Jahangir Aziz (1-212) 834-4328
jahangir.x.aziz@jpmorgan.com
J.P. Morgan Securities LLC

CNY valuation: where angels fear to tread

- **The current CNY debate is a 20 year rerun trapped in a false binary: "yuan as weapon" vs. "yuan as victim"**
- **Both camps are troubled by widening "global imbalances," and agree that CNY is undervalued 20–30%**
- **They disagree on the why: China's FX management or policies that suppress consumption**
- **We find the debate moot: a misalignment of this size should be showing up as inflation in China and disinflation elsewhere, contrary to current price dynamics**
- **Our view is also mundane: Fiscal will help growth, but not lower export dependency; CAS and appreciation pressures will stay high**
- **China will smooth the pace of appreciation, but not fight the direction**

Debate around CNY valuation has flared up again in recent months. This has now become a decadal ritual, yet its framing has barely moved on from the mid-2000s. Back in 2004–05, the renminbi was effectively pegged to the dollar, and the seemingly relentless rise in China's trade and current account surpluses became the defining exhibit of global anxiety over widening "global imbalances."

The dominant diagnosis was disarmingly straightforward: the cause was a severely undervalued currency, and the adjustment required a stronger CNY. Estimates of the undervaluation varied widely, from zero to 50%. On the other side of the debate were those that argued that the large and rising current account surplus was a symptom of domestic distortions across, input, capital, and goods markets. While greater CNY flexibility was deemed to be integral to the solution, by itself it would do little to correct China's domestic or global imbalances without accompanying policy changes and reforms.

If today's discussion feels like déjà vu, that is because the arguments are much the same as they were twenty years ago. While the common ground is a shared concern over growing global imbalances, on one side are those who see the renminbi as a rigged price, undervalued by as much as 30%, that distorts global trade and must be forced higher by pressure.

On the other side are those who argue that global imbalances—China's current account surplus and the U.S. deficit—primarily reflect each country's domestically driven saving–investment gap, itself shaped by policy choices, with the exchange rate a byproduct rather than a fundamental cause. Ergo, even if the CNY is undervalued, forcing it higher could do more harm than good. What is needed instead are reforms and policy changes that lift household consumption in China and reduce fiscal deficits in the United States, allowing China's excess savings and America's savings shortfall to narrow on a sustained basis.

As we have seen in many similar episodes (e.g., the impact of the 1985 Plaza Accord), neither the diagnosis nor the cure is simple or tidy; they are almost always messy. Casting the argument as a false choice between two caricatures—CNY as weapon and CNY as victim—distorts the debate and overstates both sides' claims in self-righteous overreach.

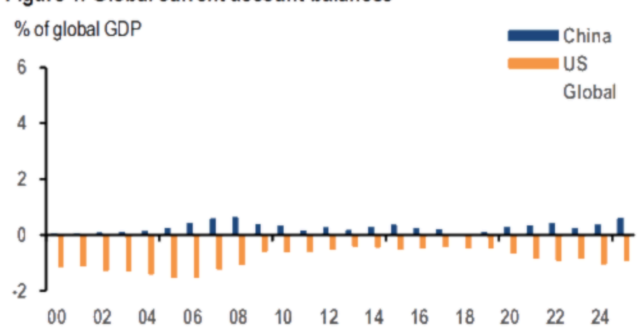
What is "global imbalance?"

While there have been rumblings around China's rising trade surplus and associated concerns over its managed exchange rate, the current form of the debate centers on the IMF's 2026 External Sector Report (ESR) that reports that global external imbalances widened in 2025, bucking the post-GFC trend.

The IMF describes imbalances as having "widened" in two related but distinct ways: first, as the increase in the aggregate global current account imbalance; and second, as the increase in "excess" balances, meaning the gap between countries' (mainly China and the US) actual current account positions and the IMF's EBA (external balance assessment) norms.

Both criteria are conceptually and empirically weak, and they are not necessarily harbingers of disruptive adjustments in global prices, trade, or capital flows.

Figure 1: Global current account balances



Source: IMF

Trade with Mars

Figure 1 reproduces the data from the IMF report on global current account balances. IMF membership covers almost all the countries of the world, and consequently the aggregate current account balance should be zero. The fact that the global current account balance does not add up to zero is a long-standing problem. Much of the discrepancy is attributed to lags in reporting, incomplete and weak data collection, and poor classification.

