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What's the Yuan Worth?

Yes, it's undervalued. But perhaps not as much as often assumed.

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For years, U.S. politicians and economists have groused about China's heavily undervalued currency. But their case may not be quite as clear-cut as it once was.

Journal Report

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The Chinese yuan has strengthened to 6.5 yuan to the dollar from 8.2 yuan to the dollar in June 2005, and Chinese consumer prices have risen more than 5% over the past year. That has meant nominal appreciation of 25% against the dollar and real appreciation of 20% against a basket of the currencies of China's major trade partners since 2005. At the same time, China's current-account surplus—exhibit A in the case against an undervalued yuan—fell to 5.2% of gross domestic product last year from a high of 10.1% of GDP in 2007.

These changes have prompted a small chorus of influential investment-bank and policy economists to change their tune, arguing that China's currency is approaching fair value. That view is by no means universal. But even among the staunchest critics of China's exchange-rate regime, there is a growing acceptance that the yuan is less undervalued today than it was a few years ago.

A Difficult Assessment

Assessing the fair value of a currency isn't a straightforward undertaking. For floating currencies, economic fundamentals such as growth and inflation have an impact on the value set by the market, but exchange rates also can be moved by a bewildering variety of other economic and psychological factors. The wild movements of the Japanese yen against the U.S. dollar over a period when the fundamentals of the Japanese economy have been little changed are a case in point.

For the yuan, where the value is tightly controlled by the government, assessing the value that would be set by the market is even more difficult. But by looking at the size of China's current-account surplus and the buildup of foreign-exchange reserves, economists can arrive at ballpark figures for the degree of undervaluation.

The contention in Washington is often that the yuan is undervalued against the dollar by 40%. Introducing legislation aimed at China's exchange rate in 2010, Democratic Sen. Sherrod Brown of Ohio and other members of a bipartisan group cited this number.

The origins of the 40% figure are related to research by John Williamson and William Cline, economists at the Peterson Institute for International Economics, into what the yuan's value would need to be to bring all current-account balances—including those of China and the U.S.—down to 3% of GDP. The reasoning is that a stronger yuan would increase the cost of China's exports and reduce the cost of imports. By calculating the relationship between prices and import and export demand, economists can estimate the degree of appreciation required to redress China's unbalanced trade relationship.

The difficulty with making this calculation is that it is highly sensitive to movements in China's current account. As China's current-account surplus has fallen as a share of GDP, estimates of the required degree of appreciation have become smaller. Mr. Williamson's latest research suggests that the degree of undervaluation has fallen to almost 30%. Others believe that even this overstates the degree of appreciation required to bring the yuan to fair value.

Jim O'Neill, chairman of Goldman Sachs Asset Management, says his firm's investment model no longer suggests that the yuan, also known as renminbi, is undervalued at all.

"There is quite a lot of evidence [that] most adults in Washington and the rest of the U.S. choose to ignore," says Mr. O'Neill. "The Chinese trade surplus and current-account surplus have declined sharply, so I would say the ongoing evidence is quite supportive for those who don't believe the renminbi is that undervalued anymore."

Standing Their Ground

But looking at the size of the current-account surplus is only one way to estimate the degree of undervaluation of the currency. To manage the value of the yuan against the dollar, China's central bank has to make continued interventions in foreign-exchange markets. The consequence of that intervention is China's enormous and growing stock of foreign-exchange reserves—which the latest data put at $3.04 trillion at the end of March. The buildup of foreign-exchange reserves suggests that the People's Bank of China continues to intervene strongly in the markets to support the yuan at an artificially low level—indicating that the degree of undervaluation remains higher than the falling current-account surplus suggests.

The unpredictable nature of capital flows further complicates the picture on what would happen to the yuan if Beijing were to shift to a floating exchange-rate regime. Eswar Prasad, a Cornell University professor and senior fellow at the Brookings Institution, believes that if China opened its capital account, households might shift a portion of their bank deposits offshore, triggering short-term pressure for depreciation of the yuan. "It is far from obvious that if China's capital account opened, the yuan would be a one-way bet," he says. "Capital flows mean depreciation could also be a possibility."

The economic evidence might be shifting against them, but the yuan's main critics in Washington aren't ready to concede defeat.

A leading Republican critic of China's currency policy, Rep. Tim Murphy of Pennsylvania, acknowledges that the yuan has made some gains against the dollar. But the congressman—who last year co-sponsored a bill on currency manipulation—isn't toning down his rhetoric.

"Just because the fire may be cooling down doesn't mean you don't go get a fire hose," Mr. Murphy says. Although the yuan has appreciated by close to 10% against the dollar since last June by some inflation-adjusted measures, "it still began by being undervalued by as much as 40%," he says. "So some movement in one direction doesn't mean that we have fair trade."

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