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IMF Directors Split Over Whether China's Yuan Is Undervalued

By Shamim Adam - Jul 27, 2010

International Monetary Fund directors split over whether the yuan is undervalued, reflecting similar differences between U.S. and Chinese officials over the nation’s exchange-rate regime.

Some IMF board members said the assumption that the exchange rate is undervalued is based on “uncertain forecasts” for China’s current account surplus, the Washington-based lender said in a statement dated yesterday after concluding a July 26 meeting. In its annual assessment of the country’s economy discussed by the board, the IMF said growth is expected to remain robust and the outlook for inflation is benign.

The yuan has advanced less than 1 percent against the dollar since China indicated on June 19 it would scrap the currency’s two-year-old peg to the greenback. Asia’s second- largest economy has faced pressure to allow the yuan to rise from U.S. lawmakers, who claim an undervalued currency gives its exporters an unfair advantage.

“Directors welcomed the recent decision to return to the managed floating exchange rate regime,” according to the statement. “This decision will increase the central bank’s flexibility to tighten monetary conditions.”

China had kept the yuan stable at about 6.83 per dollar between July 2008 and June 2010, having allowed it to gain 21 percent in the previous three years. It was little changed at 6.7792 per dollar as of 10:40 a.m. in Shanghai.

Shrinking Surplus

China’s current-account surplus will shrink for a second year in 2010 as domestic demand plays a greater role in driving the nation’s economic growth, according to the State Administration of Foreign Exchange on July 8. The gap, the broadest measure of trade, amounted to 6.1 percent of China’s gross domestic product last year, down from 9.6 percent in 2008, the currency regulator said.

A nation’s current-account balance can be used as a “window” to watch if its exchange rate is at an equilibrium level, China’s deputy central bank governor Hu Xiaolian said on July 3.

IMF officials estimated the Chinese currency could be undervalued between 5 percent and 27 percent, Reuters said, citing two people who had seen the fund's staff report on the country.

Catalyst for Change

Some IMF directors said strengthening in the yuan, a denomination of China's currency the renminbi, will help the country rebalance its growth drivers, while others said such a shift is already taking place.

"Many directors stressed that, over time, a stronger renminbi would help facilitate a shift from exports and investment to private consumption as the principal driver of economic growth," according to the statement. "A number of directors pointed to signs that a structural shift in the balance of payments is already underway, reflecting the reforms already put in place to strengthen consumption."

The fund also called on China to use "market-based instruments" such as higher interest rates and reserve- requirement ratios to protect banks' balance sheets.

Premier Wen Jiabao has left interest rates unchanged since December 2008, relying on administrative measures and controls on lending to prevent overheating. The central bank has raised banks' reserve-ratio requirement three times this year to contain property prices and inflation.

Monetary Policy

IMF officials "agreed that the targeted reduction in broad money growth this year balances well the need to provide continued support to the economy with the desire to safeguard the health of bank balance sheets," the statement said. They "highlighted the need for regulatory and supervisory vigilance to manage any deterioration in credit quality, and for increased transparency in lending to local government financing vehicles."

Chinese banks may struggle to recoup about 23 percent of the 7.7 trillion yuan ($1.1 trillion) they've lent to finance local government infrastructure projects, a person with knowledge of data collected by the China Banking Regulatory Commission said earlier this month.

China's budget is supporting a resumption in private demand and there is more room for the government to redirect the stimulus toward measures to boost consumption and raise household incomes, the IMF said. The lender supported a "gradual phase out" of fiscal stimulus in 2011.

The government may need to consider more measures to control increases in real estate prices, the IMF said, suggesting the consideration of a property tax and more financial market development to channel savings.

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