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# THE END OF EUROPE'S LONGSTANDING INDIFFERENCE TO THE RENMINBI

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

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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 (G-7) communiqué or replied that the issue was best dealt with behind closed doors in discussions between ministers or among central bankers. Europe was apparently relying on the implicit assumption that, to it, the issue was second order, and in any case, its interests coincided with those of the United States. Therefore, Europe could rely on US 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.

Is there a rationale for this difference in attitudes between the two sides of the Atlantic? Or is the euro area only slower in reacting to China's emergence as a major surplus country in the world economy? This is the issue I intend to investigate in this paper. To this end, I examine five potential explanations of transatlantic differences of view: that China does not matter that much to Europe; that the renminbi/US dollar exchange rate is a bilateral issue; that the alternatives are worse; that the Europeans have divergent interests; and that the euro area does not have an 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 contrast with the emotional, generally politicized, and sometimes tense character of US-China relations, EU-China relations have only recently become a matter of public interest in Europe[1]. Previously, the international rise of China and its global economic implications had long remained underestimated, sometimes almost unnoticed. In the 1990s and early 2000s, political energy was

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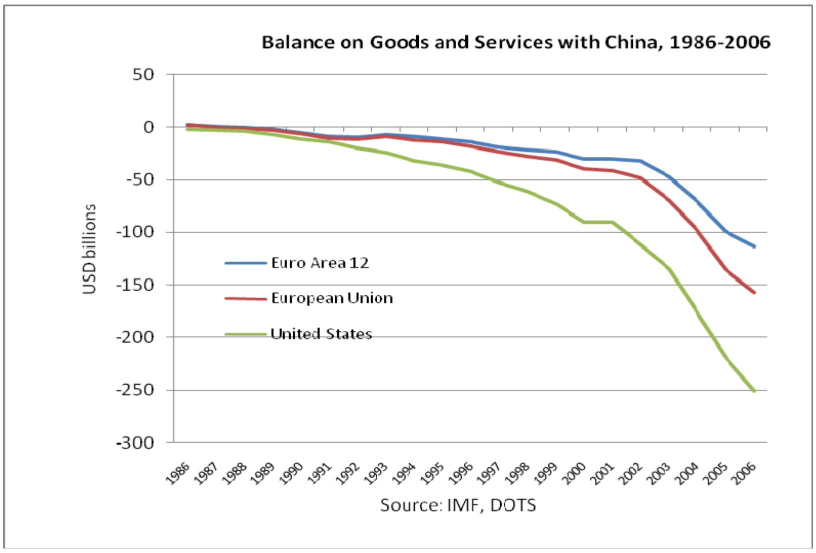
[1] The first EU policy paper on China was issued in 1995, almost two decades after the Chinese economy had begun its transformation. The first EU-China summit meeting occurred in 1998.

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 trade Commissioner Peter Mandelson said in November, "the number that preoccupies Europe these days is $20 million dollars. Because that is how fast the EU-China trade deficit is growing every single hour. Fast enough to catch up with the US-China trade deficit in the next year or so[2]."

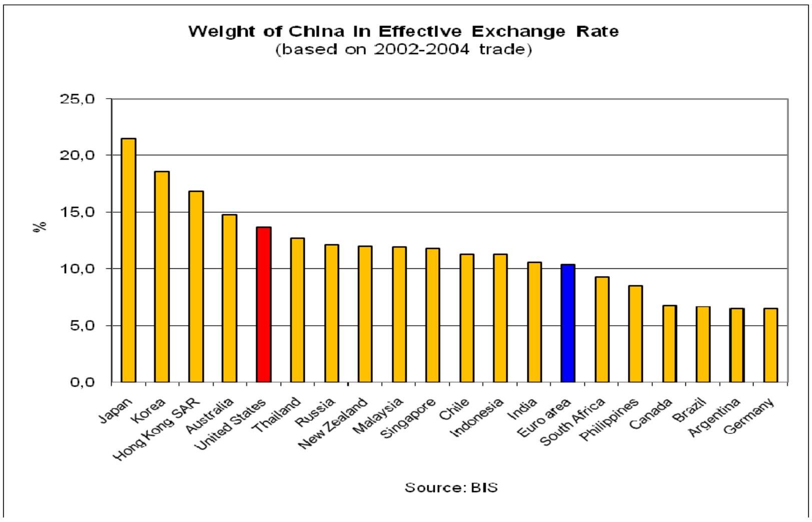
**Figure 1: US and European Deficits in Trade with China**




