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IMF Sees Yuan as Undervalued

By BOB DAVIS in Washington and AARON BACK in Beijing

Despite China's decision to adopt a "flexible" exchange rate, the International Monetary Fund's long-delayed review of the Chinese economy found that the yuan is "substantially undervalued," according to IMF officials.

The IMF determination is bound to put pressure on Beijing to let the currency appreciate more than the 0.7% it has risen since China loosened the yuan's peg to the dollar on June 19. The IMF determination was backed by the U.S., Germany, France, the United Kingdom, among others, say two individuals familiar with the deliberations, as the IMF's executive board debated the China report on Monday, though none of the countries pushed China to boost its currency quickly.

In China, the central bank had been explaining to the public how a flexible exchange rate can help the economy by alleviating inflation pressures and improving the effectiveness of monetary policy.

On Monday, before the IMF's board met, Hu Xiaolian, a respected deputy governor of the People's Bank of China, made her third statement in less than two weeks addressing the reasons for the government's decision last month to loosen the yuan's de facto peg against the U.S. dollar, a change that was vocally opposed by Chinese exporters and some other interest groups.

Her comments echoed arguments made by IMF and other global institutions, but were unusual coming from a Chinese official. "This kind of openness is very rare," said Ken Peng, an economist at Citigroup. "The tone of Hu's statements has actually grown stronger as they have come out."

It's unclear whether the IMF's determination will strengthen the hand of those in Beijing urging a revaluation, or create a backlash. One indication of the direction will be whether China will block the IMF from publishing a detailed summary of the board's Monday deliberation over the next few weeks. The full IMF analysis would likely be published in September unless China withholds its permission.

IMF members are entitled to block publication of IMF reviews, though most now allow publication. The U.S. has been pressing Beijing to permit publication.

China hadn't allowed the IMF to conduct an annual review of its economy since 2007 as the two sides fought over China's policy of

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The People's Bank of China has made its third announcement explaining its decision to loosen the yuan's de facto peg against the U.S. dollar.

pegging the yuan tightly to the dollar, a policy that China put in place in 2008. The U.S. and Europe—the IMF's largest shareholders—complained that policy gave Chinese exporters an unfair advantage. The IMF began the current review in the spring of 2010.

Eswar Prasad, a Cornell University economist and a former head of the IMF's China desk, said a draft of the IMF staff report he had seen noted positively Beijing's decision to let its currency float. The report also highlighted that China's current account surplus had fallen in recent months—which could be an indication that the currency is properly valued. But the IMF forecast that the change in the surplus was only temporary, a determination it had made in April as well.

"Significant action" was needed to reduce the undervaluation, Mr. Prasad said.

Brazil largely backed the Chinese position that the reduction in China's current account balance could be long lasting, said the country's IMF representative, Paulo Nogueira Batista.

Chinese officials argued that "they have done what they needed to do and the rest of the world should give them room" to act, he said. Another individual familiar with the deliberations said the report's finding hadn't changed significantly from the draft.

In Ms. Hu's latest statement on the yuan, which was posted on the central bank's website, she focused on the dangers of inflation. That is familiar territory for any central banker, but Ms. Hu turned up the rhetorical heat by quoting legendary free-market economist Milton Friedman's statement that inflation is "a dangerous and sometimes fatal disease."

"Looking at China's situation, those who suffer greatest from inflation are the low-income masses, especially China's over 40 million poor urban residents and nearly 100 million poor migrant workers, a situation which if improperly handled will affect social equality and stability," she said.

Such comments probably indicate that the central bank would like to allow the yuan to appreciate further if it perceives inflationary risks, economists said. But major decisions on currency and monetary policy require approval from China's top political leadership.

At the moment, most economists generally see China's current inflation rate as manageable and don't see a need for a major policy shift to stop price increases. China's consumer price index rose 2.9% from a year earlier in June, down from May's 3.1% rise.

Ms. Hu said that although the consumer price index has "basically stabilized at a low level" in recent years, other measures of price levels, such as the producer price index, real estate prices and other asset prices, have all risen by larger margins.

She said that China faces inflationary pressures from the capital flowing into the country from its massive trade surpluses with the outside world. To keep the currency from rising sharply, the central bank has been forced to buy up the incoming foreign currency with yuan, thus increasing domestic money supply, she said.

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