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China's Currency: U.S. Options

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China's Currency, the United States and the IMF

Summary

In recent years, the United States and other countries have expressed, with considerable concern, the view that China's national currency (the yuan or renminbi) was seriously undervalued. Some analysts say the yuan needs to rise by as much as 40% in order to reflect its true value. Critics say that, by undervaluing its currency, China gains unfair trade advantage and has seriously injured the manufacturing sector in the United States. Chinese officials say that they have not pegged the yuan to the dollar in order to gain trade advantages. Rather, they say the fixed rate promotes economic stability. Without this, they say, fluctuations in the yuan's value could cause serious dislocations in China's domestic economy.

On July 21, 2005, China announced a new foreign exchange system which is intended, officials said, to allow more flexibility and to permit the international value of the yuan to be established by market forces. The yuan was increased in value by 2% and a "crawling peg" was introduced so that the yuan could rise gradually in value. On July 27, however, Chinese officials said that they did not intend the new mechanism to produce further increases in the yuan's valuation. Together, the two announcements have sown much confusion as to China's real intent.

The Treasury Department has urged China strongly in recent years to adopt procedures that would allow the yuan to rise in value. Congress is considering legislation that would place a 27.5% tariff on Chinese imports to the United States if the yuan is not revalued. It is not clear whether the new system Chinese officials adopted will meet U.S. expectations. A Senate vote on the legislation to impose special tariffs is scheduled for late September 2005.

The United States has pursued the yuan-dollar exchange rate issue as a bilateral U.S.-China issue. Other countries are also affected by the presumably undervalued yuan — some more than the U.S. — but they have allowed the United States to take the lead. In this, they stand to benefit from any changes the U.S. effects in its confrontation with China while they take none of the blame. There are at least five ways the United States could deal with the yuan exchange rate issue. Some of these would involve other countries more explicitly in the process.

First, the United States might continue pressing China publicly for further changes in its foreign exchange system in order that the yuan's value would better reflect market conditions and economic realities. Second, the U.S. could restrict imports from China pending action to revalue the yuan. Third, the U.S. might stop pressing China publicly, on the expectation that China will move more rapidly towards reform if it is not pressured. Fourth, the U.S. might ask the IMF to determine whether China has been manipulating its currency in violation of IMF rules and whether its new exchange rate mechanism complies. Fifth, the United States might refer the issue to the World Trade Organization (WTO), asserting that the United States has been injured by unfair trade practices linked to the undervaluation of China's currency and asking the WTO to authorize trade remedies (tariffs on Chinese goods, for example) aimed at correcting this abuse. This report will be updated as new developments arise.

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China's Currency: U.S. Option

Scope and Purpose of This Report

In recent years, the United States and China have disagreed whether China's national currency, the yuan or renminbi, is properly valued compared to the U.S. dollar and whether China is manipulating its currency.¹ The United States has pushed China to raise the value of its currency. Chinese officials say they want to make their exchange rate system more flexible, but China also needs long-term stability in its currency value in order to avoid dislocations. Chinese officials also say they will not bow to foreign pressure. China announced a new exchange rate procedure on July 21, 2005. This report summarizes this controversy, it describes actions and positions taken by the United States, China and other countries, and it discusses various approaches the United States might use to address this concern.

The IMF says, in Article IV of its Articles of Agreement that countries shall "Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."² The U.S. Omnibus Trade and Competitiveness Act of 1988 requires (sec. 3004) that the Secretary of the Treasury determine whether other countries "manipulate the rate of exchange between their currency and the United States dollar for the purpose of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade."³

Yuan-Dollar Exchange Rate Issue

Is China's Currency Undervalued?

From 1994 until recently, China's central bank pegged the yuan at roughly 8.3 to the dollar, and it held the yuan at that value by buying or selling dollars or dollar-based assets in the market. Under a floating exchange rate system, by contrast, the yuan's value would be determined by the relative supply and demand for goods and services in the two countries and the relative demand for each currency in the market.

¹ For a comprehensive discussion of the exchange rate issue, see CRS Report RS21625, *China's Currency Peg: A Summary of the Economic Issues*, updated April 25, 2005, and CRS Report RL32165, *China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy*, updated May 10, 2005. See also CRS Issue Brief IB91121, *U.S.-China Trade Issues*, updated July 22, 2005. The term "renminbi" means "people's currency" while "yuan" is the unit of account (one yuan, two yuan, etc.)

² Articles of Agreement of the International Monetary Fund. Entered into force December 27, 1945. 60 Stat. 1401, T.A.I.S. 1501.

³ The Omnibus Trade and Competitiveness Act of 1988, P.L. 100-418 as amended.

China announced a new exchange rate mechanism on July 21, 2005.⁴ Many believe the new system will rectify the situation. Others are concerned, however, that the new procedures will be only fitfully employed and China will continue to manipulate and undervalue its currency.

Critics claim that China's currency is significantly undervalued vis-a-vis the U.S. dollar (perhaps by as much as 40%) and that this hinders U.S. exports to China and gives Chinese firms a price advantage in their exports to the United States and other countries. They say that China's currency is held by government action at a level well below its true level and that, without official manipulation, the value of the yuan would rise substantially. Critics say that China's undervalued currency has added to the U.S. trade deficit and hurt output and employment in the manufacturing sectors of the U.S. economy. Many have urged the Administration to put pressure on Chinese officials in order to stop them from manipulating the yuan. They say China should either raise the international value of the yuan by official action ("revalue") or let the yuan trade freely in foreign exchange markets ("float") so that the free market can determine its international value.

Chinese officials have argued that the fixed exchange rate between their currency and the U.S. dollar is not intended to promote exports but rather to promote economic stability. They worry that an economic crisis could ensue in China, with serious negative effects on employment, growth and their economic reform program, if the dollar-yuan exchange rate were to fluctuate widely. In particular, they worry that their weak domestic banking system might be unable to cope with any speculative pressure that might follow the advent of a more flexible exchange rate system and more open capital markets. Chinese officials say the Asian financial crisis of 1997-1998 was caused mainly by the combined effect of convertible currencies and poorly regulated financial systems. Pegging their exchange rate will help them avoid the dangers, they claim, which precipitated the Asian crisis.

