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Emilio Umeoka
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The
Economist

The yuan-dollar exchange rate Nominally cheap or really dear? China's exchange rate has risen faster than you think. Really

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AMERICAN manufacturers complain that China undervalues its exchange rate. But which one? The nominal exchange rate is now 6.67 yuan to the dollar, having strengthened by almost 2% since September 5th (when Larry Summers, an adviser to President Barack Obama, flew to Beijing to complain about the currency in person) and by 24% since 2005.

But China's real exchange rate with America has strengthened by almost 50% since 2005, according to calculations by *The Economist* (see chart). A real exchange rate takes account of price movements in each country. If prices rise faster in China than in America, China's real exchange rate goes up, even if its nominal exchange rate stays the same. That's because higher prices at home make China's firms less competitive abroad, just as if their currency had gone up.

To calculate the real exchange rate, you need a gauge of prices in each country. Many economists use the consumer-price index (CPI). But the CPI contains lots of goods and services (such as housing rents) that cannot be traded across borders. Our measure of the real exchange rate, which we will regularly update, offers a more direct measure of competitiveness by looking instead at unit labour costs: the price of labour per widget. These costs go up when wages rise or productivity (widgets per worker) falls. In American manufacturing, unit labour costs have risen by less than 4% since the first quarter of 2005, according to the Bureau of Labour Statistics. In Chinese industry they have risen by 25% over that period, according to our sums.

Those estimates are rough and ready. There are no official statistics on China's unit labour costs. Our calculations are based on the value-added in industry (which extends beyond manufacturing) and the wage bill of urban factories, which does not count the town and village enterprises that employ over two-thirds of China's metal-bashers. But the urban plants probably churn out a big share of the goodies that America buys.

The combination of a 24% rise in the yuan against the dollar and a 21% increase in Chinese unit labour costs, relative to America's, explains the steep appreciation shown in the chart. The yuan may well still be undervalued but our index suggests American manufacturing should have less to fear from Chinese competition than it did five years ago. Until June 2009 appreciation was largely because of the stronger yuan. Since then it is largely because China's unit labour costs have grown much faster than America's. Employers in China's coastal factories have suffered labour shortages and strikes. America's factories have reported strong productivity gains as they have wrung more out of the workers that survived the recession (although those gains will be hard to repeat).

Of course, China and America do not trade only with each other. China's big surpluses and America's big deficits depend on the real exchange rate between them and all of their trading partners. But calculating that would require timely estimates of unit labour costs for all of China's trading partners. That is a bit too laborious.

Finance and Economics

Reality check

China's yuan-dollar exchange rates
Q1 2005=100



Sources: *The Economist*; Bureau of Labour Statistics; CEIC; Thomson Reuters *November 2nd

