Yuan value: Stumbling Block to Regionalism

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Voice of China-India-Japan: Some Issues

• Regional Co-ordination led by the three major countries of Asia, China, India and Japan

•Why the need for another region?

•Lessons from the Euro

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Lessons from the Euro

- Not clear integration has worked in an economic sense
- Recent PIIGS crisis – how much due to Euro?
- Currency values of major concern

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Lessons from the Great Global Recession

- Global Imbalances
- Exchange Rate Misalignment
- But how do we know that exchange rate is misaligned?

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Possible consequences of currency misalignment

- Accumulation of Reserves
- Current account surpluses instead of deficits
- Intervention in foreign exchange markets

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Other consequences of currency misalignment

- Investment is a function of currency undervaluation; lowers costs, increases profits
- This affects growth in own country and in other countries
- So if China undervalues its currency, and by not insignificant amounts, it hurts investment, and exports, and growth in India and Japan.
- So how can collaboration be possible, on equal terms, if China's currency is deeply undervalued?

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How do we know that the Chinese yuan is undervalued?

- Natural experiment – world faced a similar problem in the mid 1980s
- It was thought that the yen was undervalued and an inter-governmental committee decided to change the value of the yen – the Plaza agreement
- The yen appreciated by 40 percent – from 238 in 1984 to 145 in 1987
- This led to a major slowdown in the Japanese economy in subsequent years
- This may be an important factor in China's reluctance to change course – look what happened then, the same will happen now.

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Indicators of currency misalignment

- Look at several indicators of output and two indicators of input – changes in the real effective rate (inflation adjusted) and real depreciation that occurs due to higher productivity growth and prevention of currency appreciation

- The latter is the Balassa-Samuelson adjustment or what I term the "standing still" real depreciation

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Comparing Japan 1970 to 1985 to China 1990-2005

- 1985 marked the bottom of the yen in much the same way as 2005 marked the bottom o fthe yuan; similar inter-governmental action followed ; Plaza agreement in the case of Japan and the beginning of currency appreciation in China; so the two periods are comparable (shorter periods e.g. 1982 to 1985 and 2002-2005 yield the same results).
- Look at several indicators of "output" and two indicators of "input" – changes in the real effective rate (inflation adjusted) and real depreciation that occurs due to higher productivity growth and prevention of currency appreciation
- The latter is the Balassa-Samuelson adjustment or what I term the "standing still" real depreciation
- Some orders of magnitude or what to expect – the elasticity of real exchange rate appreciation with respect to relative per capita income growth (proxy for relative productivity growth) is around 0.75 i.e. each 10 percent extra growth (extra to US) means the currency in question has to appreciate by 7.5 percent just to stay at the same level of under or over valuation.

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Yuan – if undervalued in 2005, considerably more undervalued in 2010

- Claim by some experts is that the 20 percent nominal appreciation that has been seen in the Chinese yuan since 2005 is sufficient to eliminate any undervaluation that had been present before e.g. Jim O'Neill, Goldman Sachs.
- This 20 percent nominal is actually 20 percent real so the assertion has some credibility (inflation in US and China broadly equal since 1996, and especially since 2000).
- Per capita income growth 2005-2009 in China 9.0 percent per annum; in US, 0.3 % per annum
- So the yuan needs to appreciate by 8.7 percent for 5 years or 54 percent to be at the same level it was in 2005.
- The yuan has appreciated by 20 percent since then, so its *undervaluation* has increased by 34 percent.
- Given that China did appreciate the yuan by 20 percent, it must mean that the yuan was undervalued in 2005; if undervalued then, considerably more undervalued in 2010.

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The China-Japan comparison

- A surprising conclusion (see Bhalla(2010b) for details) is that at its peak in 1985, the yen was undervalued by only -4 percent (the Deutsche mark slightly more undervalued by -17 percent).
- Per capita income growth between 1970-1985 Japan, Germany and US, 1970-1985: 3.3, 2.3 and 2.2 percent per annum, respectively.
- Inflation rates 6 percent for Japan and US, 4.3 percent for Germany.
- Currency appreciation in Japan and Germany: 2.6 and 1.8 percent annually or a cumulative 34 and 25 percent respectively i.e. considerably more than that predicted due to productivity effects.
- In 1970, the yen and dmark were undervalued by -39 and -17 percent respectively.

