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
Objectives of Paper (p 1):

1. Meaning of “equilibrium real exchange rate”?
2. Quantify uncertainty around equilibrium rate
3. Discuss lessons about rates since Asian crisis
Weaknesses

- Not all interesting questions have answers
- The PPP-based approach is limiting
- 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

- 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 $\beta$, 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!