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China's Currency: A Summary of the Economic Issues

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Summary

In response to international pressure over its policy of pegging its currency (the yuan) to the U.S. dollar, the Chinese government on July 21, 2005, announced it would immediately appreciate the yuan to the dollar by 2.1% and adopt a currency policy based on a basket of currencies (including the dollar). Many Members have long charged that China "manipulates" its currency in order to make its exports cheaper and imports into China more expensive than they would be under free market conditions. They further contend that this policy is responsible for the large and growing U.S. trade deficits with China and the loss of U.S. manufacturing jobs. China's July 2005 reforms have done little to lessen congressional concerns. Several bills addressing China's currency have been introduced in Congress, including S. 295, which would raise U.S. tariffs on Chinese goods by an additional 27.5% unless China appreciated its currency. This report summarizes the main findings CRS Report RL32165, *China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy,* and will be updated as events warrant.

Unlike most developed economies, such as the United States, China does not allow its currency to float, i.e., let its exchange rates be determined by market forces. Instead, from 1994 until July 21, 2005, China maintained a policy of pegging its currency (the renminbi or yuan), to the U.S. dollar at an exchange rate of roughly 8.28 yuan to the dollar. The Chinese central bank maintained this peg by buying (or selling) as many dollar-denominated assets in exchange for newly printed yuan as needed to eliminate excess demand (supply) for the yuan. As a result, the exchange rate between the yuan and the dollar basically stayed the same, despite changing economic factors which could have otherwise caused the yuan to either appreciate or depreciate relative to the dollar. Under a floating exchange rate system, the relative demand for the two countries' goods and assets would determine the exchange rate of the yuan to the dollar. Many economists contend that for the first several years of the peg, the fixed value was likely close to the

market value. But in the past few years, economic conditions have changed such that the yuan would likely have appreciated if it had been floating.[1] Because its currency is not fully convertible in international markets, and because it maintains tight restrictions and controls over capital transactions, China can maintain the exchange rate peg and still use monetary policy to pursue domestic goals (such as full employment).[2]

China Reforms the Peg. The Chinese government modified its currency policy on July 21, 2005. It announced that the yuan's exchange rate would become "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket," (it was later announced that the composition of the basket includes the dollar, the yen, the euro, and a few other currencies), and that the exchange rate of the U.S. dollar against the yuan would be immediately adjusted from 8.28 to 8.11, an appreciation of about 2.1%. Unlike a true floating exchange rate, the yuan would (according to the Chinese government) be allowed to fluctuate by 0.3% on a daily basis against the basket.[3] The Chinese government initially hinted that further reforms would be made over time, but later ruled out making further revaluations in the near future.

U.S. Concerns Over China's Currency Policy

Many U.S. policymakers and business and labor representatives have charged that China's currency is significantly undervalued vis-à-vis the U.S. dollar (even after the recent revaluation), making Chinese exports to the United States cheaper, and U.S. exports to China more expensive, than they would be if exchange rates were determined by market forces. They further argue that the undervalued currency has contributed to the burgeoning U.S. trade deficit with China (which has risen from $30 billion in 1994 to $202 billion in 2005) and has hurt U.S. production and employment in several U.S. manufacturing sectors (such as textiles and apparel and furniture) that are forced to compete domestically and internationally against "artificially" low-cost goods from China. Furthermore, some analysts contend that China's currency policy induces other East Asian countries to intervene in currency markets in order to keep their currencies weak against the dollar in order to compete with Chinese goods. Critics contend that, while it may have been appropriate for China during the early stages of its economic development to maintain a pegged currency, it is no longer so today, given the size of the Chinese economy and the impact its policies have on the world economy.

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[1] Many analysts argue that the sharp increase in China's foreign exchange reserves (which grew from $403 billion at the end of 2003 to $819 at the end of 2005) is a major indicator that the yuan is significantly undervalued.

[2] The currency is convertible on a current account basis (such as for trade transactions), but not on a capital account basis (for various types of financial flows, such as portfolio investment). In addition, holdings of foreign exchange by Chinese firms and individuals are closely regulated by the government.

[3] Theoretically, fixing the yuan to a basket of currencies does not rule out the possibility that the yuan could depreciate or appreciate against the dollar. When the other exchange rates in the basket depreciate against the dollar, so will the yuan, but to a lesser extent. How closely the yuan moves with the dollar against other currencies will depend on how large a weight the dollar has in the basket (which has not been revealed by the Chinese government).

China's Concerns Over Modifying Its Currency Policy

Chinese officials argue that its currency policy is not meant to favor exports over imports, but instead to foster economic stability through currency stability, as many other countries do. They have expressed concern that floating its currency could spark an economic crisis in China and would especially be damaging to its export industries at a time when painful economic reforms (such as closing down inefficient state-owned enterprises) are being implemented. They further contend that the Chinese banking system is too underdeveloped and burdened with heavy debt to be able to deal effectively with possible speculative pressures that could occur with a fully convertible currency. The combination of a convertible currency and poorly regulated financial system is seen to be one of the causes of the 1997-1998 Asian financial crisis. Chinese officials view economic stability as critical to sustaining political stability; they fear an appreciated currency could cause deflation, reduce employment, and lower wages in several sectors, and thus could cause worker unrest.

