THE WALL STREET JOURNAL.
WSJ.com

ASIA BUSINESS | January 27, 2012, 8:34 p.m. ET

IMF Reviewing Whether Yuan Still 'Substantially Undervalued'

By IAN TALLEY

WASHINGTON -- The International Monetary Fund is reviewing whether China's currency should still be considered "substantially undervalued," as the yuan has appreciated more than 8% in the last year and the fund is developing a new method of assessing global currencies.

The IMF told the Group of 20 industrialized and developing countries last week that China's exchange rate has been allowed to rise faster than in the past. The real effective exchange rate, based against a basket of currencies and accounting for inflation, is up almost 20% in the last three months on an annual basis and by over 8% in 2011.

The fund said China needs to continue to allow the exchange rate to appreciate "closer to equilibrium."

But, "since our last assessment in the summer of 2011, the RMB has certainly appreciated," IMF spokesman William Murray told Dow Jones Newswires. Asked if that rise meant the yuan was still "substantially undervalued," Murray said the fund is "in the process of assessing China's exchange rate."

"However this information alone does not permit us to offer a new judgement on is valuation. We have more analysis to do," he said.

The IMF has called China's currency "substantially undervalued" for the last half-decade, a term weighted with political implications for the country and its trade partners. If the IMF says the currency is only "undervalued" under the new assessment, or is near a level that is closer to reflecting market fundamentals, it could undermine efforts to challenge the country's currency policy.

U.S. lawmakers are pushing legislation that would penalize China if the U.S. Treasury found its currency "misaligned." The U.S., as the IMF's largest shareholder and most powerful board member, will help to guide how the IMF assesses currencies. A less critical assessment by the IMF would make it politically more difficult on the international stage to attack China's currency policy, much less assign tariffs to Chinese imports.

It would also likely frustrate efforts to censure Beijing over its currency policy at the World Trade Organization. Brazil said late last year, for example, it wants the WTO to take exchange rate imbalances into account in trade disputes. At Brazil's request, the WTO agreed to discuss in the coming months whether international trade rules can be used to punish governments that manipulate their currencies.

In the meanwhile, the IMF is conducting a pilot program using a new method to assess exchange rates that takes into account a country's size, its trade relationships and currency reserves. The board plans to review the new method for assessing exchange rates and current accounts before the annual IMF spring meetings.

Eswar Prasad, Cornell University economist and former senior IMF China expert, said it is increasingly difficult for the IMF to make a strong case that the yuan is undervalued.

"All of the relevant indicators, the current account and trade surpluses, the pace of reserve accumulation and the exchange rate itself, have moved in the direction of suggesting the yuan is no longer much undervalued," Prasad said.

Since 2007, the real effective exchange rate has appreciated around 25% according to the Bank of International Settlements. From 2007 to 2010, the yuan appreciated by an average of 4% a year. In 2011, the rate jumped 8%.

Prasad notes that in the last two quarters of 2011, China's accumulation of foreign currencies has been relatively small compared to previous months and years. China must accumulate foreign currencies to offset its policy of keeping the value of the yuan at a set level.

The IMF's new assessment of China's exchange rate comes as the fund seeks more cash from China to help finance a $600 billion emergency cash pool at the IMF. Chinese officials have indicated they're willing to contribute between $50 billion to $100 billion. Beijing has said one condition may be that China is granted free market economy status.

Write to Ian Talley at ian.talley@dowjones.com