The transatlantic difference does not become wider when competition in third markets is accounted for, such as by using Bank of International Settlements measures of effective exchange rates (EERs): China's weight in the euro area's EER is only somewhat lower that its weight in the US EER (figure 2). Clearly no number supports the view that the intensity of US economic relations with China is of a different order of magnitude than those of the European Union or euro area.

2 "Europe and the US: Confronting Global Challenges," speech at the Carnegie Endowment for International Peace, Washington, November 8, 2007.

**Figure 2: China's Weight in Effective Exchange Rate**




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

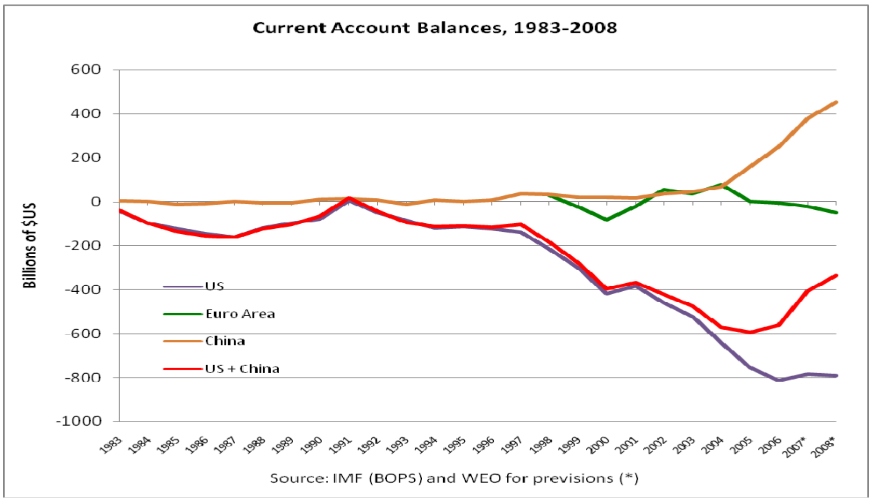
The second potential explanation for Europe's relative detachment from the renminbi issue is that the European currencies are in a floating exchange rate regime against the dollar. Thus, while the renminbi/dollar exchange rate is not market determined, the exchange rate of European currencies against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

What the asymmetry may imply can be best understood by imagining the United States and China as partners in a de facto currency union. Accordingly, it should not be the US or Chinese current account balance that matters, but rather the aggregate US-China current account balance or that of a wider dollar zone, in the same way that what matters for the exchange rate of the euro is neither the Spanish deficit nor the German surplus, but the aggregate balance, which is close to equilibrium. The aggregate US-China balance, while still far from equilibrium, has improved somewhat in recent times and is set to improve further in 2008 (figure 3[3]). Also, the bilateral trade balance of the euro area regarding the United States and China combined is very close to zero.

The trade balance figures suggest that the dollar peg of the renminbi and its undervaluation might result in the euro being stronger against the dollar and weaker against the renminbi than would be the case if the renminbi were to float, with no clear consequences in effective terms. This type of reasoning is consistent with the revived Bretton Woods approach of Dooley, Folkerts-Landau, and Garber (2003), who emphasise that emerging countries have entered a stable fixed exchange rate arrangement with the dollar; it may also have underpinned the view frequently held in the early 2000s that the euro had no stake in global adjustment because it was itself close to equilibrium in effective terms.

[3] Forecasts for 2007 and 2008 are from the IMF, based on the conventional assumption of stable exchange rates throughout the forecast period.

