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

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Summary

The continued rise in the U.S.-China trade imbalance has led to complaints from various U.S. manufacturing firms and workers. Some Members of Congress assert that China's policy of pegging its currency (the yuan) to the U.S. dollar constitutes a form of currency manipulation, maintained to make Chinese exports cheaper, and its imports more expensive, and that this policy has negatively affected U.S. employment in several sectors. This report evaluates that assertion, and considers other effects China's peg has on the U.S. economy. These include the beneficial effects on consumption, interest rates, and investment spending. Nationwide, these effects should offset job loss in the trade sector, at least in the medium term. Several bills were introduced in the 108th Congress to address China's currency policy. This report summarizes the analysis presented in CRS Report RL32165, *China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy,* and will be updated as events warrant.

China pegs its currency, the yuan (also called the renminbi), to the U.S. dollar. Under this system, China's central bank issues a reference dollar/yuan exchange rate along with a limited band (about 0.3%) in which the reference rate is allowed to fluctuate. This system has been in place with a peg of about 8.3 yuan to the dollar since 1994.[1] The Chinese central bank maintains 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 stays the same, despite changing economic factors which could otherwise cause 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

[1] Prior to this time, China maintained a dual exchange rate system: an official exchange rate of about 5.8 yuan to the dollar and a market swap rate (used mainly for trade transactions) of about 8.7 yuan to the dollar (at the end of 1993). The reforms in 1994 unified the two rates.

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.[2] 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).[3]

U.S. Concerns About China's Currency Peg

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 (by as much as 40%), 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 $124 billion in 2003, and to an estimated $158 billion in 2004) 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 peg 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.[4] Several groups are pressing the Bush Administration to pressure China to either revalue its currency (by increasing the band in which it is allowed to be traded in China) or to allow it to float freely in international markets. President Bush on a number of occasions has criticized China's currency peg, stating that exchange rates should be determined by market forces.

China's Concerns About Its Currency Peg

Chinese officials argue that its currency peg policy is not meant to favor exports over imports, but instead to foster economic stability by tying its currency to the U.S. dollar at a constant level, as many other countries do. They have expressed concern that abandoning the peg 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

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[2] Many analysts argue that the sharp increase in China's foreign exchange reserves (which grew from $168 billion in 2000 to $403 billion in 2003, to $515 billion at the end of September 2004) is one indicator that the yuan is undervalued.

[3] 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.

[4] See Prepared Remarks of Dr. C. Fred Bergsten, President, Institute for International Economics, before the House Small Business Committee, June 25, 2003.

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. Chinese officials also point out that during the Asian crisis, when several other nations sharply devalued their currencies, China "held the line" by not devaluing its currency (which might have prompted a new round of destructive devaluations across Asia). This policy was highly praised by U.S. officials, including President Clinton. During a visit to China in September 2003 by U.S. Treasury Secretary John Snow, Chinese officials stated that, while making the yuan fully convertible was a long term goal, China had no immediate plans to eliminate the peg. However, Chinese officials have pledged implement certain financial reforms, and in October 2003, they agreed to a U.S. proposal to set up a joint technical cooperation program to promote the development of China's financial markets and to examine ways China can move more quickly towards a floating exchange rate.

Economic Consequences of China's Currency Peg

If the yuan is undervalued against the dollar, as many critics charge, then there are benefits and costs of this policy for the economies of both China and the United States.

Implications of the Peg for China's Economy

If the yuan is undervalued, 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. The accumulation of large foreign exchange reserves by China may make it easier for Chinese officials to move more quickly toward adopting a fully convertible currency (if the government feels it could defend the currency against speculative pressures). However, the accumulation of large foreign exchange reserves also entails opportunity costs for China: such funds (instead of sitting in the central bank) could be used to fund China's massive development needs, such as infrastructure improvements.

Implications of the Peg for the U.S. Economy

Effect on Exporters and Import-Competitors. When a fixed exchange rate 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.[5]) This causes the trade deficit to rise and reduces aggregate demand in the short run, all else equal. On the other hand, over the long run, the fixed exchange rate encourages trade (and investment) between the two countries by eliminating exchange rate risk. The reduced risk could make both imports and exports higher than under a floating system.[6]

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

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[5] 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 12.8% in 2002. 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. With enhanced globalization, the theory of comparative advantage predicts the U.S. will produce knowledge- and technology-intensive goods that it is best at producing for trade with countries, such as China, who are better at producing labor-intensive goods. Since many manufactured goods are labor-intensive, comparative advantage leads to more manufacturing abroad, and less in the United States. Over time, it is likely that the trend shifting manufacturing abroad will continue regardless of China's currency peg.

[6] 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.

such as consumer durables and housing, is also higher than it would be if capital from China did not flow into the U.S. 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 September 2004) held $174 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 its U.S. Treasuries. This would 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 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 about 12% of U.S. imports in 2003 and 22% of the sum of the bilateral trade deficits. Over a span of several years, a country with a floating exchange rate can run an ongoing 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.[7] The returns to

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[7] 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

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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. (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, China had a $26 billion trade surplus (Chinese data), indicating that China had a trade $98 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 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.

For these reasons, economists generally are more concerned with the overall trade deficit than bilateral trade balances. Because of comparative advantage, it is natural that a country will have some trading partners from which it imports more, and some trading partners to which it exports more. For example, the U.S. has a trade deficit with Austria and a trade surplus with the Netherlands even though both countries use the euro, which floats against with the dollar. Of concern to the United States is that its low saving rate makes it so reliant on foreigners to finance its investment opportunities, and not the fact that much of the capital comes from China. If the U.S. did not borrow from China as a result of the exchange rate peg, it would still have to borrow from other countries.

Proposed Legislation in the 108th Congress

A number of bills have were submitted to address the exchange rate peg. H.R. 3058 (English), S. 1758 (Voinovich), and H.R. 4896 (Rogers) would require the U.S. Treasury Secretary to determine if China manipulates its currency. If such a determination were made, the Administration would be required to impose additional tariffs on imported Chinese goods equal to the estimated amount (in percentage terms) of that manipulation.[8] H.R. 3269 (Dingell) would require the Secretary of Commerce to issue biannual reports describing actions by foreign governments to manipulate their currencies and would direct the President to take specific steps (including direct negotiations and utilization of U.S. trade laws and international agreements) to end such practices. S. 1586 (Schumer) and H.R. 3364 (Myrick) would impose an additional duty of 27.5% on imported goods from China if the Chinese government refused to make its currency freely convertible. S. 1592 (Lieberman) would require the President to negotiate with China, Japan, Taiwan, and South Korea to end their currency manipulations and to make China's currency fully convertible, and would mandate action under U.S. trade laws if such negotiations failed. H.Res. 414 (English) encourages China to comply with its commitments in the WTO and to adopt a market-based exchange rate (passed in the House on October 29, 2003).

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[7] (...continued)
if investment were funded by domestic savings alone — this results in a trade deficit.

[8] H.R. 4896 would require the Administration to seek authorization from the WTO for such sanctions.