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The Impact of US Political Pressure on the RMB Exchange Rate

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Abstract

The US-China game of Renminbi (RMB)/US Dollar exchange rate has aroused increasing attention recently. From the US perspective, appreciation of RMB exchange rate could reduce the US-China trade deficit, boost the US economy and thus lower the unemployment rate (Cheng and Zhang, 2012). Therefore it is crucial for the US government to figure out whether there is an influence from US political pressure on RMB flexibility and the most effective way to accelerate the appreciation of RMB exchange rate. Aminian et al (2008) believed that US political pressure may be one of the causes for the appreciation of RMB exchange rate, while Liu and Pauwels (2012) stated that there is no significant impact from external political pressure on RMB exchange rate. Previous studies only examined the impact of one aspect of US political pressure on the RMB exchange rate. That's why the conflict appears. This paper will fill in the gap of previous literature and resolve the conflict by investigating the impact of US political pressure from three aspects, namely, from US Congress, the US public media and from US lobbyists. This paper finds that the political pressure from Congress and the US public media alone have little impact on the RMB exchange rate in the short run, while the political pressure from US lobbyists has a positive impact on the appreciation of RMB exchange rate. By recognizing this, the US government could reinforce the lobbyist way to accelerate the appreciation of RMB exchange rate effectively.

The appreciation of Renminbi exchange rate has aroused increasing debate in recent years. The US always considered the Chinese government a currency manipulator because of the Chinese *de facto* pegged exchange rate regime. In other words, China has conducted a relatively fixed exchange rate policy. On one hand, the US urged the Chinese government to revalue and accelerate the appreciation of RMB exchange rate in order to reduce the US-China trade deficit gap, boost the US economy and thus lower the unemployment rate (Cheng and Zhang, 2012). On the other hand, the Chinese government had little change in its exchange rate policy because they were afraid that the value of the US national bonds they bought would shrink in the process of appreciation (Liu, 2011). Although China reformed its exchange rate policy in 2005 from US peg regime (fixed exchange rate regime pegged to US Dollar) to a basket-targeting policy (floating exchange rate policy referring to a variety of weighed foreign currencies), the fluctuation of RMB exchange rate is still limited, since keeping the RMB exchange rate at a low level is a major driving force to maintain a substantial trading export amount (Sato et al, 2012). So the US has exerted a great amount of pressure on accelerating the RMB exchange rate in order to narrow the US-China trading gap (Liu and Pauwels, 2012). The RMB exchange rate has appreciated by around 25 percent since its reform in 2005 (Board of the Governors of the Federal Reserve System, 2012). The question is whether the 25 percent appreciation of RMB since 2005 is the result of the US government's effort.

Newspapers and politicians assume that US political pressures have an impact on the RMB exchange rate. Some politicians criticize Obama's government as not tough enough to exert pressure on RMB appreciation, while others claim that the 25 percent appreciation of RMB since 2005 is the contribution of the US government's effort. Aminian et al (2008) believe that the US political pressure may be one of the causes for the appreciation of RMB exchange rate.

However, Liu and Pauwels (2012) state that through the empirical study on the daily exchange rate of RMB, there is no significant impact from external political pressure on RMB exchange rate. Also, Hufbauer and Brunel (2008) believe that the US legislation alone can have little influence on appreciating RMB exchange rate because China's government has a strong power in intervening and controlling the fluctuation of RMB exchange rate. So two positions conflict with each other on whether there is an actual influence.

This is an important issue that arouses increasing attention. If US political pressures have no impact on RMB exchange rate, it makes no sense for the US government to exert political pressure on China's currency. Nevertheless, if there does exist an impact from US political pressures on RMB exchange rate, the US government should implement more political pressure to achieve the appreciation of RMB in their favor.

Previous studies only examine one aspect of the impact of US political pressure on the RMB exchange rate. That's why the conflict appears. Although Liu and Pauwels (2012) do examine those three parts, they fail to use proper sources and indices for those aspects. According to their work, data resources for US Congress and lobbyists are all from newspapers, which are not a reliable and stable database to resort to. Also Liu and Pauwels (2012) use times of US-China meeting as an index of lobbyist activity, which is not convincing enough. Those two defects make the final results and finding of their paper unconvincing.

This paper will fill in the gap of previous literature and resolve the conflict problem by investigating the impact of US political pressure from three aspects, namely, from US Congress, US public media and from US lobbyists. This paper finds that the US political pressure from US Congress and US public media alone have little impact on the RMB exchange rate in the short

run, while the political pressure from US lobbyists has a positive impact on the appreciation of RMB exchange rate.