Partly as a result of currency values and partly as a result of the need by the United States to borrow foreign funds to finance its Federal budget and its foreign trade deficits, China has accumulated large reserves of U.S. dollars and U.S. dollar-denominated assets. China's foreign reserves have grown rapidly in the past decade and now total more than \$711 billion. Accumulating foreign reserves in this manner puts substantial pressure on China's internal financial system. To offset possible inflationary pressure, China has had to restrict monetary growth and to regulate capital inflows. Over the long term, such actions may cause dislocations in China's domestic economy. However, if the yuan is at an advantageous exchange rate, China's export prospects are enhanced and foreign investment in its economy is encouraged. So long as China is willing to continue accumulating foreign exchange and to accept its domestic consequences, the Chinese authorities should be able to hold down the international value of the yuan for a considerable period of time.

⁴ People's Bank of China. *Public Announcement of the People's Bank of China on Reforming the RMB Exchange Rate Regime*. July 21, 2005 (Beijing time.) Available at [<http://www.pbc.gov.cn/english/detail.asp?col=6400&id=542>].

Currency Manipulation

Many Exchange Rate Systems. The issue of currency manipulation is difficult and complex. Until the early 1970s, the IMF played the central role in world exchange rates. All currencies had a fixed value compared to the U.S. dollar and the U.S. dollar had a fixed value compared to gold. If countries wanted to change their par value compared to the U.S. dollar, the IMF had to first approve. Since 1976, however, with passage of the Second Amendment to the IMF Articles of Agreement, each country is free to determine the exchange rate system it will use. Some countries have floated the value of their currency in world money markets, others have fixed the value of their currency to that of another major country, and others have pursued a mixed strategy.

IMF Surveillance. The IMF is responsible for surveillance, under Article IV of its charter, to ensure that countries comply with basic standards. Article IV prohibits countries from manipulating their exchange rates in order to gain unfair trade advantage. It also says that “the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies.” Its current principles for surveillance were adopted by the IMF executive board in 1979 and have been revised periodically since.⁵

The principles say, in effect, that countries may peg the value of their currency to another currency but they cannot do this in ways which violate the requirements of Article IV. Basically, the pegged rate needs to reflect a country’s underlying economic realities. These include, for example, changes in the volume and composition of its domestic output, in the size, composition and direction of its foreign trade, in its domestic rates of growth and national income, in the size of its reserves and in shifts in its domestic fiscal and monetary policies. Countries may hold the value of their currencies at a fixed rate under this system for a long period of time. Whether this is manipulation in violation of Article IV depends on the economic conditions and the way a country holds the value of its currency constant.⁶

⁵ The IMF’s detailed procedures and guidelines for surveillance of country exchange rate systems are specified in a series of board decisions, first adopted in 1977 and revised in later years. These are published in the IMF’s *Selected Decisions and Selected Documents*, cited above, pp.10-29. Reference here is to the General Principles, Principles for the Guidance of Members’ Exchange Rate Policies, and Principles of Fund Surveillance over Exchange Rate Policies specified in the IMF board decision *Surveillance over Exchange Rate Policies: Review*, Decision No. 6026-(9/13), January 22, 1979, as amended, pp. 10-16.

⁶ Morris Goldstein argues that efforts to maintain a country’s exchange rate at a fixed level over a long period of time, despite changes in domestic and international economic conditions, are just as much evidence of manipulation as are efforts to change a currency’s international advantage in order to achieve short term trade advantage. See his “China and the Renminbi Exchange Rate.” in C. Fred Bergsten and John Williamson, ed. *Dollar Adjustment: How Far? Against Whom?* Washington, D.C.: Institute for International Economics, November 2004. Special Report 17.

Manipulation Defined. Persistent intervention in exchange rate markets is one indicator for manipulation. According to the IMF principles for surveillance, countries may intervene in foreign exchange markets to counter short-term disorderly conditions that cause disruptive short-term movements in the exchange value of their currencies. However, the IMF guidelines say that other kinds of intervention “might indicate the need for discussion with a member.” These include “protracted large-scale intervention in one direction in the exchange market” and “behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.” As may be seen below, China’s management of its foreign exchange system has given rise to concern that it has been or may be violating these criteria.

Countries are allowed, under the guidelines, to use their exchange rates to promote growth and development. The IMF rules for surveillance say the Fund’s appraisal of country policies “shall take into account the extent to which the policies of a member, including its exchange rate policies, serve the objectives of the continuing development of orderly underlying conditions that are necessary for financial stability, the promotion of sustainable economic growth, and reasonable levels of employment.” However, countries are also required to “take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.” In other words, countries can use exchange rate policy to help sustain growth and employment in their domestic economy but they cannot use an unrealistic exchange rate to prevent balance of payments (BOP) adjustment or to gain unfair trade advantages. Adjustment includes such things as increased imports, capital inflows to fund BOP deficits or outflows to offset BOP surpluses, increased domestic interest rates or price levels, the accumulation of excess reserves, etc. If one country does not adjust its BOP imbalance, the burden of adjustment will be thrown upon its trading partners through monetary contraction, unemployment and the like.

China and Manipulation. China says that it needs exchange rate stability to avoid injury to its domestic economy. The issue is whether China’s old and new procedures for attaining stability are throwing undue burdens onto other countries and violating the prohibition against manipulation.

Most countries which seek to sustain unrealistic exchange rates for their currencies eventually find, as did several major Asian countries during the foreign exchange and BOP crisis of the late 1990s, that their foreign exchange reserves are insufficient to maintain their currency at the desired value indefinitely. In most cases, countries have tried to value their currency at a higher level than the market might otherwise find appropriate. This raises the income level for their people and it lowers the price of imports. If confidence in the government’s economic management disappears, people holding their national currency will increasingly desire to exchange it for established foreign currencies such as the dollar. When the government runs out of dollars and other such foreign exchange, it can no longer “defend” its currency and devaluation follows.

In the case of China, however, critics argue that the yuan has been kept at an international value lower than its actual market value. This increases exports but it raises the cost of imports and lowers domestic income. However, this also stimulates

domestic economic growth and employment, though at some risk that too much stimulation might cause the economy to overheat. Other domestic economic policies need to be oriented to keep this stimulus under control.

