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Q&A: Peterson Institute's Bergsten on China's Currency

*The widely quoted and influential director of the **Peterson Institute for International Economics** in Washington, **Fred Bergsten** has until recently been one of the most prominent critics of China's policy of intervening in foreign exchange markets to weaken its currency. Now he thinks progress is finally being made to resolve this acrimonious dispute between the U.S. and China. In an article he wrote for the Institute's website last week, he said that a "breakthrough" appeared to have been made because of a combination of Chinese inflation and the gradual appreciation in the yuan's nominal exchange rate to the dollar since mid-2010, which is putting the inflation-adjusted exchange rate on track to achieve a needed correction of 20 to 30% over the next two to three years.*

Courtesy of the Peterson Institute

Fred Bergsten

You recently wrote that the combination of inflation and gradual appreciation in the Chinese yuan's exchange rate could be achieving a "breakthrough" in terms of U.S. demands for an increase in Chinese competitiveness. You said the increase in the inflation-adjusted real exchange rate was now in line with the trend that's expected of China over the next two years. Can you explain?
Bergsten: The real [inflation-adjusted] renmimbi exchange rate has appreciated against the dollar at an annual rate of about 12% since last June, although considerably less on a trade-weighted basis. The dollar has fallen against most other currencies, so on a trade-weighted basis, the renmimbi has risen less. On the other hand, one has to accept that the Chinese think of this totally in dollar terms. So the dollar exchange rate is a legitimate focus for them, and if you believe that the dollar is going to bounce around and come back over time it will drag the renmimbi back up with it [against those other currencies.]

They have been letting [the real exchange rate] go up an average of 10 to 12% on an annual basis so it's fair to say that if they would let that continue for another couple of years they would achieve a restoration of underlying equilibrium in the exchange rate. That would take away most, if not all, of the distortions that their persistent interventions have created.

About four months ago, you estimated that the yuan was 30% undervalued, and many commentators read that as a strong critique of China's exchange rate policy. Have the changes over past four months improved things enough for the U.S. to accept that the policy of deliberate undervaluation has changed?
Bergsten: During its previous period of appreciation [between 2005 and 2008] the renmimbi went up 20 to 25% in a period of two and half years. I suggested recently that the goal should be the same amount this time and [Treasury Secretary **Timothy**] **Geithner** seemed to endorse this. I took that as a kind of wide agreement on what the outcome should be.

You're talking about real exchange rate adjustments in which inflation plays a key role. Surely it would be China's and other countries' interests to have this adjustment take place through the nominal exchange rate

and avoid the disruptions that inflation could cause in the world's second biggest economy?
Bergsten: Yes, especially given China's history of hyperinflation, it would be far better to adjust via the nominal rate. It has always surprised me that they seem to prefer to do part of it through inflation. And now that they are really worried about inflation, which has become the focal point of their economic policy, this would be the perfect time for them to let the currency adjust. They know the currency is going to adjust over time anyway and it is better to let it happen through the nominal rate. At the same time, it's an ideal time for us if they make the move now because it will help rebalance our external accounts and help deal with our high unemployment. From the standpoint of both sides there couldn't be a better time to adjust the nominal exchange rate for the renmimbi.

Surely other countries aren't happy about China basing its appreciation policy solely on the dollar exchange rate when the dollar itself is falling sharply against other currencies, especially emerging market currencies.
Bergsten: One of the reasons the Chinese are moving now is because they have gotten a pretty wide array of complaints from other emerging markets — from Brazil, from India, from Mexico and others. They have been quite pointed in their criticism. Most of them have respected China's desire not to be criticized publicly, so they do it privately. I've been in on some of those discussions, recently at Davos, for example. There is a lot of pressure on the Chinese from other emerging market countries.