Basic Concepts

The Flexibility of RMB Exchange Rate

There are four types of indices related to RMB exchange rate. The first index is the spot value of RMB exchange rate. The second indicator is the Non-Deliverable Forward (NDF) price of RMB. The RMB NDF can be used as a proper indicator for the expectation of RMB exchange rate because it is exchanged in Hong Kong, which is an off shore market without regulation by the Chinese government (Liu & Pauwels, 2012). The third measurement for RMB exchange rate flexibility is the weight change in the currency basket since the currency basket is a variety of weighed foreign currencies. The more diverse of the currency basket, the more flexible the currency regime is. The first three methods focus on the fluctuation of the currency value or on the weight change in the currency basket. Both aspects look at only one side of the RMB flexibility. The fourth method is “exchange market pressure” (Frankel, 2009). Frankel (2009) presents a new method to measure the flexibility of RMB exchange rate that could overcome this downside. He introduces a new indicator called “exchange market pressure”, which combine both the fluctuation and the weigh change together to create a new measurement for RMB flexibility.

US Political Pressure

Different authors have different understandings and use different indicators to measure the US political pressure on RMB appreciation. However, each author examines only one aspect of the political pressure and assumes it to represent the whole picture of the political pressure, which makes their conclusions unconvincing and quite different from each other. To investigate

the political pressure from a comprehensive view, this paper sums up the political pressure into three aspects. The first aspect of the political pressure is from US Congress. From 2003, different political swings in US Congress have had a consensus on urging China to appreciate its currency (Hufbauer & Brunel, 2008). The number of sponsors supporting the “Currency Exchange Rate Oversight Reform Act of 2011” was 19, which amounts to the second highest number of sponsor among the 112 Congress public bills related to China (The US-China Business Council, 2011). The second aspect of political pressure is from public media. According to Frankel and Wei (2007), political pressure can be reflected by the number of reports appearing in newspapers that the US governors urge China to accelerate the RMB flexibility. Also Liu and Pauwels (2012) use the similar data collecting method. They recorded the number of headlines which have RMB appreciation keywords and used the number as an indicator of US political pressure. The US political pressure index Liu and Pauwels (2012) created include two aspects: one is from US Congress bill. The other is from the number of meetings between China and the US. But since their sources are all from newspapers, I categorize their method into public media influence. The third political pressure is from US lobbyists. Aminian et al (2008, 2012) believe that the major US political pressure is from lobbyists.

The Influence of US Congress on RMB Exchange Rate

The US legislation alone can have little influence on appreciating RMB exchange rate. In the Fall 2003, there was an increasing trend of political pressure from US Congress targeting the appreciation of RMB exchange rate. Although different swings of political parties in Congress disagree with to what extent should the pressure be and who is in charge of supervising those pressures, all of them agreed on the urgent need to push China to accelerate its exchange rate (Hufbauer & Brunel, 2008).

The legislation alone can have little influence on appreciating RMB exchange rate because China's government has a strong power in intervening and controlling the fluctuation of its currency. The control mainly aims at protecting China's export industries and at maintaining US-China trade surplus (Cheng and Zhang, 2012). Another reason is that if the RMB exchange rate appreciates, the real value of US debt will decrease. However, the Chinese government bought a huge amount of US bonds. In order to prohibit the devaluation of US debt, the Chinese government strictly controls the RMB exchange rate (Liu, 2011).

The effect of US Congress bills on the appreciation of RMB exchange rate is more like "turning the screw rather than slamming the hammer" (Hufbauer & Brunel, 2008; p.226). Screwing means long-term, slow effort on the RMB appreciation, while slamming indicates short-term sudden effect. By examining three major Congress bills related to the Chinese currency, Hufbauer & Brunel (2008) find that the bills focused on the long-term oversight of China's behavior on revaluing RMB exchange rate rather than on the short-term action to suddenly punish or to prevent the RMB's misalignment. That's why the US Congress alone has little direct influence on the RMB revaluation.

