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Should China revalue its currency? Lessons from the Japanese experience

Dr Claude MEYER[1]

Abstract

There is a similarity of pattern between the present international pressures for RMB revaluation and pressures which were exerted on Japan in the ‘80s for Yen revaluation. The undervaluation of the RMB has been much debated over the past four years and again China has been recently under strong international pressure to revalue its currency.

This paper aims at clarifying certain issues raised by this debate on the RMB revaluation in the light of Japan's experience after the 1985 Plaza Agreement, which led to a quasi-doubling of the Yen exchange rate against the US$ over a period of two years.

As to the first question whether the RMB is undervalued, such an undervaluation has to be assessed on the basis of the real effective exchange rate (REER) and not only of the market forex rate against a falling US$. On a REER basis, the undervaluation of the RMB may be estimated in the range of 15-20%, which would mean about 10-15% against the US$ and 20-25% against the Euro.

The next question is whether China should let its currency appreciate gradually or proceed immediately to a massive RMB revaluation of 20-25%, as requested by the US and Europe? A steep revaluation of the RMB would have probably devastating effects on China's economic growth and stability, while it would not solve the problem of the growing trade deficits of the US and Europe. This is confirmed by the example of Japan during the '80s and '90s: the quasi-doubling of the Yen exchange rate against the US$ after the Plaza Agreement did not reduce the US trade deficit, but its negative effects have weighted on the Japanese economy and financial system throughout the '90s.

As for the US and Europe, the key for the reduction of their trade deficits is not primarily in the RMB revaluation but in a continuing improvement of their technological competitiveness, as shown by Japan, whose booming trade with China over the past years has remained quite balanced.

Finally, the appraisal of China's foreign exchange policy over the past years gives rather mixed results. For the period 2005-2006, the policy of a very gradual RMB appreciation of its currency seemed justified. However the appreciation of the RMB effective exchange rate has been far too slow in 2007. This over prudent policy does not seem any more in the best interest of the Chinese economy itself, without speaking of the relations with trading partners. The explosion of the current account over the past years would now require that China make full use of the instruments given by the reforms of July 2005 for the optimal management of its currency.

[1] Senior Fellow, Groupe d’Economie Mondiale at Sciences Po (GEM). This paper was presented in October-November 2007 at several institutions in Asia, in particular at Beijing University, at the University of International Business and Economy in Beijing and at the Central Compilation and Translation Bureau in Beijing, which reports to the Central Committee of the CCP.

Should China revalue its currency?
Lessons from the Japanese experience.

Dr Claude MEYER[2]

Introduction

There is a similarity of pattern between the present international pressures for RMB revaluation and pressures which were exerted on Japan in the ‘80s for Yen revaluation.

The undervaluation of the RMB, which was pegged to the US$ at a rate of 8.28 since 1995, has been much debated over the past four years and again recently Chinese authorities have been under strong international pressure to revalue it.

Until 2006, this pressure came mainly from the United States. American politicians and manufacturers accused China of not playing the game of fair competition by keeping its currency outrageously undervalued. In their view, the fast growing trade deficit with China, which has tripled between 2000 and 2007 and represented more than 30 % of its total deficit in 2007 (see table 1) , came mainly from the undervaluation of the RMB.

Table 1 - US trade deficits with its main trading partners

(US$ billions)	2000	2001	2002	2003	2004	2005	2006	2007	%
Total US trade deficit	-436	-411	-470	-536	-652	-760	-838	-815	100%
of which:									
China	-84	-83	-103	-124	-162	-201	-233	-256	31,4%
Japan	-81	-69	-70	-66	-75	-83	-89	-83	10,2%
Mexico	-24	-30	-37	-41	-45	-50	-64	-74	9,1%
Canada	-53	-53	-50	-55	-67	-78	-72	-64	7,9%
Germany	-29	-29	-36	-39	-46	-51	-41	-45	5,5%

Source: U.S. Census Bureau, Foreign Trade Division

On the other hand, many economists stressed the fact that the RMB undervaluation creates some dangerous imbalances in the world saving-investment balance, leading to a China trade surplus with the US of US$ 256 billions in 2007; a significant part of this surplus comes back to the US as investments in US Treasury Bonds, thus financing an increasing saving deficit in the US.

