Comments on

Why the Renminbi Might be Overvalued (But Probably Isn't)

by Cheung and Chinn

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Strengths

- Important Topic!

- Clear, logical progression of analysis

  - Start with PPP

  - Add more regressors

- All the (appropriate) Caveats

- Usually sensible results

<u>Objectives of Paper</u> (p 1):

1.   Meaning of "equilibrium real exchange rate"?

2.   Quantify uncertainty around equilibrium rate

3.   Discuss lessons about rates since Asian crisis

Weaknesses

o Not all interesting questions have answers

o The PPP-based approach is limiting

o Few observations

- Short span of data necessarily means poor precision

- No solution; longer span (if possible!) implies more structural change

Suggestion 1: Choice of Model

o Is productivity approach natural starting place?

■ Data-reliant

• Requires long time-series span

• Much estimation (e.g., Table 2) based on 15

annual observations (11 dependent df)

- The data is especially suspect

    - P 11: "Once one has to determine the appropriate Chinese productivity numbers, one enters a data quagmire."

    - P 12: 'nontradables is proxied by the "Other" sector.'

    - Labor productivity, not TFP

- Can one avoid the quagmire?

Suggestion 2: One Model or Many?

○ Key problem is poor precision

○ Why not combine models optimally?

    ▪ Different point-estimates can be combined

       optimally (with covariance matrix)

    ▪ If b_1 and b_2 are unbiased estimators of β, then

       $ab_1+(1-a)b_2$ is unbiased and lower variance if a

       chosen optimally (proportional to precision)

- Two noisy indicators optimally combined are better than one

- Seems obvious extension, since models with trade flows imply larger deviations with measurable imprecision

o Appropriate, given objective #1

Suggestion 3: Focus More on Second Moment

- Do we have precise estimate of width of confidence interval? If so, what is it?

  - Must be very high.

    - Span of data necessarily short (20 years)

    - Much structural change during sample

- Appropriate, given objective #2

Bottom Line

- Cheung and Chinn clearly correct that misalignment is poorly understood

  - This true of almost all recent crises (Asia, Mexico, Russia, Europe but not Argentina, Brazil)

- Conservative tone appropriate

  - But all those notes of caution are somewhat depressing!