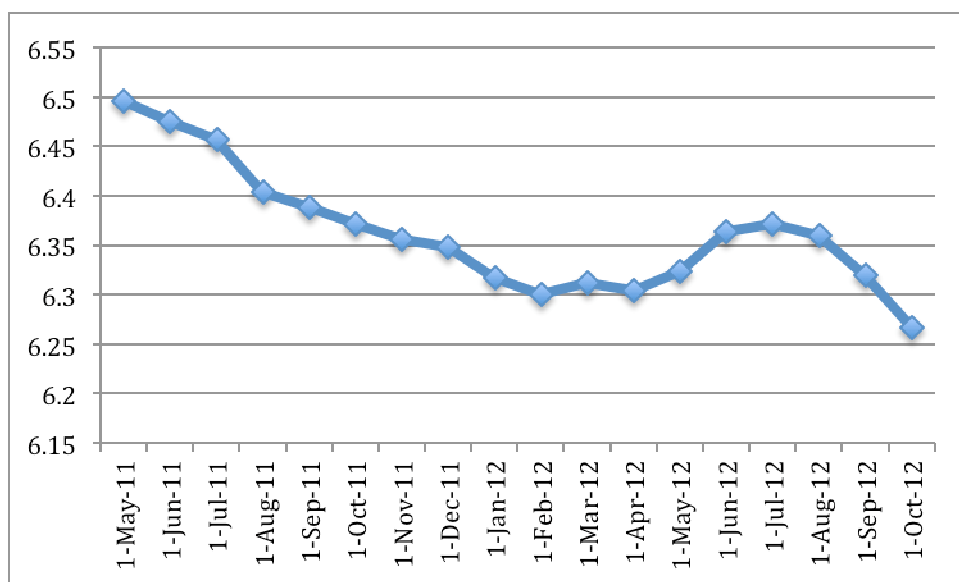


Figure1: The Monthly RMB exchange rate from 2011 to 2012

Note: Source from Board of the Governors of the Federal Reserve System. (2012). Historical rates for the Chinese Yuan Renminbi. Available from http://www.federalreserve.gov/releases/h10/hist/dat00_ch.htm

The above graph shows the tendency curve of monthly value of RMB exchange rate from May 2011 to October 2012. I will now examine how the RMB exchange rate behaved before and after the main Currency Act related to China during 2011 and 2012. By October 4th, 2012 there were four major Congress bills about China's currency. One of them "Currency Exchange Rate Oversight Reform Act" passed the Senate in October 2011. So I list the RMB exchange rate data for five months before and after the passing. We can find that this curve has three stages. The first stage is from May 2011 to December 2011, when the RMB exchange rate was appreciating at a slow speed. The second stage is from December 2011 to July 2012, when RMB was depreciating. The third stage is from July 2011 to October 2012, when the RMB exchange rate appreciated dramatically. Therefore December 2011 and July 2012 are the turning points in this curve. However, none of them match the passing date of the Act. Also we can find that the curve slope remains unchanged from August 2011 to December 2011, which shows that the tendency of RMB appreciation did not change two months before or after the passing date. Thus the influence of US Congress bill has little impact on the fluctuation of RMB exchange rate. This method just roughly shows the tendency of the fluctuation. It did not exclude the impact of significant domestic news in China. Liu and Pauwels (2012) exclude that impact from the fluctuation of RMB and investigate the impact of US congress on RMB. They find little evidence to support a significant impact from the US congress to RMB exchange rate, which is consistent with my conclusion.

The Influence of Public Media on RMB Exchange Rate

The political pressure appearing on public media has little influence on the fluctuation of RMB exchange rate. The political pressure from public media is different from public media pressure. Political pressure from public media means the urges or demands from US officials, who appear on public media. Normally, to simplify data collection, authors use newspapers as a representative of public media. For instance, Frankel and Wei (2007) measure political pressure from the public media aspect. The index use is the number of reports that appear in newspapers, in which the US officials urge China to accelerate RMB flexibility. However, public media pressure means any pressure or attack reported by the newspaper. It includes not only the pressure from US governors but also from other entities. In some cases, it just reflected the stands or perspective from the journalists or certain medias. For example, Liu and Pauwels (2012) record the number of headlines, which have RMB appreciation keywords. They use the number as an indicator of US political pressure.

Both the political pressure from public media and the public media pressure hardly have any significant effect on the appreciation of RMB. According to Frankel and Wei (2007), the political pressure from public media could lower the proportion of US dollar in the currency basket while it could hardly influence the currency policy on RMB revaluation. In other words, their results shows that there is little evidence to support the influence of political pressure from public media on the fluctuation of RMB exchange rate. Moreover, the empirical evidence from Liu and Pauwels (2012) shows that the public media pressure has little effect on the daily return of RMB exchange rate. Those empirical findings act as strong evidence to support the idea that the political pressure from public media has little influence on the fluctuation of RMB exchange rate.

The Influence of the US Lobbyists on the RMB Exchange Rate

US lobbyist activities have a direct impact on the origin and an indirect impact on the acceleration of RMB appreciation. Firstly, the lobbyist activities from the US Treasury Act as a driving force to persuade China to start RMB exchange rate flexibility. Frankel and Wei (2007) find that there were meetings between US Treasury Secretary and Chinese officials, where the US Treasury Secretary tried to persuade the Chinese government to promote the RMB flexibility. From Figure2, as found in Frankel and Wei (2007), we can tell that the difference between spot rate and forward rate flipped its sign in October 2003, turning from the forward discount to the forward premium. Frankel and Wei (2007) found that the flipping sign time fit the time, in which the US Treasury's persuading effort, during September and October of 2003.