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As a first step and as gesture of good will, China took in July 2005 some timid measures which did not calm down the sharp critics of some American politicians and economists.

Thereafter, Europeans who had been so far rather moderate on this topic, started to criticize more and more strongly the Chinese monetary authorities for their foreign exchange policy leading to a depreciation of the RMB against the Euro: indeed, while the Chinese currency started to appreciate against the US$ after the July 2005 reforms, it depreciated against the Euro, due to the fall of the US$, in particular against the European currency.

In this highly complex and passionate debate, economic history relating to Japan's experience in this respect may help to clarify the issues. For this purpose, after having described the present exchange rate regime of China and the reforms of July 2005, four fundamental questions have to be raised:

- Is RMB really undervalued and if so, by how much?
- What would be the merits and demerits of a revaluation, both for China and its partners?
- Which lessons may be drawn from Japan's experience in the '80s and presently?
- How to assess China's foreign exchange policy over the past years?

1. China's exchange rate regime

First, it should be noted that presently the RMB is not fully convertible, due to exchange controls. While foreign exchange transactions linked to foreign trade are permitted, transactions relating to capital movements are in principle prohibited, except for very limited cases and amounts applying respectively to companies, banks and individuals [3].

The exchange regime between 1995 and 2005

The RMB exchange rate has been pegged to the US$ at 8.28 RMB for 1 US$ (after a 30% devaluation in 1994), with narrow fluctuations bands of +/- 0.3% per day.

[3] Rules have been slightly relaxed since 2006, taking into account the steep increase of China's international reserves over the past years.

The exchange regime since July 2005

On July 22, 2005, Chinese authorities announced a series of measures:

- A modest reevaluation of 2.1% to 8.11 RMB for 1 US$
- A far more important change: the RMB would not be any more pegged to the US$ but linked to a basket of currencies ((US$, €, ¥, K. Won, etc.).
- In spite of narrow fluctuations bands (+/- 0.3% for US$, +/- 5% for Euro, etc.), daily variations could theoretically add up, so that for example the US$ could appreciate by about 6% per month, should Chinese authorities make maximum use of the 0.3% band applicable to the US$.

Beyond the technicalities involved, these measures represented a major move by China from a quasi-fixed exchange rate regime to a managed float system, as explained by the PBC's Governor:

"As you all know, with authorization of the State Council, on July 21, 2005 China moved into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. The RMB will no longer be pegged to the US dollar. Instead, the RMB exchange rate will be determined based on a basket of certain major currencies with assigned weights selected in line with the real situation of China's external sector development" [4]

2. Is RMB undervalued and if so, by how much?

This question, if so worded, has not much meaning, as one must first define against which currency the RMB would be undervalued and distinguish the situation before the 2005 reform and after.

[4] People's Bank of China. "Speech of Governor Zhou Xiaochuan at the Inauguration Ceremony of the People's Bank of China Shanghai Head Office," August 10, 2005

Before July 2005

The literature until 2005 dealt almost exclusively on the parity RMB / US$.

While most economists considered that the RMB was undervalued, some outstanding scholars or analysts like R. Mundell, T. Callaguer or S. Roach claimed that no revaluation was needed and that there was a « compelling evidence that the RMB is not substantially undervalued » (Funke and Rahn, 2005).

However, the convergence of some indicators through several models[5] supported the opinion of an undervaluation of the RMB, even if estimations of such undervaluation diverged considerably between economists, since they ranged from 5-10% to 50%, the median being at around 20-25% [6].

In fact, no economist was in a position to determine the real value of the RMB, since exchange controls and interventions of the Central Bank hindered the market to give reliable indications in this respect.

Several new elements since July 2005 have to be taken into account to answer the question of the RMB appropriate value, in particular the reform of the exchange rate regime and the respective movements of third currencies, such as Euro against US$.

After July 2005

Indeed the continuing fall of the US$, notably vis-à-vis the Euro, impose to analyze separately the evolution after July 2005 of the RMB exchange rate against the world's major currencies, first the US$ and second the Euro (Figure 1 and Table 2).

Appreciation against the US$

After the reforms of July 2005, the RMB has appreciated by 2.5% in 2005 and by 10.5% over the period 2006-2007.

