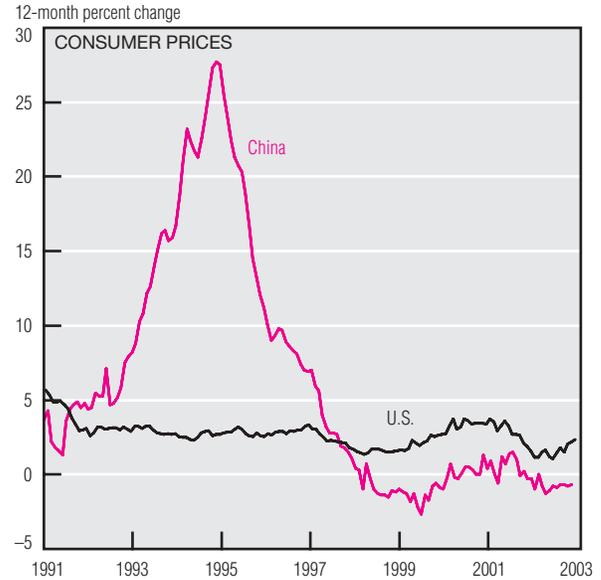
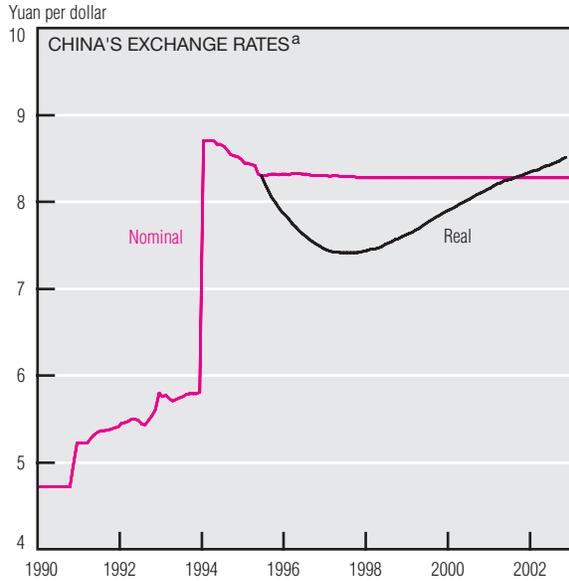


Is China's Currency Undervalued?



- a. A rise indicates a depreciation of the renminbi. China's currency is the renminbi and its currency unit is the yuan. A renminbi consists of one yuan.
 b. A rise indicates an appreciation of the renminbi.
 c. Total trade is the sum of imports and exports. Percentages do not sum to 100 due to rounding.
 SOURCE: International Monetary Fund, *International Financial Statistics*.

If China adopted freely floating exchange rates, its currency would probably appreciate somewhat more than it has on a trade-weighted basis and, perhaps, relative to the dollar. This observation does not imply, however, that maintaining a peg gives China an international trade advantage.

Because China does not yet possess the financial infrastructure to support floating exchange rates, its central bank pegs the renminbi's exchange value to the U.S. dollar, the

Hong Kong dollar, and the Japanese yen. The current peg against the dollar, at approximately 8.3 yuan per dollar, has been in place since the middle of 1995.

Pegs do not automatically give China a competitive advantage in world markets; that also depends on comparisons of international price differentials. Real exchange rates, which include such price comparisons, give a clearer picture than nominal—or commonly quoted—exchange values. On a real basis, the

