket peg, revalue the RMB by enough to remove the

¹⁸See Goldstein and Lardy (2006).

existing disequilibrium in China's balance of payments in one fell swoop, and widen the bands around the new peg. It would also retain most of its controls on capital outflows. In stage two—several years down the road when China's banking system was strong enough—it would float the RMB and remove the controls on capital outflows.

Unfortunately, it now looks like the Chinese authorities have let pass the window of opportunity to implement “two-stage” currency reform along the lines we originally proposed. China's underlying current account surplus and the associated undervaluation of the RMB are now larger than before; the size of the initial RMB revaluation announced on July 21 was grossly inadequate and little appreciation of the RMB has occurred since then; and tensions between the United States and China over exchange rate policies have risen. It therefore no longer looks feasible to expect all of China's needed RMB adjustment to be accomplished in one step. We are thus well into the realm of the second best.

Conclusion

If a train wreck is to be avoided, China needs to make a meaningful “down payment” of 10–15 appreciation of the RMB from its current level within the next say, three to six months. The United States should show its intent to put its own house in order and to reduce its saving-investment imbalance by proposing a more ambitious and more credible medium-term plan for fiscal consolidation.

That approach would still leave a sizable real appreciation of the RMB to be done later, with all the expectations-cum-capital-flow problems that such a phased exchange rate adjustment entails.¹⁹ Moreover, other key players in the system—including members of the European Union, other Asian economies plus Japan, and the IMF—would also need to firm up their contributions to global adjustment.²⁰ But at least there would be a shared recognition that sustainable progress was being made in overcoming both the very large undervaluation of the RMB and the fiscal policy excesses of the United States.

Just as important, a helpful signal would be sent to financial markets that the United States and China were committed to leading the

¹⁹See Goldstein and Lardy (2003) on the expectations problem when exchange rate misalignments are reduced in stages.

²⁰The IMF has an important role to play in *enforcing* its guidelines on exchange rate surveillance—something it has not been doing to date (Goldstein 2006a). The Fund could also be helpful in any negotiations on a coordinated set of exchange rate changes in Asia.

way on global payments adjustment in a manner that kept markets open and that supported economic growth.

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