**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 (Ahearne et al. 2007), and to the extent that the Europeans are sensitive to the dollar exchange rate because the United States is their direct competitor in certain industries, most notably aerospace, the latter is something they should be sensitive to.

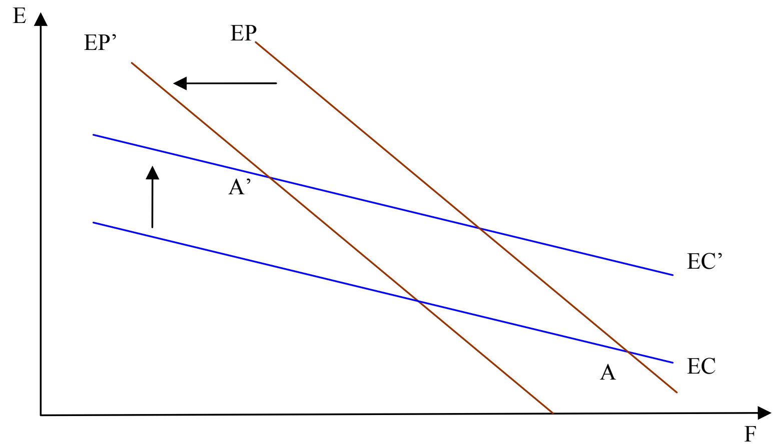
## 3. Third View: The Alternatives Are Worse

The third reason for Europe's caution regarding the reform of the Chinese exchange rate regime may be an aversion to the risk of unintended adverse consequences. Better the devil you know than the devil you do not. Europeans might fear that a Chinese move toward a more flexible exchange rate regime would result in an appreciation of the euro as China diversifies its reserves away from US dollar assets and, at least partially, into European currencies. The reasoning here starts from the financial account rather than the current account, resulting in the opposite conclusion. Thus, there 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 larger trade surplus, which allows for servicing of the debt. Higher debt also implies that nonresidents hold more dollar assets, which they are inclined to do if a lower dollar makes those assets cheaper[5].

Suppose now that E represents the exchange rate of the dollar against the euro and that F represents the holdings of dollar assets by European residents. A Chinese move to a floating exchange rate regime means two things: First, an appreciation of the renminbi resulting in an outward shift of the EC curve, as for a given level of debt, the same US current account balance can be achieved with a higher bilateral euro-dollar exchange rate; and second, the removal of a marginal buyer of US dollar assets, which moves the EP curve inward, as for a given level of debt, the dollar needs to depreciate as Europeans have to hold more of it in their portfolios. In the long run, the result of the two moves is unambiguously an appreciation of the dollar against the euro (a move from A to A' in figure 4).

**Figure 4: Effects of a RMB float on the euro-dollar exchange rate**




In the short term, however, the dynamics are likely to imply a depreciation of the US dollar against the euro (see Blanchard, Giavazzi, and Sa 2005), as for a given level of debt and US current account deficit, an end to Chinese intervention implies a lower demand for dollar-denominated assets, which implies a further depreciation of the US currency.

The issue for the Europeans is therefore one of time preference. The renminbi peg on the dollar has the advantage of avoiding too sharp a depreciation of the US currency in the short run, but it also contributes to the build-up of US external debt, and thus, to an eventually lower dollar in the long run.

[4] A rise in E represents an appreciation.
[5] Returns on dollar and nondollar assets are supposed to be identical.