Depreciation against the Euro

On the opposite, the RMB has depreciated against the Euro by 11% during the period 2006-2007, after an appreciation of about 5% in 2005. That explains why, since 2006, European leaders joined the Americans in requesting a quick and substantial reevaluation of the RMB.

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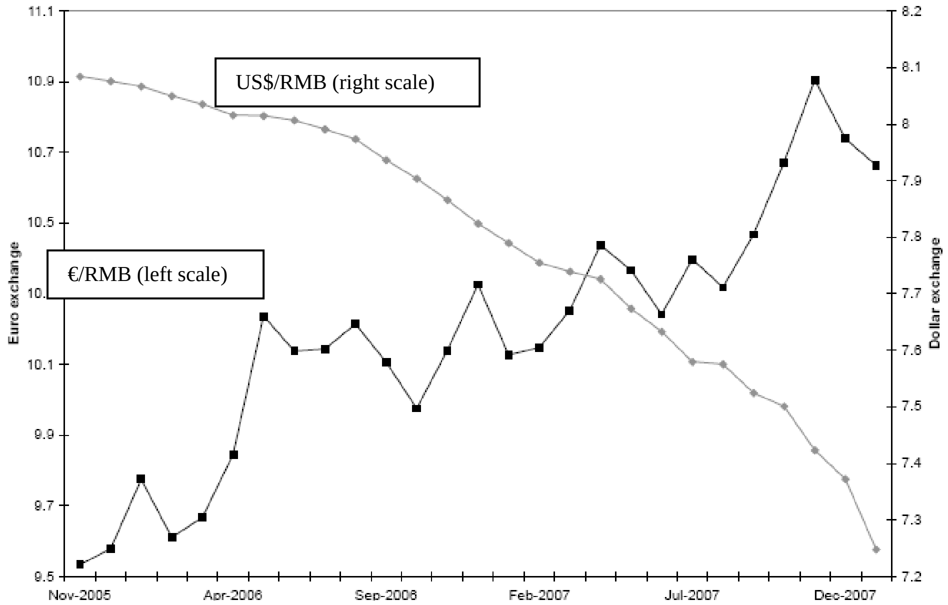
[5] REER, FEER, PPP., etc.

[6] G. Hufbauer, *China Bashing 2004*, Policy Brief PB 04-5, IIE, Washington

Figure 1 – RMB/Euro and RMB/US$: market rates between end of 2005 and of 2007



Sources: Freytag (2008), OECD (2008)

A better instrument: the Real Effective exchange Rate (REER)

Thus the question of a possible undervaluation of the RMB cannot be answered by assessing its value only vis-à-vis the US$, since over the past two years it has depreciated against the Euro, while appreciating against the US$; in other words, the fall of the US$ triggers mechanically a rise of the RMB, but it does not mean that the RMB reached its appropriate value on international trade and capital markets.

A better instrument of measure for this purpose is the Real Effective Exchange Rate (REER), which is the weighted average of a country's currency relative to a basket of the currencies of its major trading partners, adjusted for the effects of the respective inflation rates.

This REER is computed by several institutions, with some differences resulting from the period chosen for assessing the respective weight of trading partners to be taken into account.

Table 2 – RMB, Euro and US$: market rates and REER (2000=100)

	RMB / US$		RMB / Euro		RMB REER	US$ REER	Euro REER
	Rate	Variation vs. Dec 05	Rate	Variation vs. Dec 05			
April 17 08	0,143	15,6%	0,090	-13,6%			
Dec 2007	0,137	10,5%	0,093	-10,9%	99	85	125
Dec 2006	0,128	3,3%	0,097	-7,4%	94	90	121
Dec 2005	0,124		0,104		92	95	117
Dec 2002					99	103	113

Sources: FRB, ECB, BIS

If one chooses the computations made by the BIS, the RMB's REER was 99 at the end of 2007 on the basis of 100 in 2000. Given the fact that China's current account surplus has been multiplied by more than fifteen over the period 2000-2007 (21 billion US$ in 2000, about 360 billion in 2007 [7]) and that consequently the international foreign reserves have increased from 180 billion US$ to 1500 billion, the RMB's REER should have been closer to say 115-20 at the end of 2007, rather than the 99 level actually recorded.

