A A 2008

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Note prepared for the Peterson Institute conference on China's

**The End of Europe's Long-Standing Indifference to the Renminbi**

Jean Pisani-Ferry*

Is the renminbi's exchange rate an important issue for Europe? For a long time, it seemed as though it was not. As recently as 2006–07, when Henry Paulson, secretary of the US Treasury, was calling the US-China economic relationship the most important in the world and no less than three congressional bills envisaged potential trade retaliation against an allegedly deliberate currency undervaluation, Europe was surprisingly silent. It apparently had no strong views on either the exchange rate regime or the valuation of the renminbi. Ministries of finance and the European Central Bank (ECB) investigated the issue and discussed it in contacts with Chinese counterparts, but it was not prominent on policymakers' agendas and was hardly discussed publicly. When asked, officials either referred to the latest Group of Seven (thein any case, its interests coincided with those of the United State activism for all practical purposes.

The situation began to change only in autumn 2007 as the Eurogroup, an informal gathering of euro-area finance ministers, began a more in-depth discussion of the matter. On October 8, 2007 the group issued a statement that "in emerging countries with large and growing current account surpluses, especially China, it is desirable that their effective exchange rates move so that necessary adjustments occur" and decided to initiate direct discussion with China's leadership. At the end of November, Eurogroup President Jean-Claude Juncker, ECB President Jean-Claude Trichet, and European Commissioner Joaquín Almunia were sent to Beijing for the first direct bilateral consultations on monetary and exchange rates matters. The Europeans, however, remain guarded in expressing their views on China's exchange rate policy.

After examining these five potential explanations, I conclude in the last section.

## 1. First View: China Does Not Matter That Much to Europe

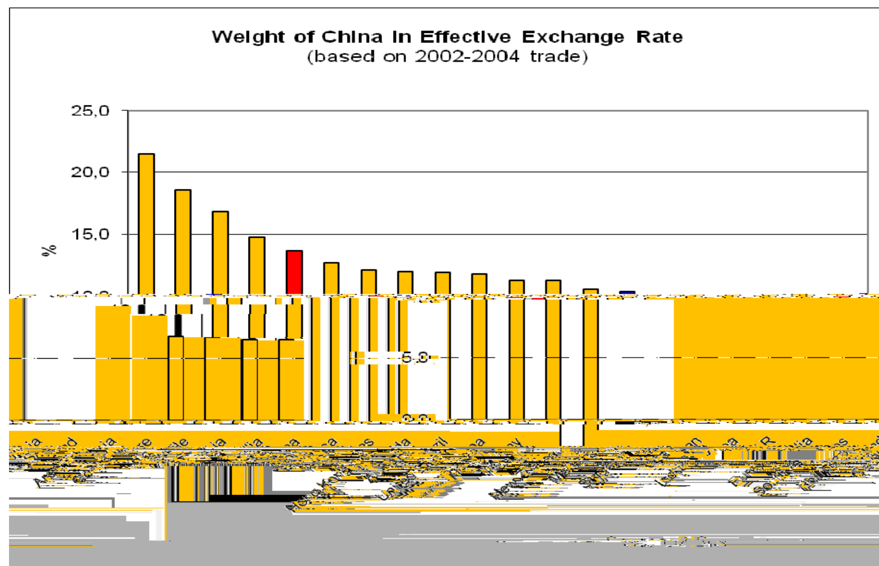
Many observers would suggest that Europe behaves as it does because China is a much more important economic partner for the United States than it is for Europe. This is a widely held perception, probably attributable to the rather smooth development of EU-China relations. In

essentially devoted to addressing internal issues, such as the creation of the single market and the euro or enlargement.

To further illustrate the apparent neglect, in 2000, in response to the perceived challenge of that time—the emergence of the so-called new economy in the United States—Europe adopted a new economic strategy, the Lisbon agenda, which essentially ignored the various opportunities and challenges that China's growth and development posed. Since then, perceptions have changed and initial inattention has started to be corrected, but European interest in and concern about China remain strikingly less intense than the US fascination with it.

However, this asymmetry in perceptions is not supported by numbers. In 2006, EU exports to China exceeded those of the United States by 45 percent and its imports from China were only 23 percent lower than those of the US. Its trade deficit is certainly lower, but it only trails that of the United States by about two years (figure 1). The euro area is in a very similar situation. As a consequence, European policymakers have started to indicate that they could soon lose patience. As

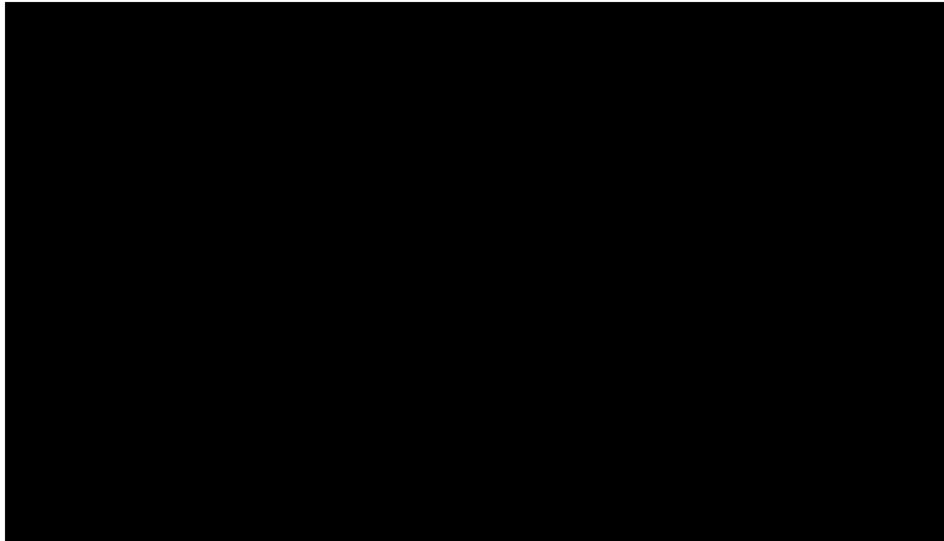
Figure 2: China's Weight in Effective Exchange Rate




