How High Should China Appreciate Its Currency?

Lessons from 1970s Japan.

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The question of how much China's currency should appreciate to rebalance its trade has become a global hot-button issue. But the answers have been all over the map, with some finding that the yuan is not undervalued at all, while others argue that it should appreciate against the dollar by more than 30 percent.

Clearly, there must be major differences in the macroeconomic models used to produce such a wide range of estimates. But the one thing about which everyone seems to agree is the theoretically and empirically unjustified assumption that an equilibrium exchange rate actually exists.

The theoretical problem is simple: a country's trade balance depends on a lot more than the value of its currency in the foreign exchange markets. Interest rates, employment, aggregate demand, and technological and institutional innovation all play a role. As the economist Joan Robinson pointed out in 1947, just about any exchange rate will be the equilibrium value for some combination of these other variables. The equilibrium exchange rate, she famously argued, is a chimera.

Not surprisingly, the empirical evidence that trade imbalances can be resolved through exchange rate changes alone is unconvincing. In the case of China, the most useful precedent is probably that of Japan in the period from the end of the Bretton Woods fixed exchange-rate regime in August, 1971, to the collapse of its "bubble economy" in 1990. During that period, the yen's value more than doubled against the dollar, rising from its original fixed rate of 360 to 144 at the end of 1989. Yet, even as Japan's exports became much more expensive in dollar terms and its imports much cheaper in yen, its trade surplus rose from $6 billion in 1971 to $80 billion in 1989.

The exchange rate alone does not determine equilibrium.

For two decades, expectations that an appreciating yen would restore external balance were repeatedly disappointed. At the time of the December 1971 Smithsonian Agreement, 308 yen to the dollar was supposed to do the trick. Fourteen years later, during the Plaza Accord negotiations, the Japanese argued for an eventual level of 200–210, while some U.S. Treasury officials thought the final target should be as high as 165–170. At the end of the 1980s, some analysts thought rates as high as 120 might finally produce the long-sought equilibrium.

Yet, as Japan entered the "lost decade" of the 1990s, its exports continued to grow faster than its imports. Japan's trade surplus peaked only in 1994, at $144 billion, just a few months before the yen's April 1995 all-time high of 79.75.

In retrospect, it is easy to see why none of these supposed equilibrium exchange rates delivered external balance. As the yen appreciated, Japan responded not by exporting less but by improving productivity and quality control through plant and equipment investment and innovations in factory management, making possible rapid growth in exports of high-value-added products.

Exchange-rate equilibrium calculations from the 1970s and 1980s, which could only have been based on the export sector's contemporary structure, naturally would have little relevance subsequently. The same is true of calculations at the beginning of the 1990s, which would have forecast Japanese import growth based on extrapolations from the high GDP growth rates of the previous forty years rather than on the decade of stagnation that ensued.

In China, changes in the export sector's structure similar to those observed in Japan are now taking place. These changes are likely to make today's attempts to find an equilibrium yuan-dollar exchange rate seem just as chimerical in hindsight as previous calculations of the yen-dollar equilibrium rate.

For the thirty years since the beginning of China's economic reforms, Chinese industry has achieved impressive efficiency gains by adopting new technologies and realizing economies of scale, leading to a huge expansion in locally made products suitable for export. While an appreciating currency might eventually drive labor-intensive manufacturers out of business, if Japan's economic history is any guide, they are likely to be replaced by producers of things like ships, machine tools, semiconductors, and doubtless new products yet to be invented.

The equilibrium yuan-dollar rate is a chimera not because China's trade could never be balanced, but because the exchange rate alone does not determine equilibrium. The structure of the entire economy matters, too. As this is constantly evolving in unpredictable ways, there is no reason to expect that the assumptions underlying any particular macroeconomic model will ever remain valid long enough for its steady-state solution to be achieved in practice. ◆

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