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# China's Currency: A Summary of the Economic Issues

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## Summary

Many Members of Congress charge that China's policy of buying foreign reserves to influence the value of its currency constitutes a form of currency manipulation intended 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 has caused a surge in the U.S. trade deficit with China and has been a major factor in the loss of U.S. manufacturing jobs. Threats of possible congressional action led China to make changes to its currency policy in July 2005, which has resulted in a modest appreciation of the yuan. However, many Members have expressed dissatisfaction with the pace of China's currency reforms and have warned of potential legislative action. This report summarizes the main findings CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte and will be updated as events warrant.

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. The sharp increase in China's foreign exchange reserves (which grew from $403 billion at the end of 2003 to $1.2

trillion at the end of March 2007) and China's large merchandise trade surplus (which totaled $178 billion in 2006) are indicators that the yuan is significantly undervalued.

**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.[1] Since July 2005, China has allowed the yuan to appreciate steadily but very slowly. It has continued to accumulate foreign reserves at a rapid pace, which suggests that if the yuan were allowed to freely float it would appreciate much more rapidly. The current situation might be best described as a "managed float" — market forces are determining the general direction of the yuan's movement, but the government is retarding its rate of appreciation through market intervention.

## 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 hit $233 billion in 2006) and has hurt U.S. production and employment in several U.S. manufacturing sectors 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 should let the yuan freely float today, given the size of the Chinese economy and the impact its policies have on the world economy.

## 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. Concerns have also been raised over the effects an appreciating yuan would have on farmers (due to lower-priced imports). Chinese officials view economic stability as

[1] On May 15, 2007, the Chinese government increased the daily band to 0.5%.

critical to sustaining political stability; they fear an appreciated currency could reduce employment and lower incomes in various sectors, and thus could cause worker unrest. However, Chinese officials have indicated that their long-term goal is to adopt a more flexible exchange rate system and to seek more balanced economic growth through increased domestic consumption and the development of rural areas, but they want to proceed at a gradual pace to ensure economic stability.

## Implications of China's Currency Policy for its Economy

If the yuan is undervalued vis-a-vis the dollar (estimates rage from 15 to 40% or higher), 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 (and, to some degree, an indirect subsidy). Eliminating exchange rate risk through a managed 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, which has promoted the banks to adopt easy credit policies. In addition, "hot money" has poured into China from investors speculating that China will continue to appreciate the yuan.[2] At some point, these factors could help fuel inflation, overinvestment in various sectors, and expansion of nonperforming loans by the banks — each of which could threaten future economic growth.

## 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.)[3] This causes the trade deficit to rise and reduces aggregate demand in the short run, all else equal.[4]

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[2] For the most part, China has been able to avoid the potential inflationary impact of its currency policy through "sterilization" (i.e., by issuing bonds to remove yuan from the economy), increasing the level of reserves that banks are required to maintain, and by using administrative action to reduce investment in certain "overheated" sectors.

[3] U.S. production has moved away from manufacturing and toward the service sector over the past several years. U.S. employment in manufacturing as a share of total nonagricultural employment fell from 31.8% in 1960, to 22.4% in 1980, to 10.4% in December 2006. 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.

[4] 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

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**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 April 2007) held $414 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 country on net, and the government would have to find other buyers of 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

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[4] (...continued)
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.

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 15.4% of U.S. merchandise imports in 2006 and 26% 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. Over the past two decades, U.S. 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 United States; the trade deficit is the result.[5] 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.[6]

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. (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 2006, China had a $55 billion trade deficit with the world excluding the United States. These factors imply that much of the increase in U.S. imports (and hence, the rising trade deficit with China) is largely the result of China becoming a production platform for many foreign companies, rather than unfair Chinese trade policies.

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[5] 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.

[6] China on the other hand has one of the world's largest savings rate. U.S. officials have urged China to take steps to boost domestic consumption (and hence increase imports).

**Most Recent Events.** In September 2006, President Bush and President Hu agreed to establish a Strategic Economic Dialogue (SED) in order to have discussions on major economic issues at the "highest official level." China's currency policy was a major topic during the first SED meeting held in December 2006 and the second meeting held in May 2007. The two sides agreed to work to reduce global imbalances through increased savings in the United States and increased domestic consumption and exchange rate flexibility in China. However, China refused to agree to any new major changes to its currency policy. From July 21, 2005 to June 28, 2007, the dollar-yuan exchange rate went from 8.11 to 7.62, an appreciation of about 6.0%.

## Congressional Legislation

For many Members, the pace of China's currency reforms and level of the yuan's appreciation against the dollar have been too slow, and some have introduced legislation to put further pressure on the Chinese to speed reforms or to enable U.S. producers to use U.S. trade law to address the impact of China's undervalued currency:

- **H.R. 321** (English) would increase tariffs on imported Chinese goods if the Treasury Department determined that China manipulated its currency, and would require the United States to file a WTO case against China over its currency policy and to work within the WTO to modify and clarify rules regarding currency manipulation. **H.R. 1002** (Spratt) would impose 27.5% in additional tariffs on Chinese goods unless the President certifies that China is no longer manipulating its currency.

- **S. 364** (Rockefeller) would apply U.S. countervailing laws (dealing with government subsidies) to products imported from non-market economies (such as China), and would make currency manipulation actionable under this measure. **H.R. 782** (Tim Ryan) and **S. 796** (Bunning) would make exchange rate "misalignment" actionable under U.S. countervailing duty laws, require the Treasury Department to determine whether a currency is misaligned in its semi-annual reports to Congress on exchange rates, prohibit the Department of Defense from purchasing certain products imported from China if it is determined that China's currency misalignment has disrupted U.S. defense industries, and would include currency misalignment as a factor in determining safeguard measures on imports of Chinese products that cause market disruption.

- **S. 1607** (Baucus) would require the Treasury Department to identify currencies that are fundamentally misaligned and to designate such currencies for "priority action" under certain circumstances. Such action would include factoring currency undervaluation in U.S. anti-dumping cases, banning federal procurement of products or services from the designated country, and filing a case against in the WTO. **S. 1677** (Dodd) requires the Treasury Department to identify countries that manipulate their currencies regardless of their intent and to submit an action plan for ending the manipulation; and gives Treasury the authority to file a case in the WTO.