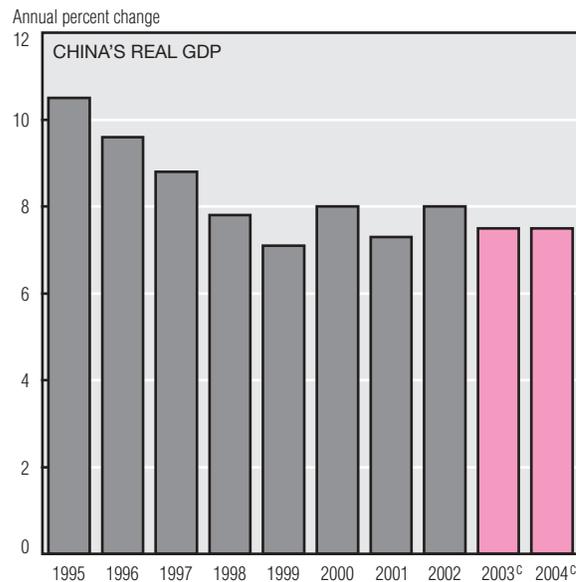
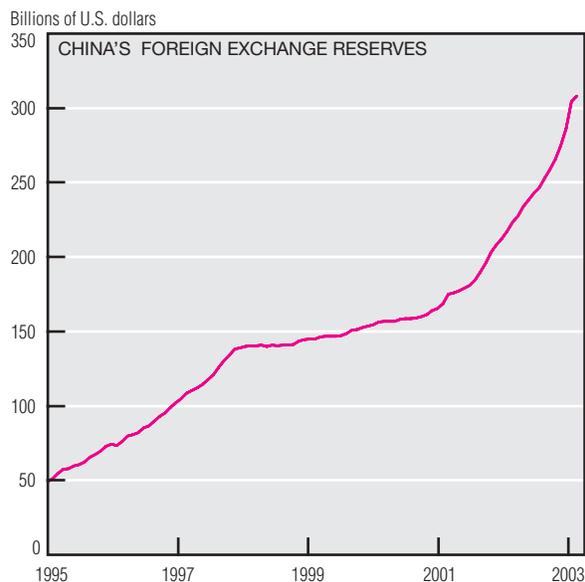
renminbi appreciated sharply against the dollar through June 1997 because China's inflation rate exceeded that of the U.S. Thereafter, as China's inflation rate fell and turned negative, the renminbi reversed all of its previous appreciation. Since 1995, the renminbi has depreciated on a real basis only about 2.5% against the dollar. On an average basis relative to China's key trading partners, the renminbi's real and nominal exchange values have appreciated 4.7% and

(continued on next page)

Is China's Currency Undervalued? (cont.)

	Current account	Net financial flows	Official ^b reserves
1996	7,243	24,462	-31,705
1997	36,963	-1,106	-35,857
1998	31,472	-25,224	-6,248
1999	21,115	-12,463	-8,652
2000	20,518	-9,825	-10,693
2001	17,401	30,046	-47,447

	Current account	Net financial flows	Official ^b reserves
1996	0.9	3.0	-3.9
1997	4.1	-0.1	-4.0
1998	3.3	-2.6	-0.7
1999	2.1	-1.2	-0.9
2000	1.9	-0.9	-1.0
2001	1.5	2.5	-4.0



a. A statistical discrepancy is treated as an unrecorded private financial flow. The latest available data are for 2001.

b. Negative values indicate an acquisition of official reserves.

c. Forecasts from the Blue Chip panel of economists.

SOURCES: International Monetary Fund, *International Financial Statistics*; and Blue Chip Economic Indicators, May 10, 2003.

18%, respectively, since 1995, suggesting a slight dulling of China's overall competitive edge.

Of course, as many have argued, China's hefty acquisition of foreign exchange reserves has artificially limited the renminbi's nominal appreciation. In recent years, the country has experienced a current account surplus, which reflects a favorable balance of trade in goods as well as large interest and dividend receipts on foreign investments in China.

This should promote a renminbi appreciation unless a net financial outflow—of both private and official funds—exactly offsets the current account surplus. In most years since 1995, however, China has experienced only a small net private financial outflow, requiring its central bank to accumulate official foreign reserves to maintain its currency pegs. In 1996 and 2001, it experienced a large net private capital inflow, leading it to acquire substantial amounts of official reserves. Had it been able to operate

a clean float, the nominal appreciation of the trade-weighted renminbi probably would have been greater.

Maintaining a nominal peg, however, does not give China control over its real exchange rate or an artificial competitive advantage. Any country's ability to grow and compete ultimately depends on its capacity to accumulate capital, educate its workforce, secure property rights, and adopt technological advances—not on its exchange rate arrangements.