Even so, a 4% global GDP of unaccounted trade in goods, services, and income transactions raises concerns about the accuracy of the underlying country-level data, including for major economies.

Problems with the current account norm

Perhaps reflecting the obvious problems with the aggregate current account balance, the ESR shifts much of the focus of the report to China (and to the U.S.) on the grounds that the rise in global imbalances has been driven primarily by China's current account surplus, which has risen to its highest level in more than 25 years. The worry being that both the countries' actual current account balances have deviated significantly from the IMF's own EBA norm.

Table 1: China-US current account, 2025

	China	US
Cyclically adjusted CAB (% GDP)	3.6	-3.5
IMF's CAB norm (% of GDP)	0.6	-1.3
CAB gap (%-pts GDP)	3.0	-2.2
FX (REER) misalignment (%)	-21.3	19.9

Source: IMF 2026 External Sector Report

As Table 1 shows, the deviations for both China and the U.S. are large, implying massive under- and overvaluation that should have created severe distortions in other countries' bilateral exchange rates with spillovers to financial conditions, trade and capital flows, and, importantly, inflation. Volatility has increased over the last two years, but there is little sign of severe global stress.

One issue is the norm itself. It is cross-country model based benchmark, estimated from historical data for what a country's saving-investment gap, i.e., the current account balance, should be. The norm takes observed and expected fundamentals and policy settings to compute the external balance consistent with a sustainable net foreign asset position over the medium term. If the actual balance is higher or lower than the norm, then prices such as interest rates, inflation, and the exchange rate will adjust to close it. Such adjustments can be disruptive and painful, so the right thing to do is to change policy (monetary and mainly fiscal) instead.

Despite refinements, the IMF itself acknowledges that the framework leaves large unexplained residuals, relies on imperfect proxies and country comparisons, and remains contentious in practice. For example, China's CAB norm of 0.6% of GDP is, to a large extent, determined by the average behavior of other countries in the sample with a similar configuration of macroeconomic variables.

Similarly, a sustainable level of net foreign assets can change if residents decide to diversify their portfolio for reasons unconnected to macro variables (e.g., for a political-economic reassessment of a shift in government bias towards the public away from the private sector).

Then there is the causal primacy of the domestic savings-investment balance embedded in the norm. This is often not true in EMs. No consideration is given to the reality that, unlike DMs, they are liquidity constrained. International investors will lend to EMs only up to a limit, regardless of the interest rate offered, creating a virtual ceiling on the current account deficit, regardless of what the implied EBA norm is.

Put differently, in EMs, the domestic savings-investment balance is the resdual: it adjusts to changes in other variables. This includes fiscal policy, which in EMs has been forced to be procyclical rather than countercyclical because of such liquidity constraints.

Finally, there is the question of what the global imbalances are useful for. The IMF suggests that they signal "inefficient resource allocation" and build-up of macro-financial risks." It might be tempting to argue that the rise in imbalances over 2004-07 led to the correction (also driven by China's rising external balance) in 2008-19 (Figure 1), but it would be a gross remiss to not attribute the main cause behind the GFC to the problems in the U.S. subprime housing market.

A curiously well-behaved misalignment

Apart from their shared concern over rising global imbalances, both camps also agree that the CNY is undervalued between 20-30%. This presumably is in trade-weighted real terms (REER), although the authors do not make this very clear. Given that China is a major trading partner (if not the largest) of almost all major economies, arithmetically, the currencies of the rest of the world should, on average, also be overvalued by the same margin. In fact, the IMF considers the dollar to be overvalued by 20% in REER terms.

Such large misalignments rarely stay contained. They usually spill over into the rest of the economy. China's rising surplus over the past three years is seen as the smoking gun by one camp, but dismissed by the other as a by-product of domestic policy rather than exchange-rate management.