Implications of China's Currency Policy for its Economy

If the yuan is undervalued vis-a-vis the dollar, then Chinese exports to the United States are likely cheaper than they would be if the currency were freely traded, providing a boost to China's export industries (which employ millions of workers and are a major source of China's productivity gains). Eliminating exchange rate risk through a peg also increases the attractiveness of China as a destination for foreign investment in export-oriented production facilities. However, an undervalued currency makes imports more expensive, hurting Chinese consumers and Chinese firms that import parts, machinery, and raw materials. Such a policy, in effect, benefits Chinese exporting firms (many of which are owned by foreign multinational corporations) at the expense of non-exporting Chinese firms, especially those that rely on imported goods. This may impede the most efficient allocation of resources in the Chinese economy. Another major problem is that the Chinese government must expand the money supply in order to keep purchasing dollars, and hot money has poured into China from investors who are speculating that China will continue to appreciate the yuan. These factors could help fuel inflation.

Implications of China's Currency Policy for the U.S. Economy

Effect on Exporters and Import-Competitors. When exchange rate policy causes the yuan to be less expensive than it would be if it were determined by supply and demand, it causes Chinese exports to be relatively inexpensive and U.S. exports to China to be relatively expensive. As a result, U.S. exports and the production of U.S. goods and services that compete with Chinese imports fall, in the short run. (Many of the affected

firms are in the manufacturing sector.)[4] This causes the trade deficit to rise and reduces aggregate demand in the short run, all else equal.[5]

Effect on U.S. Consumers and Certain Producers. A society's economic well-being is usually measured not by how much it can produce, but how much it can consume. An undervalued yuan that lowers the price of imports from China allows the United States to increase its consumption through an improvement in the terms-of-trade. Since changes in aggregate spending are only temporary, from a long-term perspective the lasting effect of an undervalued yuan is to increase the purchasing power of U.S. consumers. Imports from China are not limited to consumption goods. U.S. producers also import capital equipment and inputs to final products from China. An undervalued yuan lowers the price of these U.S. products, increasing their output.

Effect on U.S. Borrowers. An undervalued yuan also has an effect on U.S. borrowers. When the U.S. runs a current account deficit with China, an equivalent amount of capital flows from China to the United States, as can be seen in the U.S. balance of payments accounts. This occurs because the Chinese central bank or private Chinese citizens are investing in U.S. assets, which allows more U.S. capital investment in plant and equipment to take place than would otherwise occur. Capital investment increases because the greater demand for U.S. assets puts downward pressure on U.S. interest rates, and firms are now willing to make investments that were previously unprofitable. This increases aggregate spending in the short run, all else equal, and also increases the size of the economy in the long run by increasing the capital stock.

Private firms are not the only beneficiaries of the lower interest rates caused by the capital inflow (trade deficit) from China. Interest-sensitive household spending, on goods such as consumer durables and housing, is also higher than it would be if capital from China did not flow into the United States. In addition, a large proportion of the U.S. assets bought by the Chinese, particularly by the central bank, are U.S. Treasury securities, which fund U.S. federal budget deficits. According to the U.S. Treasury Department, China (as of January 2006) held $263 billion in U.S. Treasury securities, making China the second largest foreign holder of such securities, after Japan. If the U.S. trade deficit with China were eliminated, Chinese capital would no longer flow into this

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[4] There is a long run trend that is moving U.S. production away from manufacturing and toward the service sector. U.S. employment in manufacturing as a share of total nonagricultural employment has fallen from 31.8% in 1960 to 22.4% in 1980 to 10.7% in 2005. This trend is much larger than the Chinese currency issue, and is caused by changing technology (which requires fewer workers to produce the same number of goods) and comparative advantage.

[5] Putting exchange rate issues aside, most economists maintain that trade is a win-win situation for the economy as a whole, but produces losers within the economy. This view derives from the principle of comparative advantage, which states that trade shifts production to the goods a country is relatively talented at producing from goods it is relatively untalented at producing. As trade expands, production of goods with a comparative disadvantage will decline in the U.S., to the detriment of workers and investors in those sectors (offset by higher employment and profits in sectors with a comparative advantage). Economists generally argue that free trade should be pursued because the gains from trade are large enough that the losers from trade can be compensated by the winners, and the winners will still be better off. See CRS Report RL32059, *Trade, Trade Barriers, and Trade Deficits: Implications for U.S. Economic Welfare*.

country on net, and the government would have to find other buyers of its U.S. Treasuries. This would likely increase the government's interest payments.

Net Effect on the U.S. Economy. In the medium run, an undervalued yuan neither increases nor decreases aggregate demand in the United States. Rather, it leads to a compositional shift in U.S. production, away from U.S. exporters and import-competing firms toward the firms that benefit from Chinese capital flows. Thus, it is expected to have no medium or long run effect on aggregate U.S. employment or unemployment. As evidence, one can consider that the U.S. had a historically large and growing trade deficit throughout the 1990s at a time when unemployment reached a three-decade low. However, the gains and losses in employment and production caused by the trade deficit will not be dispersed evenly across regions and sectors of the economy: on balance, some areas will gain while others will lose. And by shifting the composition of U.S. output to a higher capital base, the size of the economy would be larger in the long run as a result of the capital inflow/trade deficit.