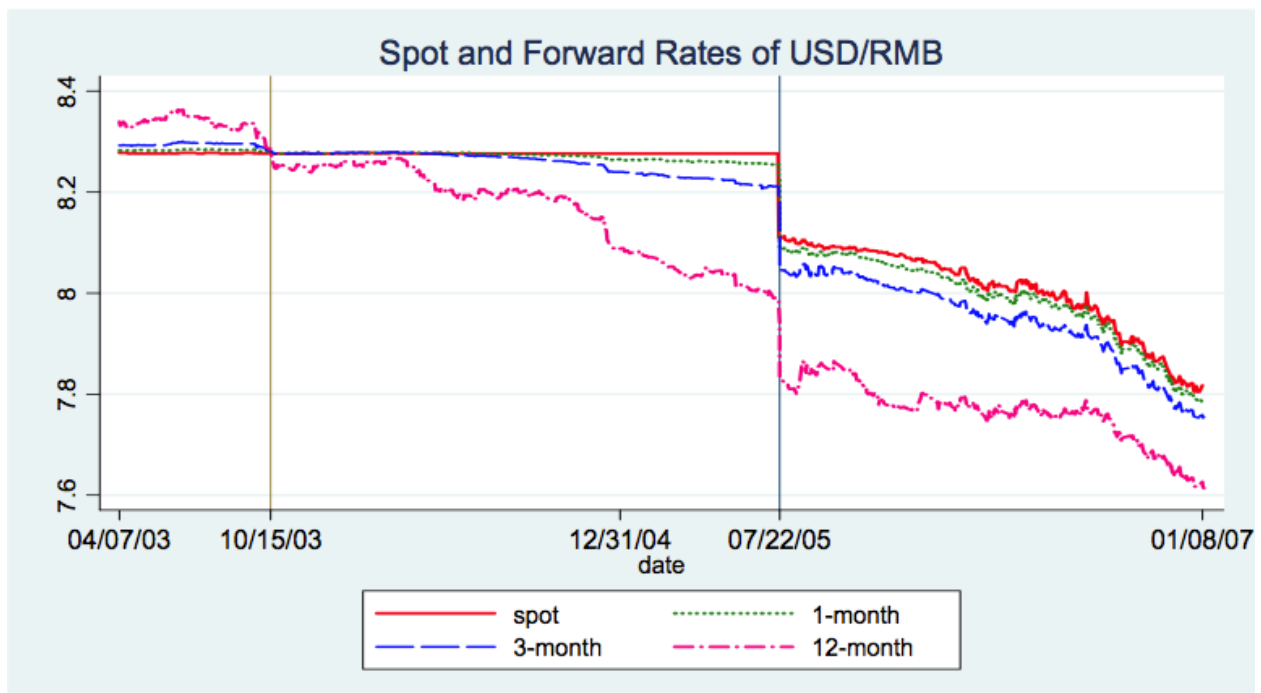


Figure2 Prices of NDFs Around the Time Official US Pressure Began

Note: Source from Frankel, J. A., & Wei, S. (2007). Assessing china's exchange rate regime. *Economic Policy*, (51), 575. doi: <http://www.economic-policy.org/>

Secondly, US lobbying could indirectly accelerate the appreciation of RMB exchange rate. Aminian et al (2008, 2010) built a theoretical political model concerning the US political pressure and the RMB exchange rate. Their results show that an increase in US political pressure on China would lead to an appreciation of RMB exchange rate. In other words, appreciation of the RMB exchange rate is partly due to the external political pressure from the US. However, we cannot arbitrarily conclude that political pressure from the US lobbyists has a significant direct impact on the appreciation of RMB, since no empirical evidence as of now supports this conclusion. Some indirect evidence indicates that there may be an indirect and long-term impact. Evidence shows that US-China meetings have a negative relationship with the volatility of RMB exchange rate, but have a positive relationship with the RMB NDF rate. (Liu and Pauwels, 2012). Those empirical results imply that the interaction between US and China may enhance the market's expectation of the RMB appreciation, raise the flexibility of RMB exchange rate in the future and increase the possibility of its appreciation.

Conclusion

To sum up, the US political pressure from both Congress and the US public media have little impact on the RMB exchange rate, while US political pressure from lobbyists do have a significant influence on the appreciation of RMB exchange rate. There are two prospective aspects for future work. All the political pressure in this paper is short-term pressure. So although in the short run US political pressure has little impact on the RMB exchange rate, there may be a significant impact in the long run (Liu and Pauwels, 2012). This is a prospective aspect for future work. Also, the united effort from US and European countries may have a significant impact on accelerating the flexibility of exchange rate policy (Hufbauer & Brunel, 2008).

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