Thus, by using the REER approach, it can be said that the RMB would be undervalued by, say, 15 to 20% on this weighted basis; taking into account the relative weight of China's trade with the US and the Euro area in the computation (respectively 18.5% and 16.2%) as well as the fall of the US$ against the Euro over the period 2002-2007, the undervaluation of the RMB would be on this basis in the range of 10-15% against the US$ and in the range of 20-25% against the Euro.

Assuming that the RMB would be undervalued in the range of 15% - 25%, depending on the currency considered, the question is now whether China should yield to the US and Europe's pressures and accept their requests of a quick and substantial revaluation, or rather, as it has done so far, to manage the RMB with increased flexibility so as to let it appreciate gradually.

3. The merits and demerits of a substantial revaluation

Although views diverge also between economists on this question, it is highly probable that a substantial revaluation of the RMB as requested by the US and Europe would not, at least in the short term, meet their expectations of reducing their trade deficit with China and saving the jobs threatened by Chinese competition. On the other hand, such a massive reevaluation would have very detrimental effects on China, and subsequently on the world economy.

[7] IMF's estimate in *World Economic Outlook Database*, April 2008

Effects on US and European economies

For the US and Europe, it is unlikely that an immediate and strong RMB revaluation would solve their trade deficits; indeed, the competitiveness of Chinese products are not primarily due to the RMB undervaluation but derive essentially from China's comparative advantage regarding the cost of labor.

In the case of the US for example, taking into account the weight of China in the total US trade, even a substantial RMB revaluation by 25% against the US$ would reduce the global trade deficit by less than 5%, and even less than 1% according to some other computations.

Indeed, it should be kept in mind that the terms of "Chinese exports" refer to the data recorded by the customs but do not give any indication as to the proportion in such exports of the real Chinese content and of the added value originating from China, as the share of processing trade is estimated at more than 50% of China's exports[8]. Given the regional division of labor in Asia and the pivotal role of China therein [9], a "Chinese export" may include many inputs coming from Japan, South Korea and Southeast Asia, whose implicit prices are not expressed in RMB but in the currency of such countries.

Furthermore, it is likely that Chinese manufacturers would cut their margins to remain competitive and if not, the US and European consumers would probably replace the less competitive Chinese goods by products coming from other low costs emerging countries; in both cases, there would be no significant effect either on the trade balances of the US and of European countries or on their job markets threatened presently by Chinese competition.

On the opposite, such RMB revaluation could have some negative effects on their economies. While presently consumers as well retailers in the US and Europe benefit from Chinese products low prices, substantial price increases would obviously fuel inflation in the US and European economies; at the same time it is highly probable that the RMB revaluation would trigger higher interest rates in the US, as the shrinking of China's trade surplus would reduce its investments in US financial assets, in particular US Treasury Bonds, of which it is a major investor[10].

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[8] Freytag (2008) pp. 3-4.

If we take the example of Japan, the apparent stabilization of its trade surplus with the US and the EU is misleading, as a significant part of its exports to China represent intermediate goods which are processed in China, notably by Japanese subsidiaries; the final goods exported to the US and the EU will be classified as "Chinese exports" on a custom basis but actually their Japanese content in terms of added value may be very high.

[9] On this crucial point, refer to Messerlin and Wang (2008) for a thorough analysis

[10] At the end of 2007, China's investments in US Treasury Securities amounted to US$ 478, representing 5.3% of the total and 20% of US Treasury Securities owned by foreigners.

Effects on China

While a gradual RMB revaluation could have some positive effects for China (such as more autonomy in monetary policy and easier control of inflation, decrease of illegal capital inflows fueling speculation in the real estate sector, lowering of the cost of the imported inputs, etc.), it is almost certain that an immediate and substantial reevaluation would entail very severe drawbacks and possibly a dangerous disruption of Chinese economy which could spread out to the rest of the world.

First, it would obviously bring about a significant loss of China's competitiveness on foreign markets and would threaten many industrial companies and their sub-contractors, whose margins are often very thin and financial situation rather fragile.

It would have also very negative effects on the agricultural sector, which is still very uncompetitive by world standards and would be severely hit by foreign products benefiting from a strong RMB reevaluation; this would jeopardize the present public policies aiming at reducing the gap between rural and urban revenues and could trigger uncontrollable social unrest.