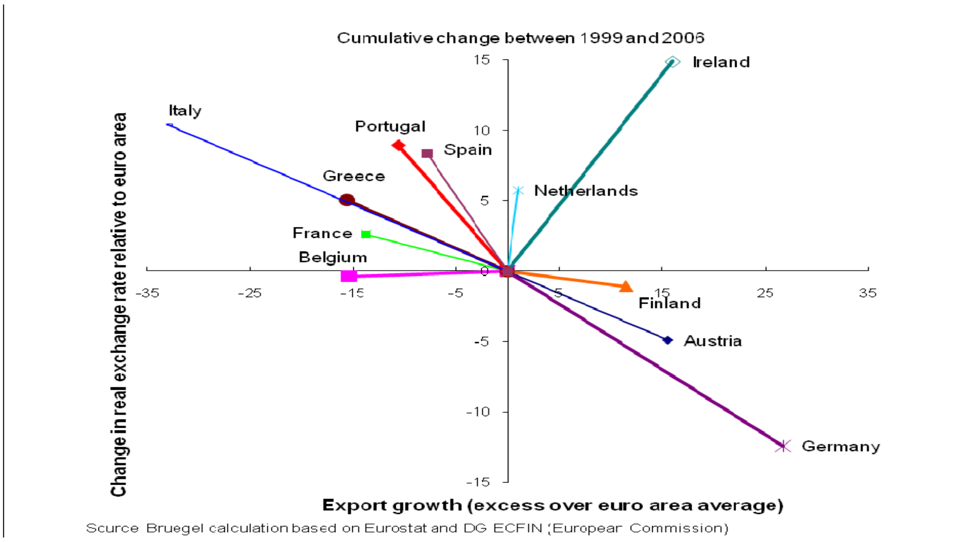
## 4. Fourth View: The Europeans Are Divided

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. In autumn 2007 German Finance Minister Peer Steinbrück notoriously claimed "love"[6] for the strong euro at the same time that French President Nicolas Sarkozy was lamenting its detrimental effects on the aerospace industry. At the root of this divergence are strongly divergent performances in world trade, the determinants of which can be found in structural factors and the evolution of the real exchange rate of the participating countries against their partners in the euro zone since the start of the monetary union.

Figure 5 illustrates those diverging trends. For each of the euro-area member countries, the X-axis plots the deviation since 1999 of the real exchange rate from the euro area average and the Y-axis plots the deviation of exports from the euro area average. Countries in the southeast quadrant, most notably Germany, have experienced real depreciation and an improvement in their relative export performance. Countries in the northwest quadrant, especially Italy, Portugal, and Spain, have experienced the opposite development. France also belongs to this category. Ireland has experienced both a sharp real appreciation and a structural improvement in its relative export performance. The extent of divergence over a rather short time span is striking. These developments have taken policymakers by surprise, contributing to an explanation for why national ministers have different views on the exchange rate of the euro.

**Figure 5: Real Exchange Rate and Export Performance Divergence within the Euro Area, 1999-2006**




Other reasons why the Europeans react differently have to do with the wide dispersion of geographical and sectoral trade patterns, resulting in different sensitivity to exchange rate changes.

However, the Europeans are no less divided on trade matters—largely for the same reasons—but they nevertheless have a common trade policy that makes the European Union one of

[6] Declaration on July 9, 2007 at the Eurogroup meeting: "I am not worried about a strong euro—I love a strong euro."

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, not anticipating the delicate issues of financial diplomacy raised in any dialogue with Chinese authorities. By nature, a conversation about the renminbi has to include both the Eurogroup, because only governments speak to governments, and the central bank, because of its extensive responsibility on exchange rate matters. Against the background of controversies about the monetary stance of the ECB, such a conversation is also bound to be regarded as a test of the central bank's effective independence. All these factors may have contributed to delaying Europe's response to the renminbi issue.

However, the communiqué of October 2007 and the decision to send a mission to Beijing indicate that the complexity of internal arrangements is not an insurmountable impediment to expressing views any more. It probably signals the end of Europe's long-standing benign neglect toward the renminbi.

## 6. Conclusion

There is no convincing reason for the Europeans to be more indifferent than are Americans regarding the Chinese exchange rate policy. Of all the possible explanations we have examined—that China matters less for Europe than it does for the United States, that the exchange rate of the renminbi is a bilateral issue, that alternatives to the dollar peg can only be worse, that the Europeans are divided,

[7] "Europe and the US: Confronting Global Challenges," speech at the Carnegie Endowment for International Peace, Washington, November 8, 2007.

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.

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