Be that as it may, misalignments of this scale almost always seep into other prices, especially inflation. The PBOC might have the ability to keep its nominal exchange rate undervalued through its myriad of interventionist instruments and capital controls, but it is hard to imagine that it can also prevent price dynamics in China and, more importantly, in the rest of the world from reacting to the misalignment. Protracted undervaluation almost always shows up in inflationary and overvaluation in deflationary pressures. The real exchange rate is set by fundamentals, even when the nominal rate is

Jahangir Aziz (1-212) 834-4328
jahangir.x.aziz@jpmorgan.com
J.P. Morgan Securities LLC

not. If policy prevents the nominal exchange rate from adjusting to its equilibrium value, inflation restores the consistency with fundamentals.

Thus, if the CNY were undervalued by 20–30% and other major currencies, including the USD, overvalued by a similar margin, the result would have been inflation in China and disinflation elsewhere over the past few years. At least for goods. That is plainly not what has happened: China has been battling deflation, while in the US, and much of the world, inflation in both goods and services.

This is not to say that the CNY is overvalued or other currencies are undervalued, but that fair-value assessments of currencies should not rely on partial-equilibrium trade or current-account analyses alone. They should be based on general-equilibrium frameworks that capture the economy as a whole.

The adjustment debate

China's external surplus has risen spectacularly post COVID, with exports becoming the key demand growth driver. Both sides agree that domestic policy is driving this rise; the real dispute is which policy lever dominates.

One view holds that an undervalued CNY is central to China's ability to expand into overseas markets as a way to offset weak domestic demand, and that FX management, directly and via proxies, is what keeps the currency that way. The engineered undervaluation amounts to an unfair advantage and has widened global imbalances. Ergo, China needs to be pressured to appreciate the CNY.

As we just discussed, even if China were able to cap nominal appreciation via direct or proxy FX interventions and counter-cyclical capital controls, a 20–30% undervaluation would inevitably feed into inflation. Yet, China has largely battled deflationary pressures since the pandemic. One argument is that the slack in domestic demand is so large that even the dramatic rise in exports has not been sufficient to compensate, keeping inflation contained. Ironically, this would argue for a weaker equilibrium or fair-value real exchange rate to erase the output gap, not a more appreciated one. Reminiscent of a similar argument back in the mid-2000s. Moreover, in its latest (July 2026) report, the U.S. Treasury found that no major trading partner is manipulating its currency.

The other side believes that forcing a large appreciation of the currency will do little to fix China's excess capacity and weak domestic demand. We agree. It is likely to worsen the deflation and the demand outlook, hurting investment and growth.

Any boost to resident foreign purchasing power is also unlikely to translate into any material increase in imports. Since 2014, China has been increasing the domestic content of manufacturing, and since the 2018 trade war, it has accelerated supply-chain onshoring on national security and resilience grounds. Apart from commodities, China's biggest external dependency is on Western advanced capital equipment and technology. However, the West has increasingly restricted China's access to these, on geopolitical and technology leadership considerations. Tighter visa and travel rules have also curbed household spending on foreign travel, education, and health services. CNY appreciation doesn't reverse these constraints.

At the same time, insisting that the global imbalance is just a reflection of excess savings by China's private sector and dissavings by the US public sector reduces the problem to one of accounting. The accounting might be tidy, but it sidesteps a larger question: how can global goods and asset prices plausibly sustain such a large FX misalignment through China's intervention and capital controls alone?

Where we stand

Our stance is mundane in comparison. Two decades of "fair value" exercises have produced more heat than light on the CNY, and there is little reason to expect a breakthrough now. Instead, we believe that better fiscal execution may lift headline growth in the near term, but it is unlikely to unwind China's excess-capacity problem with the investment shortfalls now compounding weak consumption. A meaningful shift of fiscal support toward households, or reforms that materially reduce precautionary saving, also looks unlikely. The upshot is that exports will remain the main driver of demand growth and net exports will stay elevated. With the export-revenue conversion solid, appreciation pressure should persist. Authorities will smooth the pace, but not fight the direction.

External uncertainties loom with the prospective new U.S. Section 301 tariffs and tighter Western technology restrictions, inviting retaliation. China could again lean on the currency, as it did in 2018, but the past two years suggest it prefers export controls on critical minerals, rare earths, and related inputs as better levers. And with the U.S. Treasury declining to label China a currency manipulator, Washington is unlikely to make currency manipulation an issue in the upcoming talks.