Furthermore, a steep revaluation would likely disrupt the financial system, which remains weak and fragile in spite of the huge recapitalizations made over the past years by the State. Not so long ago, major banks were only the financial arm of the public authorities and it is only recently that risk analysis has been introduced in the training and management practices of Chinese banks. Moreover, these banks have not been exposed until very recently to the specific foreign exchange risks involved in a floating rate system and are not yet very familiar with specific techniques of hedging such risks.

Last but not least, such RMB revaluation would mean huge losses for China's foreign assets, as more than 70% of its US$ 1500 billion international reserves are invested in the greenback.

Thus a steep revaluation of the RMB would probably not solve the problem of the growing trade deficits of the US and Europe, while it could have devastating effects on China's economic growth and stability, and hence on the world's economy.

To better understand the issues at stake, it may be useful to examine the question of the RMB revaluation in the light of Japan's experience during the '80s and '90s, namely a steep appreciation of the Yen during the period 1985-1988 and then an ensuing lengthy crisis throughout the '90s.

4. Which lessons from Japan?

There are obviously major differences between China and Japan in terms of development and rhythms of economic growth, weight of foreign trade and FDI, patterns of competitiveness (price vs. technological excellence), exchange controls, currency regime, etc.

However there are some similarities between the cases of China presently and Japan during the '80s: positive trade balance, important current accounts surplus invested in US Treasury Bonds, same pattern of the US and Europe scapegoating China now like Japan at that time, etc.

Two main lessons may be drawn from Japan's experience during the '80s (dangers of a steep revaluation) as well as nowadays (limited effects of currency revaluation on trade balances).

Dangers of a steep and brutal revaluation

From the beginning of the '80s, the US began to record a growing trade deficit with Japan which reached US$ 50 billions in 1985. From the US point of view, this was essentially due to the undervaluation of the Yen and Washington first tried to internationalize the use of Yen thru the 1984 Yen-$ Agreement; then in September 1985, it obtained from the G5 members an agreement (the" Plaza Agreement") whereby Central Banks would intervene to push the US$ down, in particular vis-à-vis the Yen. The overreaction of the markets in a context of freedom of capital movements pushed the Yen far higher than was originally intended: the parity Yen/US$ almost doubled between 1985 and the end of 1987, the so-called *Endaka.*

The overreaction of the markets was followed by an overreaction of the Japanese monetary authorities. In order to prevent a recession, they enforced a loose monetary policy, which fueled speculation and asset inflation. This speculative bubble bursts in 1990 with far-reaching detrimental effects on the economy throughout the '90s: low growth of 1% on average and acute financial system problems, which threatened the very stability of the international financial system.

Actually the shock of a quasi-doubling of the Yen value against the US $ in 18 months was almost impossible to be absorbed smoothly. The overreaction of markets, which was triggered by Central Banks' intervention, was made possible by the combination of three factors, the exchange rate regime (floating rate), the removal of exchange controls and the financial liberalization (in particular on the euroyen markets). It triggered a vicious spiral due to mismanagement of risks, both in the public and the private financial sector: on the side of public authorities, there has been mismanagement of monetary policy and inadequate supervision of financial institutions, while in the private financial institutions, a hasty deregulation was not accompanied by the control and management of the new risks involved.

Thus, in the light of this Japanese *Endaka*, several elements may be kept in mind when debating about the RMB revaluation:

- An immediate and steep revaluation may be dangerous and risky. The reevaluation process of the RMB should be gradual and spread out over time, thus giving time to the economy and the financial system to progressively adjust.
- It would be preferable that the exchange controls on capital account be maintained (and made more efficient regarding hot money) during this process of a gradual appreciation of the currency
- The liberalization of the financial system shall also be made step by step, after the completion of the reforms now under way, in particular regular cleaning of doubtful loans in balance sheets as well as training of staff in risk analysis and hedging instruments.

<u>Would the RMB revaluation be the solution to the US and European trade deficits and jobs destructions?</u>

It is remarkable that even after this *Endaka* leading to the quasi-doubling of the Yen against US$, Japan has up to now continuously maintained a trade surplus in the range of US$ 50-80 billions vis-à-vis America, so that clearly the undervaluation of the Yen was not the real reason of US deficit with Japan in the '80s.

