The Overvaluation of Renminbi Undervaluation

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Summary

China's currency, the Renminbi (RMB), has occupied a central role in the ongoing debate over the source of global current account imbalances. In this paper, we step back from the debates over the merits of one exchange rate regime versus another and whether a currency realignment is desirable (although our conclusions will necessarily inform the debate over what the appropriate actions might be). Rather, we focus on the difficulty in measuring the "equilibrium real exchange rate" and on quantifying the uncertainty surrounding the measurement of the level of the equilibrium. In so doing, we sharpen our definition of what constitutes currency misalignment, at the cost of restricting the generality of our conclusions.

The well-known relationship between deviations from absolute purchasing power parity and real per capita income is used to illustrate the point. After conducting various robustness checks, we conclude that although the point estimates indicate the RMB is undervalued in almost all samples, in almost no case is the deviation statistically significant, and indeed, when serial correlation is accounted for, the extent of misalignment is not even statistically significant at the 50% level. These findings highlight the great degree of uncertainty surrounding empirical estimates of "equilibrium real exchange rates", thereby underscoring the difficulty in accurately assessing the degree of RMB undervaluation, which is in accordance with the well-known result that it is quite difficult to model exchange rates in general. While the empirical results point to the difficulty in establishing the claim that the RMB is significantly undervalued, it is imperative to recognize that these results do not constitute evidence of no undervaluation.

In a broader perspective, the finding of a highly uncertain equilibrium real exchange rate buttresses the case for a prudent, cautious exchange rate policy that avoids abrupt changes in the Chinese economy. Given its limited financial market capacity and structural rigidity, an abrupt change in the Chinese exchange rate policy could lead to some significant challenges to economic growth and stability. China's measured approach to exchange rate regime liberalization, coupled with increasing imports and domestic consumption, might facilitate a resolution of global imbalances. However, in our view, this goal will only be achieved if combined with appropriate policy changes in other countries (e.g. the US).