As long as the Chinese authorities are willing to sell yuan and buy foreign currency, they can keep their currency from rising in value compared to other countries. China has \$711 billion in foreign exchange reserves. If it is willing to accumulate further reserves, with the attendant risk of inflation and other forms of financial dislocation, China may hold the exchange value of its currency below its real international value for a long time.

Some would argue that an ability to maintain one's currency at a fixed level through market interventions, without regard for underlying economic conditions, is evidence of manipulation. Others would argue, however, that the economic benefits of stability are important and are shared by many countries. Moreover, they might contend, efforts to influence exchange rates through intervention in currency markets are not much different in their effect than are the changes in interest rates and other policies that countries with floating exchange rates use to influence the exchange rate of their currencies.

The New System Announced July 21

The New Exchange Rate Mechanism. On July 21, 2005, the People's Bank of China (PBC), the central bank for mainland China,⁷ announced that — rather than being pegged only against the dollar — the value of the yuan would be pegged in the future against a basket of currencies. The composition of the basket would not be disclosed. The central bank also announced that the yuan would be revalued (increased in value) against the dollar by 2.1% (to 8.11 yuan per dollar) and its daily value compared to the new basket of currencies would be allowed to vary by 0.3% each day above or below a central parity. The PBC said that “the closing price of a foreign currency such as the US dollar traded against the RMB [yuan]...after the closing of the market each working day” will become “the central parity for the trading against the RMB the following working day.”⁸ Economists call this kind of exchange rate mechanism a “crawling peg” because it allows currency values to be adjusted in small increments over a period of time either in response to market forces or to official announcements.

On July 27, 2005, however, the People's Bank of China (PBC) announced that no further increases in the international value of the yuan were to be expected. It said, as regards the July 21 announcement, that “This certainly does not mean that the 2 per cent adjustment of the renminbi is the first step that will be followed by

⁷ The Central Bank of China is located in Taiwan and serves the Republic of China. The term “central bank” in this paper will refer to the People's Bank of China.

⁸ The new procedure was widely discussed in the press. See, for example, “2% Solution: China lets Yuan Rise vs. Dollar, Easing Trade Tensions Slightly.” *Wall Street Journal*, July 22, 2005, p. 1; Richard McGregor *et al.* “China revalues the renminbi.” *Financial Times*, July 22, 2005, p. 1; and Peter Goodman. “China Ends Fixed-Rate Currency.” *Washington Post*, July 22, 2005, p. 1.

further adjustment.”⁹ The central bank blamed the press for “creating misunderstanding” and creating expectations that the procedures introduced on July 21 would result in further increases in the value of the yuan. Four days earlier, on July 23, the governor of China’s central bank had fueled expectations that the yuan would rise in value. Explaining the new exchange rate mechanism on national television, he told viewers that “We have made an initial adjustment to the exchange rate level of 2 percent,” implying that further adjustments were to come.¹⁰

Interpreting the Two Announcements. The July 27 announcement can be interpreted two ways. First, it can be seen as a statement that China does not really intend to allow the yuan to increase in value, as the procedures announced July 21 would suggest. If this is true, the new crawling peg mechanism would not be allowed to function and China’s currency would stay at about its current level. This might satisfy internal critics who dislike the plan to increase the value of the yuan. On the other hand, if the new announcement reflects China’s actual policy, it makes little sense for Chinese authorities to make that statement (as they did) just before the U.S. Congress was scheduled to consider legislation affecting China and the IMF was scheduled to discuss whether China is in compliance with its exchange rate obligations.

Alternatively, the new announcement can be seen as a tactical move to discourage speculators. In order to prevent its accumulation of foreign exchange assets from destabilizing China’s internal financial system, the government has had to institute a strict system of capital import controls. Analysts worry that massive speculative inflows might overwhelm these controls and seriously destabilize China’s economy. They would also make it more difficult for the central bank to implement a crawling peg mechanism which seeks gradual but continued increases in the value of the yuan. Many analysts worry that, if the yuan is going to increase in value considerably on account of the new procedures announced July 21, currency speculators have every reason to buy yuan and yuan-denominated assets as soon as possible. Doing so, they guarantee themselves large profits (when they convert their yuan back into foreign exchange) as the yuan increases in value. This would be a one-way bet that speculators could not lose, since there was little chance the yuan would fall in value.¹¹

From this second point of view, the central bank’s announcement on July 27 is not evidence that Chinese officials are shying away from their plan to revalue the yuan. Rather, it is evidence that they intend to do so even though they must walk a narrow and precarious path — discouraging speculators at the same time that they do what the speculators expect — to accomplish that end. Whether China will be able to proceed with its plans for a long-term upward adjustment in the yuan remains to be seen. Too much speculative pressure, too many people seeking to buy yuan, could

⁹ See, for example, Mure Dickie and Andrew Balls. “Beijing cools currency hopes.” *Financial Times*, July 27, 2005, p. 1. See also Peter Goodman. “Don’t Expect Yuan to Rise Much, China Tells World.” *Washington Post*, July 27, 2005, p. D1.

¹⁰ *Financial Times*. *Ibid.*

¹¹ See, for example: Morris Goldstein and Nicholas Lardy. “China’s revaluation shows size really matters.” *Financial Times*, July 22, 2005, p. 13.

force China to accelerate the adjustment process in order to limit the destabilizing effects that such speculation might have on the Chinese economy.

U.S. officials seem to have adopted the second interpretation of the July 27 announcement. A Treasury Department spokesman said that China's reform mechanism will allow greater flexibility in the yuan exchange rate over time.¹² Meanwhile, Senator Schumer also said, noting the new announcement, that "we trust that the Chinese will allow market forces to work." He also said that he and others would carefully monitor the process during the next few months.¹³

On July 28, however, Senators Schumer and Graham announced that they were not satisfied with China's progress in reforming its foreign exchange procedures and they might press for action on their tariff legislation (see below) around October 1. They seem to have concluded that the July 27 statement better reflects China's real position. "I can tell you that we are not satisfied with simply a 2 % revaluation," Senator Schumer said. "We don't want to tell the Chinese how to do it and we understand that it will take some time." Some analysts have speculated that, given their two recent announcements, Chinese officials want to drag the adjustment process out — at perhaps 2% a year — for as long as possible.¹⁴

Issues About Implementation. It is not evident that the new system announced July 21 will satisfy many of the concerns previously raised against China's old exchange rate system. Likewise, it is possible — even if the yuan goes up in value compared to the U.S. dollar — that the new system may have both desirable and undesirable consequences for the United States.