The real reason was and remains Japan's competitiveness in many high technology sectors, as can be seen by the number of Japanese patents families recorded, as compared to the US ones. Similarly, in the case of China, the undervaluation of the RMB is not the main factor of Chinese products' competitiveness: in the same way that Japan's competitiveness was and is primarily based on its technological supremacy, China's competitiveness derives mainly from the relative cost of labor in exported goods and not from the undervaluation of the RMB.

While it is important to keep this essential point in mind, it does not solve the huge problems and challenges which US and Europe are facing in terms of job destructions and manufacturing hollowing out due to the pressure of growing Chinese exports. On this point too, Japan offers an example to be followed. How to explain that Japan's cover rate of its trade with China[11] is 105% against only 25% and 42% respectively for the US and Europe (table 3)?

Table 3 – US, Europe and Japan's trade balances with China

US, Europe and Japan's trade with China (US$ Billions)	2003	2004	2005	2006
United States				
Exports of goods to mainland China + H.K.	41,9	50,5	58,0	73
Imports of goods from mainland China + H.K.	161,3	206,0	250,0	296
Trade Balance	**-119,4**	**-155,5**	**-192,0**	**-223**
% cover	**26,0%**	**24,5%**	**23,2%**	**24,7%**
Europe (25) (1 € = 1,2 $)				
Exports of goods to mainland China + H.K.	71,4	80,7	86,6	103,2
Imports of goods from mainland China + H.K.	138,4	164,2	202,4	244,8
Trade Balance	**-67,0**	**-83,4**	**-115,8**	**-141,6**
% cover	**51,6%**	**49,2%**	**42,8%**	**42,2%**
Japan				
Exports of goods to mainland China + H.K.	87,0	109,2	116,3	116
Imports of goods from mainland China + H.K.	76,5	95,8	110,6	111
Trade Balance	**10,5**	**13,4**	**5,7**	**5,0**
% cover	**113,7%**	**114,0%**	**105,2%**	**104,5%**

Sources: US Census, Eurostat, Jetro

The answer comes from the sectoral analysis of Japanese trade with China: Japan, which is permanently moving up on the technological ladder, exports to China mainly machinery and equipment with high technological added value, while it imports manufactured products with low or medium technological content. Thus Japan may maintain a balanced trade with China and run high trade surplus with the US and Europe.

Although the process will take time and will not solve quickly trade deficits, American and European public authorities as well as companies will have to follow Japan's example, in particular by increasing their R&D expenses. Job destructions are unavoidable in some industrial sectors and have to be set off by job creations at a higher level of technological ladder.

5. How to assess China's foreign exchange policy over the past years?

If we sum up the above analysis, we arrive to the following conclusions:

- The level of the RMB has to be appreciated on the basis of the Real Effective Exchange Rate and not only by referring to the market value against the US$

[11] Due to movements of re-exports between mainland China and Hong Kong, it seems more significant to aggregate their customs statistics. Japan runs a US$ 25 billion trade deficit with mainland China but a US$ 5 billion surplus with mainland China + Hong Kong.

- On this basis, the undervaluation of the RMB can be estimated in the range of 15-20% (about 10-15% against the US$ at the end of 2007 and 20-25% against the Euro).

- As shown by Japan's example during the '80s, a steep and brutal reevaluation could be quite detrimental to China's growth, and consequently very dangerous for the world's economy. Furthermore, such a reevaluation would not benefit significantly to the trade balances of the US and European countries, as their deficits with China do not stem primarily from the RMB undervaluation but from the price competitiveness of Chinese manufacturers.

Taking into account these elements, how to assess China's foreign exchange policy over the past three years? In our view, one must distinguish two periods, namely 2005-2006 on one hand and the year 2007 on the other.

<u>The period 2005-2006</u>

During the period from July 2005 to the end of 2006, China's foreign policy tried – successfully in our view – to reconcile several objectives, rather diverging if not contradictory: to maintain economic stability, to introduce a much needed flexibility in the exchange rate regime and to give some signs to its trading partners that their complaints were understood.