Although the compositional shift in output has no negative effect on aggregate U.S. output and employment in the long run, there may be adverse short-run consequences. If output in the trade sector falls more quickly than the output of U.S. recipients of Chinese capital rises, aggregate spending and employment could temporarily fall. This is more likely to be a concern if the economy is already sluggish than if it is at full employment. Otherwise, it is likely that government macroeconomic policy adjustment and market forces can quickly compensate for any decline of output in the trade sector by expanding other elements of aggregate demand. The deficit with China has not prevented the U.S. economy from registering high rates of growth since 2003.

The U.S.-China Trade Deficit in the Context of the Overall U.S. Trade Deficit. While China is a large trading partner, it accounted for only 14.5% of U.S. imports in 2005 and 24% of the sum of all U.S. bilateral trade deficits. Over a span of several years, a country with a floating exchange rate can consistently run an overall trade deficit for only one reason: a domestic imbalance between saving and investment. This has been the case for the United States over the past two decades, where saving as a share of gross domestic product (GDP) has been in gradual decline. On the one hand, the U.S. has high rates of productivity growth and strong economic fundamentals that are conducive to high rates of capital investment. On the other hand, it has a chronically low household saving rate, and recently a negative government saving rate as a result of the budget deficit. As long as Americans save little, foreigners will use their saving to finance profitable investment opportunities in the U.S.; the trade deficit is the result.[6] The returns to foreign-owned capital will flow to foreigners instead of Americans, but the returns to U.S. labor utilizing foreign-owned capital will flow to U.S. labor.

According to Chinese statistics, more than half of what China exports to the world is produced by foreign-invested firms in China, including U.S. companies, which, in many cases, have shifted production to China in order to gain access to China's low-cost labor.

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[6] Nations, such as the United States, that fail to save enough to meet their investment needs must obtain savings from other countries with high savings rates. By obtaining foreign investment (in effect, borrowing), the United States can consume more (including more imports) than it would if investment were funded by domestic savings alone — this results in a trade deficit.

(The returns to capital of U.S. owned firms in China flow to Americans.) Such firms import raw materials and components (much of which come from East Asia) for assembly in China. As a result, China tends to run trade deficits with East Asian countries and trade surpluses with countries with high consumer demand, such as the United States. Overall, in 2005, China had a $102 billion trade surplus (Chinese data), indicating that China had a $100 billion trade deficit with the world excluding the United States (based on U.S. data on its trade deficit with China of $202 billion). These factors imply that much of the increase in U.S. imports (and hence, the rising U.S. trade deficit with China) is largely the result of China becoming a production platform for many foreign companies, rather than unfair Chinese trade policies.[7]

Action in 109th Congress

Multiple bills have been introduced in Congress to address concerns over China's currency policy.[8] On April 6, 2005, the Senate failed (by a vote of 33 to 67) to table an amendment, S.Amdt. 309 (Schumer) to S. 600, which would impose a 27.5% tariff on Chinese goods if China failed to appreciate its currency to market levels. In response, the Senate leadership moved to allow a vote on S. 295 (which has same language as S.Amdt. 309) no later than July 27, 2005. However, on June 30th, Senator Schumer and other sponsors of S. 295 agreed to delay consideration of the bill after they were told by Administration officials that China would soon make significant reforms to its currency policy regime. On November 17, 2005, the Senate agreed to take up the bill no later than March 31, 2006. On July 27, 2005, the House passed H.R. 3283 (English), which would, among other things, apply U.S. countervailing laws to non-market economies (such as China); and require the Treasury Department to define "currency manipulation," describe actions that would be considered to constitute manipulation, and report on China's new currency regime.

China's July 21, 2005 reforms have been hailed by many U.S. policymakers as a good first step, but they have indicated that they expect China to make further reforms to permanently defuse the currency issue. In addition, many have expressed disappointment that China's announcement that the currency would be allowed to float within a daily band of 0.3% has not resulted in any significant appreciation of the yuan, indicating that the Chinese government continues to intervene heavily in exchange rate markets.[9] In its November 28, 2005 report to Congress on exchange rate policies, the Treasury Department did not cite China as a country that manipulates its currency, but concluded that China had failed to fully implement its commitment to make its new exchange rate mechanism more flexible and to increase the role of market forces. Instead, the report stated that China's new currency appeared to strongly resemble the previous mechanism of pegging the yuan to the dollar.

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[7] Of concern to many economists is not the high U.S. trade deficit with China or the amount of capital coming from China, but rather the low U.S. savings rate that makes the United States so reliant on foreigners to finance its investment opportunities. If the U.S. did not borrow from China, it would still have to borrow from other countries.

[8] For a listing of these bills, see CRS Issue Brief IB91121, *China-U.S. Trade Issues*.

[9] According to the Bank of China, by the end of December 2005, the yuan had appreciated against the dollar by only 0.49% since the currency reform was implemented.