First, the yuan will increase in value in the new system only if the central bank allows the daily changes to be cumulative. If this happens, the yuan could increase in value by as much as 1.5% each week or as much as 30% in five months. In the old system, "daily changes in the value of the renminbi against the U.S. dollar [were] limited to 0.3% on either side of the basic rate" established by the central bank.¹⁵ The central bank bought or sold currency to return this "market" rate to its official level each day. The central bank will also need to trade currencies under the new system to keep changes in the yuan's value from exceeding the 0.3% daily limit. In the process, if the July 27 statement reflects its actual position, it could buy or sell additional currency in order to keep the yuan's "market" rate at any level it believes appropriate. No announcement would be necessary and it would be difficult to prove whether this was taking place. China could always claim that the current exchange rate was set by the market and not by official policy. The Chinese government has not announced any procedures or guidelines for the central bank's daily interventions in currency markets in the new system put into effect July 21.

¹² Beijing cools currency hopes. Note 9.

¹³ *Ibid.*

¹⁴ Anjali Athavaley. "Schumer, Graham May Press for China Tariffs." *Washington Post*, July 29, 2005, p. D5.

¹⁵ International Monetary Fund. *Annual Report on Exchange Arrangements and Exchange Restrictions, 2004*. Washington, D.C., 2004, p. 218.

Second, it is not evident, that the value of the yuan in the new system would respond to changes in China's economic relations with other countries. The dollar might go down in value compared to the yuan in certain circumstances, for instance, but this change would be limited by the offsetting changes in the value of the other currencies in the central bank's currency basket. The yuan will still be fixed in value compared to this basket of currencies. It is conceivable, for example, that the prevailing trends in China's economic relationship with the United States would suggest a need for the dollar to go down in value compared to the yuan. However, if the dollar went up in value compared to the euro or other currencies in China's currency basket, the dollar would have to go up compared to the yuan in order to offset the falling value of those currencies. Thus, the dollar price of China's exports might depend more on changes in the relative value of the currencies in the central bank's currency basket than it would on China's actual economic situation.

Third, under the new system, China will not need to hold or acquire as many dollars as before in order to stabilize the price of its currency. To stabilize the value of the yuan compared to the currency basket, it may need to buy euros or yen or some other currency instead. If China is accumulating fewer dollars than before, it will have less need to purchase dollar-denominated securities. If China's future purchases in U.S. securities markets declines, the sellers of dollar-denominated notes and bonds may find that they need to offer higher interest rates than before in order to attract new buyers for the securities previously bought by China. The result would likely be an increase in market interest rates in the United States.

U.S. Treasury Actions

The Omnibus Trade and Competitiveness Act of 1988 (sec. 3004) requires the Secretary of the Treasury to determine, in consultation with the International Monetary Fund, whether countries are manipulating the value of their currency in order to gain unfair trade advantage. If the Secretary finds there is manipulation, he or she must "initiate negotiations with such foreign countries on an expedited basis, in the International Monetary Fund or bilaterally, for the purpose of ensuring that countries promptly address the rate of exchange between their currencies and the United States dollar" in order to permit effective balance of payments adjustment and to eliminate any unfair trade advantages they might have gained from manipulation.¹⁶ The Secretary is required (sec. 3005) to report to Congress twice annually on the international economic and exchange rate policies of other countries.

U.S. officials have spoken with Chinese officials and issued statements on several occasions, urging China to reform its exchange rate system so it would be more flexible or to let it operate according to market principles. There is no indication on the public record, though, as to whether — as required by the 1988 trade law — U.S. officials have consulted with the IMF on this matter or what, if any, response the IMF has made. In May 2005, the Treasury Department reported, in a sec. 3005 report to Congress, that China was not manipulating its exchange rate in

¹⁶ *Op. Cit.*, note 3.

violation of its obligations under Article IV of the IMF charter.¹⁷ As noted above, the language of Article IV and the language of the relevant U.S. law are essentially the same.

The Treasury Department's conclusions in its 2005 report rely more on statements that China is laying the groundwork for a future revaluation of its currency than on they do on any determination that China's prevailing exchange rate policies were appropriate. Some observers suggest, though, that the Treasury Department was more critical of China in this report than it was previously in part due to congressional pressure. The report said that, "If current trends continue without substantial alteration [i.e., revaluation], China's policies will likely meet the statute's technical requirements" for designating China as a country which unfairly manipulates its currency value. Treasury Secretary John Snow reportedly gave Chinese officials six months to rectify the situation. Treasury officials later said, however, that China should revalue its currency immediately by 10% against the dollar or risk contrary legislation from Congress.¹⁸

On July 21, 2005, in his official response to China's new exchange rate system, Secretary Snow said that he welcomed the announcement that China is adopting a more flexible exchange rate regime in which the value of its currency would be based on market supply. He noted, however, that "We will monitor China's managed float as their exchange rate moves to alignment with underlying market conditions."¹⁹ Interviewed that evening on the PBS *Nightly Business Review*, he said he was encouraged that China had "put in place a mechanism to allow their currency to better reflect market conditions, demand and supply conditions, and to move in accordance with the marketplace." He agreed that the initial 2% change was small, but he said the important thing was the commitment they have expressed to flexibility. "The really important thing that's happened today is the long term," he said. "This is the start of a process and the Chinese have indicated they want to get their currency based on markets rather than a peg."²⁰

Congressional Initiatives

Meanwhile, Congress is considering legislation that would limit China's access to the U.S. market if it does not stop manipulating the value of its currency. On

¹⁷ [U.S. Department of the Treasury.] *Report to Congress on International Economic and Exchange Rate Policies, May 2005*. Obtained from [<http://www.treas.gov>], the Treasury Department website. See especially pp. 11-14.