In 2005, Chinese authorities judged that a steep and brutal revaluation would put in danger the country's economy and its very social stability but they were aware that time had come for a reform of the exchange rate regime. If the modest revaluation of 2.1% in July 2005 was no more that a gesture of good will in direction of the US, the *de facto* end of the peg to the US$ and the switch to a floating rate system in relation to a basket of currencies was an important step: indeed it meant that the exchange policy would not take into account only the rate US$/RMB but also exchange rates with the main trading partners and thus would introduce more flexibility in the management of the currency towards its gradual appreciation, ultimately under market forces.

Indeed, during the second semester of 2005 and in 2006, the RMB appreciated gradually against the US$ at a pace of about 5-6% p.a., which could appear to some observers too slow, but which at least was an indication of Chinese authorities' willingness to let the RMB appreciate, now that they had put in place the right instruments for doing so.

The year 2007

While the prudent rhythm of a gradual RMB appreciation over the 18 months from July 2005 to end of 2006 could appear justified, keeping in mind the several arguments developed above, the same cannot be said for the year 2007.

In our view, the pace of appreciation has then be far too slow in 2007, taking into account on one hand the respective movements of the US$ and the Euro against the RMB and on the other, China's macroeconomic performance in terms of current surplus and building up of international reserves

Since the reforms of July 2005 to the end of 2007, the RMB has indeed appreciated by 13% against the US$, but at the same time the real effective exchange rate of the US$ has itself fallen by about 10%. Thus this rise of the RMB is rather due to the continuous fall of the US$, which mechanically leads to the RMB appreciation. This trend was confirmed during the first months of 2008, as the US$ fell below the 7 RMB level on April 17, 2008, which means for the RMB a further appreciation of the 4.3% since the end of 2007.

On the opposite, the RMB has depreciated against the Euro by about 6 % over the period from July 2005 to Dec. 2007 and even by 11 % between Dec. 2005 and Dec. 2007. This trend has continued in 2008 and on the same abovementioned date of April 17, the RMB had further depreciated against the Euro by 3% since the beginning of 2008, while it had appreciated by 4.3% against the greenback. One can then infer from this continuing depreciation of the RMB against the Euro that the authorities did not make full use of the flexibility given by the July 2005 reforms for the fixing of the RMB exchange rate by reference to a basket of currencies, including the Euro.

This seems to be confirmed by the evolution of the Real Effective Exchange Rate of the RMB (as defined above). In spite of its increase over the period 2005-2007, it has only regained its level of 2002, which does not reflect the strength, expansion and competitiveness of China's external sector over the past five years.

Indeed the current account surplus has exploded between 2002 and 2007, being multiplied by ten from 35 billion US$ to 360 billion. While the 250 billion US$ current account surplus in 2006 represented already 9.5% of the GNP, the 2007 current surplus reached the astonishing rate of 11% . In parallel, the international reserves surged from 286 billion US$ in 2002 to

1493 billion at the end of 2007. Such performances should normally push upwards the real effective exchange rate of the RMB.

Thus the Chinese authorities seem to slow down the natural appreciation of the currency, which should normally be triggered by the fundamentals of the external sector. This overprudent policy does not seem any more in the best interest of the Chinese economy itself, without speaking of the relations with trading partners. Indeed this leads to an unbalanced pattern of growth, depending too much on the external sector. Furthermore, the piling-up of huge international reserves is becoming a more and more difficult issue to be tackled by the Central Bank: these reserves fuel the inflation recorded in the past months and their sterilization become more and more difficult and costly. In addition, this excessive gradualism in the appreciation of the RMB delays the necessary adjustments in the productive and financial sectors, in particular the relaxation of capital controls on investments overseas. These adjustments will become more and more urgent, taking into account the emergence of China as a world financial power.

Conclusion

A steep revaluation of the RMB as requested by the US and Europe could be quite dangerous for China's stability and the world economy; furthermore, it would not solve their problems of trade deficits and job destructions, whose solution is to be found in the example of Japan maintaining a balanced trade with China thanks to its technological excellence.

On the other hand China does not dispute the need for an appreciation of its currency, but it considers that this appreciation should be gradual, so that its agricultural, industrial and financial sectors may progressively adjust to the new risks involved and to more severe conditions of international competition.

This policy seemed justified in 2005-2006, but the explosion of the current account over the past years would now require that Chinese authorities make full use of the instruments given by the reforms of July 2005 and let the RMB move more freely upwards, not only against the US$ but also against the currencies of its other trading partners, the Euro in particular.

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