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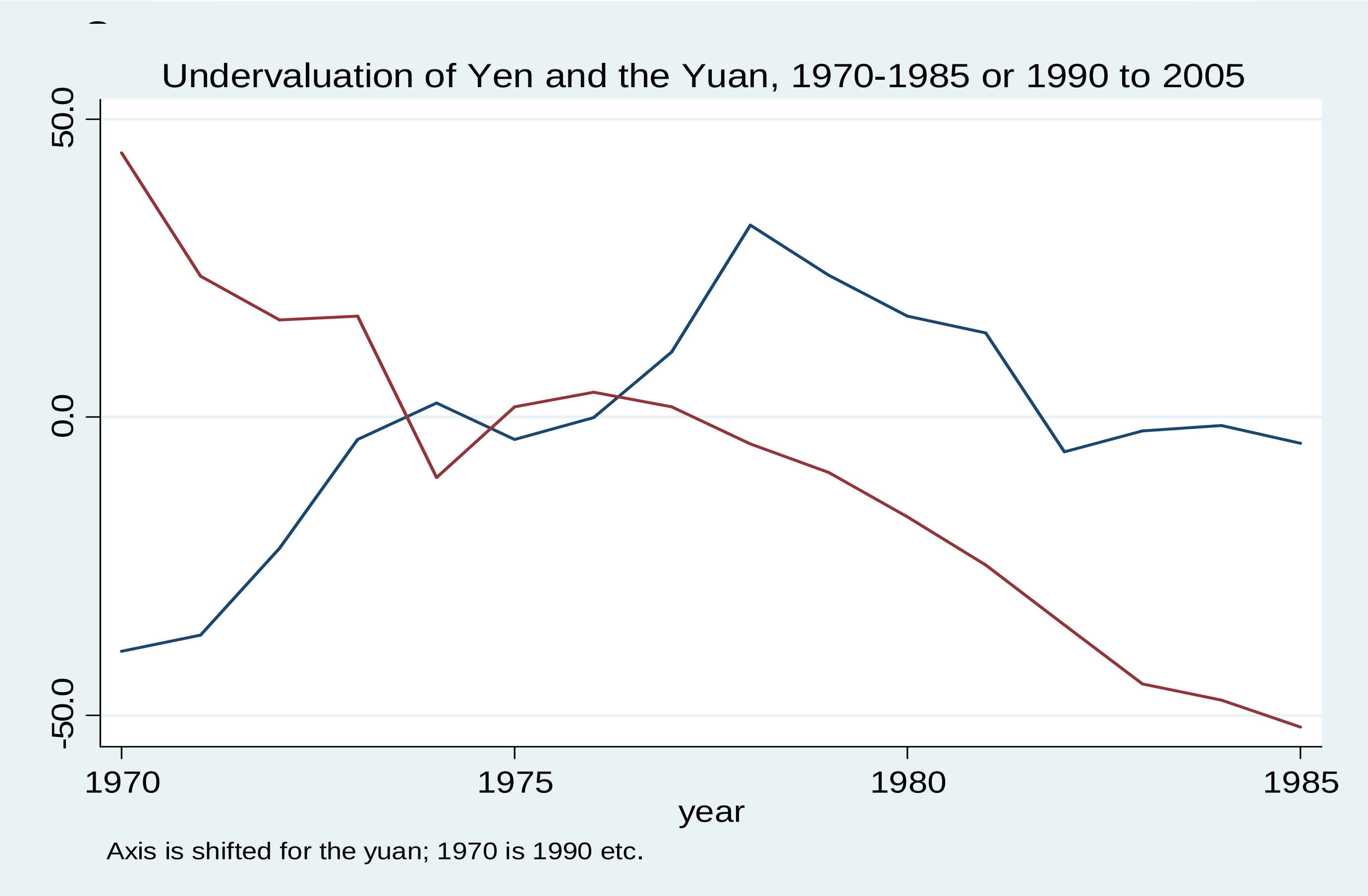
Yen in 1985 and Yuan in 2005: No Comparison



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