¹⁸ See, for example Andrew Balls, "US sets out revaluation deadline for China," *Financial Times*, USA edition, May 18, 2005, p. 1. See also Edmund L. Andrews, "Bush's Choice: Anger China or Congress over Currency," *The New York Times*, May 17, 2005, p. 1, Donna Borak, "U.S. increases pressure on China's currency," *UPI Perspectives*, May 24, 2005, and Andrew Balls, "FT.com site: China told to revalue by 10% by US," *Financial Times*, May 24, 2005, p. 1.

¹⁹ Snow Welcomes China's Currency Reforms, at [<http://www.treas.gov/news/index1.html>].

²⁰ Susie Gharib. "Secretary of State John Snow Sounds-off On China's Money Move." *Nightly Business Review*, July 21, 2005. Interview, available at [<http://www.nightlybusiness.org/transcript.html>].

April 6, 2005, for example, Senators Charles Schumer and Lindsey Graham proposed that Congress enact a 27.5% tariff on all Chinese products entering the United States if China does not raise the value of its currency.²¹ The Senate voted 67-33 to endorse this proposal and a final vote on the measure was planned to occur on or before July 27, 2005. On June 30, 2005, Treasury Secretary Snow and Federal Reserve Chairman Greenspan assured Senators Schumer, Graham and others that China is moving to revise its exchange rate policies. On the basis of those assurances, the Senators agreed to postpone until September any vote on their bill requiring tariff sanctions on Chinese imports if China does not revalue the yuan.²² Senator Schumer was quoted as saying, after Chinese officials announced the 2% revaluation of the yuan and adoption of a new exchange rate system, that “It is smaller than we had hoped, but to paraphrase the Chinese philosophers, a trip of a thousand miles can begin with the first baby step.”²³

On July 27, 2005, the House of Representatives passed legislation (H.R. 3283) proposed by Representative Phil English which addressed the Chinese exchange rate issues in several ways. First, the legislation would make imports from non-market economies (such as China) subject to the U.S. laws that authorize the imposition of special tariffs (countervailing duties) against foreign goods which cause injury to U.S. producers if those goods are found to have benefitted from subsidies from foreign governments. It also tightens the rules on anti-dumping duties to prevent non-payment of penalties by those found in violation of those U.S. laws. Countervailing duties and anti-dumping provisions are allowed under the rules of the World Trade Organization (WTO). The bill establishes a comprehensive monitoring system to track China’s compliance with specific WTO commitments and it requires periodic reports on China’s progress on meeting those commitments. It also requires the Treasury Department to define the term “currency manipulation” for the purposes of U.S. law and it requires the Department to report periodically on China’s implementation of its new currency regime. The bill passed (255 to 168) on July 27, 2005. Senator Susan Collins has introduced a similar bill (S. 1421) in the Senate.

Congress is also considering other legislation on to this issue. On April 7, 2005, for example, Representatives Duncan Hunter and Tim Ryan introduced legislation that would make it easier for U.S. firms to file complaints with the World Trade Organization (WTO) claiming that currency manipulation is a trade-distorting practice.²⁴

The new Chinese exchange rate procedure was announced less than a week before Congress was originally scheduled to consider the Schumer/Graham legislation and the English bill. Though most observers welcome the change in the

²¹ Greg Hitt. “Senate Slams China’s Currency Policy.” *Wall Street Journal*. April 7, 2005, 1. For a list of all current congressional legislation aimed at the Chinese exchange rate issue, see. *U.S.-China Trade Issues*, note 1.

²² *Ibid.*

²³ “China revalues, cited earlier, from *Financial Times*, July 21, 2005, p. 1.

²⁴ Nancy E. Kelly. “China’s currency policies prompt ‘cheat’ accusations House bill would ease trade complaint filings.” *American Metal Market*, April 8, 2005, V iii, I 13-15, P 1(2).

Chinese procedure, many question whether the new procedure will achieve a significant change in the yuan's value vis-a-vis the dollar and whether Chinese officials will forswear manipulation. Some observers also suggest that the new system was intended to be a means for deflecting criticism, for weakening the pressure for change, and for preventing or delaying passage of strong legislation.²⁵

Other Countries' Views

No other country has taken as strong a position on the Chinese exchange rate issue as has the United States. Bank of Canada Governor David Dodge called on China in early June 2005 to free its currency from the fixed rate against the U.S. dollar or to risk sparking U.S. and European trade protectionism. He did not propose that sanctions or economic pressure should be adopted, however, in order to help encourage China towards that end.²⁶

Other countries have reportedly been strong, in their private discussions with China, in urging a rapid resolution of the exchange rate issue. In their public comments, however, most have taken a softer line. In June 2005, Japan's finance minister urged China to reform its tight currency peg on grounds that the current yuan-dollar exchange rate was hurting the Chinese economy and causing it to overheat.²⁷ The same month, after Chinese Premier Wen Jiabao told an Asia-Europe ministerial meeting that China would adopt a more flexible currency policy only when it believed itself ready, European ministers said that they hoped it would not take too long²⁸ but they agreed that China should not be pressured and it had the right to determine when and how it would reform its currency.²⁹

²⁵ See, for example: "Richard McGregor. "Aim is to allow greater flexibility while still keeping firm control." and "Making sense of China's choice." *Financial Times*, July 22, 2005, pp. 2 and 4.

²⁶ Paul Brent. "Dodge's call to free the Chinese yuan has strong backing." *National Post* (Don Mills, Ontario), June 6, 2005, p. FP2.

²⁷ "Tanigaki says quick action on yuan needed." *Economic Times of India*, *The Electronic Times Online*, July 9, 2005. See the *Economic Times of India's* website at [<http://economictimes.indiatimes.com/articleshow/1165902.cms>]. By contrast, Japan previously had called for China to take immediate action. The Japanese Finance Minister told the G7 finance ministers in February 2003 meeting, that change was urgently needed and "Too much importation of China's cheap goods" was "the root-cause of the global economic depression." Yang Jian and Melinda Moore. "Renminbi" *Eurobiz Magazine*, July 2003, found at [<http://www.sinomedia.net/eurobiz/v200307/rmb.html>].

²⁸ Kervin Yao and Yoko Nishikawa. "Yuan Dominates Asia-Europe meeting." *Reuters*, June 26, 2005, reported at [http://news.yahoo.com/s/nm/economy_china_dc&printer].