## 2. Second View: The Dollar-Renminbi Exchange Rate Is a Bilateral Issue

The second potential explanation for Europe's relative detachment from the renminbi issue is that the European currencies are in a floating exchange rate regime against the dollar. Thus, while the renminbi/dollar exchange rate is not market determined, the exchange rate of European currencies

**Figure 3: Current Account Balances, 1983-2008**



For this view to be justified, however, the United States and China would have to form a true monetary union or to be expected eventually to create one. In that case, market participants could and actually would be wholly indifferent to the two countries' individual balances. But because they do not expect the peg to last forever, they still regard each country's intertemporal budget constraints as meaningful and accordingly monitor their national current accounts and net foreign asset positions.

If the US current account matters, rather than the current account of a wider aggregate comprising China, then it follows that a renminbi undervaluation has strong consequences for the euro/dollar exchange rate. For a given equilibrium exchange rate of the US currency, the more the renminbi is undervalued, the more the euro needs to appreciate in bilateral and effective terms. This type of reasoning underpins most evaluations of equilibrium exchange rates, including those of the International Monetary Fund (IMF 2006). Such evaluations generally conclude that, although the effective exchange rate of the US dollar was above equilibrium in 2007, there was no need for the euro to appreciate further in effective terms (Ahearne et al. 2007).

Following this line of reasoning, the Europeans should have every interest in pushing for an appreciation of the renminbi because such a move would reduce the upward pressure on their own currency and the risk of it becoming clearly overvalued in effective terms, at significant macroeconomic cost. It would also reduce its required appreciation against the US dollar

seems to be an inconsistency between the so-called trade view and the so-called financial account view of Europe's relationship to the renminbi issue.

The model of Blanchard, Giavazzi, and Sa (2005) helps to clarify the reason for the inconsistency, as it encompasses both views. It can be summarized in two long-term relations between the exchange rate (E)[4] and the external debt (F) of the United States, represented by current account balance (EC) and a portfolio balance (EP) schedules (figure 4). Both slope downward: In the steady state a higher debt implies a more devalued exchange rate, resulting in a

## 4. Fourth View: The Europeans Are Divided

A factor often mentioned to explain why the Europeans have difficulty defining a stance on the Chinese exchange rate is that they are internally divided. This is both true and unconvincing.

Certainly the Europeans hold different views.

the few key players in international trade negotiations. Divergence within can explain external paralysis only if governance mechanisms are too weak to ensure that a common stance is defined and implemented. After all, US states also have strongly divergent interests regarding the appropriate level of the exchange rate, yet the federal government can define its stance and communicate it. At any rate, the straightforward tone adopted in official declarations since autumn 2007—"We want an end to a managed currency in China," as Mandelson said that November[7]—indicates that divisions do not hamper common positions any more.

## 5. Fifth View: The Euro Area Does Not Have an Exchange Rate Policy

This leads to the examination of a fifth potential factor behind the Europeans' lack of assertiveness on the renminbi issue: that they do not have a proper exchange rate policy. The treaty provisions for exchange rate matters are notoriously complex and ambiguous, as they result from a compromise between German and French views (Henning 2007). The issue here is one of vertical division of labor between the European Union or the euro area, which logically has competence on exchange rate matters, and the member states, which participate individually in the G-7, Group of 20, and the IMF. It is also one of horizontal division of labor between the ECB and the Eurogroup, not to mention the European Commission. Both insiders (Bini Smaghi 2006) and observers (Ahearne and Eichengreen 2007) have assessed those arrangements as a drag on the definition and effective expression of common views on international monetary and financial matters. Such arrangements certainly make it difficult to decide who sets the objective (the Eurogroup or the ECB?), who speaks (de facto everybody), and who acts (often nobody). The fact that trade policy is a EU-27 competence while exchange rate matters are dealt with by the 15-strong euro area, and structural reforms are primarily a national competence, further complicates the issue.

Defining a stance and a strategy on the renminbi was bound to entail entering unexplored territory. The arrangements for exchange rate policy enshrined in the Maastricht Treaty had been drafted with a view to deciding how to intervene on exchange markets, manage target zones, or enter into formal agreements with third countries, no

and that they do not have a proper exchange rate policy—none provides a compelling motive for indifference.

What remains as a hypothesis to explain the difference between US and EU attitudes is probably that the Europeans are slower to react to external developments. The absence of significant external deficit, doubts about which policy stance is desirable, internal disagreements, an untested governance of exchange-rate relations, and a habit of following US leadership may have all contributed to a slow European response. That said, the Europeans have recently woken up to the issue as the euro has appreciated quickly against both the dollar and the renminbi, and they can be expected to adopt an increasingly active stance on China's exchange rate policy.

## References

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