But these countries also blame the Federal Reserve's quantitative easing policy for their driving up the values of their currencies. Is the Fed to blame?
Bergsten: I think it has had an effect. I don't think it was mainly intended to do that, but the Fed is right when it says that when you loosen monetary policy to stimulate your economy one of the transmission mechanisms is the exchange rate. Depreciation is inevitable and desirable. I don't think it was a major motivation. It was not part of some competitive devaluation, but when you consider that the U.S. economy is now characterized by high unemployment, slow growth and a very large trade deficit, the dollar has to fall. That's textbook economics.

Are these emerging market countries also guilty of manipulating their currencies? Many are intervening to stop the appreciation trend and some believe this is further stoking global inflation.
Bergsten: I make a sharp distinction between the countries that are already overvalued and keeping their currency way undervalued and those that are intervening to keep them from appreciating too far. The Fed action is a challenge for the latter group, but it really comes back to China. If they were not intervening so massively, these effects would not be seen in other currencies. China is still intervening at a billion dollars a day. They are not doing that to increase their reserves but to keep the exchange rate weak.

According to the Treasury International Capital (TIC) data this week, China was a net seller of U.S. Treasurys in both November and December. People widely believe, however, that China disguises its purchases by routing them through U.K. fund manager. Having accumulated reserves of $199 billion in the fourth quarter it seems the Chinese authorities must have bought more Treasurys than was officially recognized under China's name. If China is aspiring for a greater international role should it be coming clean with numbers like these?
Bergsten: The **IMF** has a program for reporting on reserve holdings and changes. Well over half of the countries report not only on the level of their reserves but also the currency composition. A few don't, including Saudi Arabia, and China is among that group. Yes, it definitely should be reporting all of that information. I think it goes back to when they were a much smaller reserve holder and they viewed this as a kind of a state secret. But now it's ridiculous….particularly if they want the RMB to play a bigger role in the international economy.

China's high savings rate and negative real interest rates are seen as facilitating and encouraging an investment-led growth model. Would that model be at risk if China opened up its capital account, made the yuan fully convertible, and allowed its citizens to invest their funds overseas.
Bergsten: If they let interest rates go up to the market level, they might actually reduce their savings level, which is what they need, if Chinese are target savers (seeking a certain level of investment income). If their savings are earning more, they can afford to spend more of their income. There's a big wealth effect.

As it is now, the government controls prices in three big parts of their economy. They control the price of money through interest rates, the price of foreign exchange and the price of energy, which they hold down way below market rates. These prices are all really suppressed and until they open those markets up a lot more, and move to a market outcome, it's going to be hard for them to put their economy onto a self-sustaining track. The problem here is the incentives that these distorted prices create toward increasing capital investments. But these investments are not really good at producing long-term jobs, and they are highly politicized.

It would presumably be easier for China to wean itself off this high-savings, high-investment-led growth model if there were some king of grand international agreement, presumably via the G20, where the U.S. and other big-spending countries moved gradually in the direction of more savings in concert with China. But with the G20 finance ministers meeting in Paris this weekend, observers don't hold out much hope. Is such a pact to rebalance the world economy possible at all?
Bergsten: It's highly desirable. And there the U.S. is crucial in terms of showing its commitment to reform . If the world is skeptical of our desire to change and it looks like we're going back to the good old days of running big trade and budget deficits, we won't make progress on rebalancing. A lot of this really does depend on whether the U.S. changes. It is easy for them to stick to their export-dependent trade model as long as the U.S. keeps running big trade deficits.

A big part of that is letting the dollar depreciate. I also believe it's time to think of reducing the dollar's role as the dominant international reserve currency, which creates a kind of addiction to the cheap capital that other countries provide to us. We can no longer rely on low interest rates to let us live beyond our means. I would say we should move to a multi-currency international reserve system.

But the biggest task we face is to reduce the budget deficit.

And what are the top priorities there? Reducing social security and Medicare benefits?
Bergsten: Yes, but also tax reform. We need to raise more tax revenue more effectively and efficiently. A consumption tax would be good. That way we'd raise taxes and help to discourage the excessive consumption in the economy. You'd get a two-for. You'd kill two birds with one stone.

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