²⁹ Cary Huang. "World clamours for Beijing to revalue yuan; But there is agreement that China should dictate timing of any currency reforms." *South China Post* (Hong Kong), June 27, 2005, p. 5. The EU finance minister said that China should do what it thought best. Cindi Sui. "Europe backs off on yuan value." *The Australian*, June 27, 2005, at [http://theaustralian.news.com.au/common/story_page/0,5744,15741709%255E31037,00.htm].

Though the issue was discussed at their 2005 summit meeting in Scotland, the Group of Eight major industrial countries (G8) did not mention the yuan exchange rate issue in their final communique. China's President told the G8 at this meeting that China wanted to base the yuan's value on market forces but it would do this on its own time and not as a result of foreign pressure.³⁰ Some analysts suggest that the G8's public silence on the yuan question was calculated to provide China with a "narrow window of opportunity" allowing China to "inch towards a more flexible exchange rate policy without losing face by appearing to bow to foreign pressure."³¹

Options for the United States

There are several approaches the United States might use for encouraging China to implement the July 21 crawling peg procedure it previously announced or to improve on it. These options or policy tools are not mutually exclusive, though it might be difficult for the United States to pursue some of them simultaneously. First, the U.S. Government might continue pressing China publicly for additional changes in its foreign exchange system in order to make the international value of the yuan better reflect market conditions and economic realities. Second, the United States could enact legislation restricting Chinese exports to the United States if value of the yuan is not increased. Third, the U.S. Government might stop pressing China publicly, on the expectation that China will move more rapidly towards reform if it is not pressured from abroad. Fourth, the U.S. Government might refer the question to the IMF, asking the international agency to determine whether China has been manipulating its currency in violation of IMF rules and whether its new exchange rate mechanism complies. Fifth, the U.S. Government might refer the issue to the World Trade Organization (WTO), asserting that the United States has been injured by unfair trade practices linked to the undervaluation of China's currency and asking the WTO to authorize trade remedies (tariffs on Chinese goods, for example) aimed at correcting this abuse.

Continue Public Pressure

Continued public pressure is one method the United States might use to encourage China to adopt further reforms in its foreign exchange procedures. In particular, this might push Chinese officials to address the discrepancies between their July 21 and July 27 announcements and possible difficulties with the July 21 plan. They might be pressed, by official statements and the prospect of potential legislation, to clarify whether the "crawling peg" provisions of the July 21 plan will be allowed to work or whether China will prevent (as announced July 27) the daily changes in the value of the yuan from being cumulative. Alternatively, the United States could pressure China to adopt a different foreign exchange process that will revalue its currency more quickly.

³⁰ Scott Hills. "China's Hu sidesteps yuan debate in G8 address." *Reuters*, July 1, 2005, at [<http://today.reuters.com/PrinterFriendlyPopup.aspx?type=live8News&StoryID-uri:2005-o.html>].

³¹ "G8 summit offers Hu a window to adjust yuan policy." *South China Morning Post* (Hong Kong), July 6, 2005, p. 2.

From this perspective, it would be helpful to know whether Chinese officials intend to move towards a market-based valuation of the yuan or whether their recent announcements are designed to deflect pressure and to delay the process as much as possible. If China adopted the reforms announced to date mainly in response to foreign pressure, then it is possible that further pressure might persuade them to go further. However, if Chinese officials adopted these recent changes because they believe that market-based reform is in China's best interests, foreign pressure can either enhance or complicate their progress. China has a long tradition, in reaction to the capitulations that outsiders extracted from China in earlier centuries, of not giving in to foreign pressure. Foreign pressure might strengthen the hand of the reformers, but it might also stiffen resistance by the opponents of reform and make it harder for the reformers to achieve their ends.

It might be helpful, if the U.S. Government decides to press China for more rapid and broader reforms in their exchange rate system, if U.S. officials and legislators had more information about China's internal decision making process. How strong are the reformers? What key choices do Chinese officials believe they face as regards the economy and value of the yuan? Would the United States be pushing against a closed door if it sought faster and broader reform or is the door at least partly open? In the latter case, will the door open further or will it close and lock itself when it feels foreign pressure? This is a dilemma. Pressure might work if the Chinese authorities does not really want to reform and if their recent announcements are intended to deflect or delay criticism. Pressure might be counterproductive, on the other hand, if Chinese officials really want to reform and their recent announcements are a blueprint to the future. In the latter case, public pressure might weaken the proponents of reform and cause China to slow the process of reform.

The dilemma may be less of a concern if the United States wants to push China into adopting exchange rate reforms which exceed those which most Chinese proponents of reform will accept. This might include, for examples, efforts to accelerate the pace of the exchange rate liberalization process beyond the rate which Chinese officials believe prudent for their economy. A close examination of the Chinese policy process might show whether it is likely that foreign pressure can accomplish such goals or an alternative approach might be more effective. The latter might include, for example, efforts to persuade China that it has more economic options than it thinks and that rapid increase in the value of it currency would not produce the results that Chinese officials fear.

The other question is whether the United States would have the support of other countries if it sought to press China to adopt further reforms. It is possible that other countries might be prepared to follow the U.S. lead, now that China has announced the July 21 program of reform. In that case, they would be urging Chinese officials to proceed with a plan which has already been announced rather than pressing them to do something new. However, it is also possible that other countries will stand aside — as the Europeans, Japanese and others have done to date — in order to let the United States make this effort on its own. They would stand to benefit from any changes China might adopt but they could decide (as they seem to have done to date) that it might be more advantageous for them to show understanding towards the Chinese position in their public stance.

Restrict Exports to the United States

Alternatively, instead of using verbal pressure, the United States could adopt legislation restricting China's access to the U.S. market until it raises the value of its currency. The English bill (H.R. 3282) and the proposed Schumer/Graham amendment (both mentioned above) would have this effect. By raising the price of Chinese imports, they would reduce the flow of Chinese exports to the United States. Among other things, this would make U.S. products more competitive with Chinese goods in the United States, with some possible positive employment effects in competing U.S. industries. It would also raise the prices paid by U.S. purchasers.

It is unclear what the Chinese authorities would do if faced by restrictive import legislation of this sort. It is possible that they would raise the value of the yuan in hopes that this will eliminate the new U.S. tariffs on their goods. There being no internationally recognized standard, however, it would be uncertain how much the yuan would need to be increased in order to satisfy U.S. requirements. China could make unilateral changes in its exchange rate in hopes of finding one that satisfied U.S. concerns. Alternatively, the issue could be settled by negotiations. The yuan exchange rate being a matter which affects many countries, it seems unlikely that China and its other major trading partners would wish to see the question settled through bilateral talks with the United States alone.

Alternatively, being a member of the World Trade Organization, China might ask the WTO to examine the issue. It could ask a dispute settlement panel to rule that the United States acted in a manner inconsistent with its obligations under WTO rules when it adopted unilateral tariffs and duties aimed at China. It is uncertain, under its rules and precedents, how the WTO would respond to such a complaint. For example, countervailing duties and anti-dumping penalties are permissible under WTO rules. However, exchange rates are not normally part of that calculation. The WTO might have concern that the rules governing the world trade would be difficult to enforce if countries were free to impose countervailing duties whenever they found that foreign goods were being subsidized because they decided unilaterally that the exporting country had allowed its currency to become undervalued.

The WTO might authorize China to apply comparable restrictions of its own but the impact these might have on U.S. exports to China would likely be less than the impact the U.S. charges had on Chinese exports to the United States. Ultimately, much will likely depend on whether other countries support the U.S. or the Chinese side in this dispute. Also important would be any effects that the resulting trade dispute between the United States and China might have on the broader picture of world trade negotiations.

If the volume of Chinese exports to the United States declines because of new trade legislation, the profits of the foreign firms located in China which produce those goods will likely go down as well. Depending on technical factors, some of those firms may be able to shift production to other countries in the region. In that case, unless the currencies of those other countries should increase to make their exports uncompetitive, it is possible that the issue of low-cost Chinese goods may be superseded by a similar controversy about low-cost goods from other Asian

countries. It is not clear whether the legislative tools currently being considered for use against China would be applicable as well in situations of that sort.

Pursue a Policy of Restraint

Instead of pressing China publicly for reform, the United States might decide on a policy of restraint. This approach presumes that the Chinese authorities want to proceed with their reform program as rapidly as economic conditions and the prevailing policy consensus in China permit. This approach also presumes that overt pressure would be counterproductive, slowing the process and strengthening the hand of those in China who oppose reform.

It might be argued that the United States should keep its trade and currency dispute with China in perspective. The economic issues are important, one might argue, but it is also important not to raise tensions to the point where China becomes reluctant to cooperate with the United States on other issues, such as North Korea's policies on nuclear weapons. Others might respond, however, that China will cooperate with the United States in other areas when it believes that this serves its interests even though there are other areas as trade and currency policy where the two countries disagree.

Ironically, it is possible that some form of pressure may be required to move China forward on its plans for foreign exchange reform whether or not Chinese officials really want to reform. If the recent announcements were made only to distract foreign critics and to sidestep contrary action by Congress or the IMF, then a reduction in the amplitude of the pressure will be followed by a diminution in the pace of reforms. On the other hand, even if Chinese authorities want to move forward with their reform program, they may need some external pressure — if only in the form of agreed deadlines and benchmarks — to help them overcome inertia when they encounter difficult choices as they put their currency reform policies into effect.

Take It to the IMF

The United States could also pursue issue of China's exchange rate policy at the International Monetary Fund. Rather than treating it as though it were a bilateral dispute between the United States and China, the Administration could ask the IMF to determine whether China's exchange rate system is consistent with the IMF's rules or whether China needs to take additional steps in order to comply. The later might include, for instance, assurances that the crawling peg mechanism will be allowed to work or benchmarks for measuring its implementation. Among other things, the executive directors can require China to clarify whether the July 21 or the July 27 announcement reflects actual policy. China's exchange rate policies are a multilateral issue which affect other countries in addition to the United States. Most have chosen not to challenge China publicly about its foreign exchange policies. However, when the issue is laid before their representatives on the IMF's Board of Executive Directors for confidential discussion they would have to take a position and they are more likely to be frank.

The IMF staff has finished preparation of its Article IV report on China for 2005 and the executive board is reportedly scheduled to consider it August 3, 2005. Not a pro forma exercise, this is generally a substantive review and discussion by the executive directors of the major issues and policies affecting a country's economy. Exchange rate policies are a key factor in the executive board review. The board has before it the staff's written analysis but the executive directors are free to make their own analysis and to find their own conclusions. Among other things, the board will likely consider whether China's newly announced exchange rate mechanism complies with the requirements of Article IV and whether assurances are needed to insure that it will be implemented effectively.

In its 2004 Article IV review of China's economy, the IMF staff reported that it was "difficult to find persuasive evidence that the renminbi [yuan] is substantially undervalued."³² It is likely that the IMF staff wished to avoid entanglement in a controversy which had seemingly become as much political as it was economic. Nevertheless, the staff's analysis of Chinese economic policy showed that more exchange rate flexibility, tighter monetary policy, and a reduction in the inflow of money from abroad were needed.³³ Revaluation of the yuan would be consistent with the staff's recommendations.

The IMF executive board said, in its discussion of the issue in 2004, that greater exchange rate flexibility is in China's best interest.³⁴ They welcomed the statement by Chinese authorities that they aimed (in the words of the IMF summary of the board discussion) "to introduce, in a phased manner, greater exchange rate flexibility," though several Directors said the timing of that change should be left to China. Many Directors also said that "it would be advantageous for China to make an initial move towards greater exchange rate flexibility without undue delay," with some preferring that this decision should be made soon. Many Directors also noted, though, that China would need to sequence the elements of this change carefully, in

³² International Monetary Fund. *People's Republic of China: Staff Report for the 2004 Article IV Consultation*. July 6, 2004, p. 12. This report is available from the IMF website at [<http://www.imf.org/external/pubs/ft/scr/2004/cr04351.pdf>].

³³ *Ibid*, pp. 11-13. The staff report stressed that greater exchange rate flexibility would "enhance China's ability to pursue an independent monetary policy and adjust to shocks." The staff also found that tighter monetary policy would help China slow its rate of growth to a more sustainable pace, that money and credit growth needed to be reduced but that large capital inflows (from investment and trade) were making it increasingly difficult for Chinese authorities to control money and credit growth. The staff reported that the authorities were worried that a large change in the value of the yuan would increase unemployment. The IMF staff said, however, that balanced and sustainable growth would "provide the best conditions to stimulate employment growth" and that "increased flexibility of the exchange rate would improve the effectiveness of monetary policy in reducing overheating risks." The staff also asserted that, despite China's assertions to the contrary, that increased exchange rate flexibility would not pose substantial risks for the banking system given the limited scale of the system's foreign assets and liabilities.

³⁴ International Monetary Fund. *IMF Concludes 2004 Article IV Consultation with the People's Republic of China*, August 25, 2004 Public Information Notice 04/99. It appears from context that "greater flexibility" meant an upward valuation of the yuan.

relation to other steps being taken to liberalize and reform capital markets, the capital account and the financial sector.

The Chinese announced their July 21 exchange rate procedures less than two weeks before the IMF executive board was scheduled to discuss their economic policies and exchange rate. They had talked, during the year following the board's meeting about them in 2004, about various possibilities but they had not taken any action. On July 21, IMF officials told the press, in response to the introduction of the new procedures, that China should not limit the renminbi's movements within the new foreign exchange framework.³⁵ IMF spokesman Thomas Dawson also told a press conference the same day that "We would encourage the authorities to utilize fully the scope for flexibility in the new exchange arrangement. We are ready to work with the authorities on the continuing evolution of the exchange rate system." The IMF staff does not speak for the executive board. Nevertheless, it would appear, from these indications, that the IMF views the 2.1% revaluation as the beginning, not the end, of the process for adjusting the yuan's exchange rate.

The IMF cannot make a country revise its exchange rate. Nevertheless, a statement by the IMF staff or the executive board can have significant impact on currency markets and on the policies of other countries. A statement criticizing the economic management of a country, for example, can influence the way the private sector — particularly the financial sector — deals with that country. Likewise, statements from the IMF executive board can have an affect on the policies of its member countries. If the executive board says that a country is not complying with its obligations to the IMF, countries are likely to take the IMF's position into account when they make policy on that issue.³⁶

The United States does not have to wait until the IMF does its 2006 annual Article IV review in order for it to get the China exchange rate issue on the agenda of the IMF executive board once again. Rather, it need only tell the IMF Managing Director that it believes China is not complying with the requirements of Article IV.³⁷ The Managing Director would then be required to consult with the Chinese and to report his findings formally or informally to the executive board. A formal report would provide the United States with an occasion for asking the board to reconsider the issue again in the light of developments which have occurred since the last Article IV report. If the United States believed, for example, that China were interfering with the operations of its crawling peg mechanism in order to keep down

³⁵ "US Treasury Welcomes," *Financial Times*, July 22, 2005, note 20.

³⁶ For the IMF executive board to have issued a statement of this sort, most major countries would have had to vote for it and some would have had a hand in its preparation.

³⁷ The IMF's guidelines for surveillance over exchange rate policies say that, "taking into account any views that have been expressed by other members," the Managing Director may consider whether a country's policies are in accord with the Fund's exchange rate principles and undertake informal and confidential discussions with the country on that issue. Depending on his findings, the Managing Director is required to report his or her findings formally or informally to the executive board. In the past, Germany has filed such a complaint about Sweden and the United States has filed a complaint about Korea. IMF surveillance guidelines, note 8.

the value of the yuan, it could ask the executive board for a finding critical of China's actions. This would be stronger, in its international impact, than a comparable finding by the Secretary of the Treasury in a semi-annual report on China's exchange rate practices.

It would be difficult for the United States to put bilateral pressure on China while the IMF is considering whether that country's exchange rate procedures comply with IMF guidelines and IMF rules. An IMF statement that China's procedures were not in compliance with the rules might help the United States marshal support from other countries if it decided to begin pressing China for action once again. On the other hand, if the executive board were to rule that China's procedures are acceptable — even though the Chinese Government was limiting the daily movements of the yuan in order to keep it from increasing much in value — the United States would have difficulty arguing the contrary view. The United States might wish to consult with the G8 countries and with other countries in order to prepare the groundwork and build a consensus before it formally brings the issue to the IMF.

Apply to the WTO

The United States could also file a complaint with the World Trade Organization (WTO) alleging that China has obtained an unfair trade advantage for its exports by keeping the value of its currency artificially low. The WTO has no authority to address exchange rate issues. However, the IMF and WTO have an agreement which requires the WTO will refer exchange rate disputes of this sort to the international monetary body and will accept the IMF's findings as conclusive.³⁸ By itself, a finding by the IMF that China is manipulating its currency in violation of Article IV would have no "teeth" that would require Chinese officials to change their procedures. Considered in conjunction with a trade complaint before the WTO, however, an IMF finding of this sort could result in trade sanctions if a WTO dispute reconciliation panel found that China was subsidizing its exports by undervaluing its currency.

If a WTO dispute settlement panel were to rule that China was gaining unfair trade advantage through a low valuation of its currency, it might authorize the United States to adopt special tariffs penalizing China if it fails to revalue its currency. If countries join the U.S. complaint, they would also be empowered to adopt similar tariff penalties. It might be awkward for the United States to apply to the WTO in the manner if it has already enacted tariff restrictions on its own. Moreover, it would be risky for the United States to apply to the WTO for relief if it does not know beforehand how the IMF would rule on the exchange rate issue. Support from the other major members of the IMF would be critical for this approach to work. The G8 countries and other members of the European Union comprise a majority of the

³⁸ See *Arrangement for Consultation and Cooperation with the Contracting Parties of GATT*, September 9, 1948, and *Guidelines/Framework for Fund Staff Collaboration with the World Trade Organization*, April 21, 1995. Both are included in the IMF's *Selected Decisions and Selected Documents of the International Monetary Fund*, pp. 546-9 and 552-9 of the 24th issue. Washington, D.C. June 30, 1999.

voting power in the IMF. Consultation with these countries might be appropriate before the United States approaches the WTO with a complaint.