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IN FOCUS

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China's Currency Policy

China's policy of intervening in currency markets to limit or halt the appreciation of its currency, the renminbi (RMB), against the U.S. dollar and other currencies has been an issue of concern for many in Congress over the past decade or so. Some Members charge that China "manipulates" its currency in order to make its exports significantly less expensive, and its imports more expensive, than would occur if the RMB were a freely traded currency. Some argue that the RMB is significantly undervalued against the dollar and that this has been a major contributor to the large annual U.S. merchandise trade deficits with China (which was $343 billion in 2014) and the decline in U.S. manufacturing jobs. Legislation to address foreign currencies deemed to be undervalued has been introduced in every Congress since 2003. China has often been the main target of such legislation, although in recent years, the currency policies of other countries have also come under scrutiny. In the 114th Congress, H.R. 820, S.433, and S. 1267 would seek to treat certain undervalued currencies as an actionable subsidy under U.S. countervailing laws.

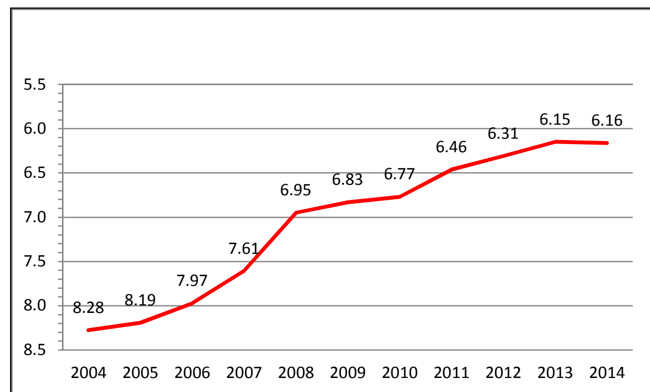
Economic Considerations

The effects of China's currency policy on the U.S. economy are complex. If the RMB is undervalued (as some contend), then it might be viewed as an indirect export subsidy which artificially lowers the prices of Chinese products imported into the United States. Under this view, this benefits U.S. consumers and U.S. firms that use Chinese-made parts and components, but could negatively affect certain U.S. import-competing firms and their workers. An undervalued RMB might also have a more limiting effect on the level of U.S. exports to China than might occur under a floating exchange rate system. However, China's large purchases of U.S. Treasury securities (which have been a consequence of its currency policy) have helped the U.S. government fund its budget deficits, which help keep U.S. interest rates low.

The RMB's Exchange Rate

China has pegged the RMB to the dollar for several years. Each day China's central bank announces a central rate of exchange between the RMB and the dollar and buys and sells as much currency as needed to reach a target rate within a specific band. In 1998, the Chinese government's central target exchange rate with the dollar on average was 8.28 yuan (the base unit of the RMB) per dollar, and this rate was generally maintained consistently through June 2005. Due in part to pressure from its trading partners, including the United States, China announced in July 2005 that it would appreciate the RMB by 2.1%, peg its currency to a basket of currencies (not just the dollar), and allow the RMB currency to gradually appreciate (described by some as a managed peg), which it did over the next three years. In July 2008, China halted RMB appreciation because of the effects of the global economic crisis on China's exporters, and then resumed RMB appreciation in June 2010. From June 2005 through December 2014, the RMB appreciated by 34% on a nominal basis against the dollar, although the rate of appreciation has slowed in recent years. In 2014, the RMB depreciated by 0.2% against the dollar over 2013 levels. During the first four months of 2015, the exchange rate averaged 6.23 yuan per dollar. Some analysts speculate that the Chinese government has sought to slow, and sometimes reverse, the pace of RMB appreciation due to concerns over a slowing Chinese economy (and its impact on exporters) and to deter illegal capital inflows from outside speculators who expect that the RMB will continue to rise and hope to profit from it. The Chinese government appears to be concerned that such inflows could lead to volatile and unpredictable movements in the RMB's value.

Figure 1. Average Annual RMB-Dollar Exchange Rates: 2004-2014 (Yuan per Dollar)



Source: Global Insight.

Notes: Chart inverted for illustrative purposes.

A broader measurement of the RMB's movement involves looking at exchange rates with China's major trading partners by using a trade-weighted index (i.e., a basket of currencies) that is adjusted for inflation, often referred to as the "effective exchange rate" (EER). Such an index is useful because it reflects overall changes in a country's exchange rate with its major trading partners as a whole—not just the United States. According to the Bank of International Settlements (BIS), from July 2005 to April 2015, the RMB's EER rose by 43% against a basket of 61 trading economies; and from December 2013 to April 2015, it increased by 10%. China's relative peg to the dollar has meant that as the dollar has depreciated or appreciated against a number of major currencies, the RMB has depreciated or appreciated against them as well.

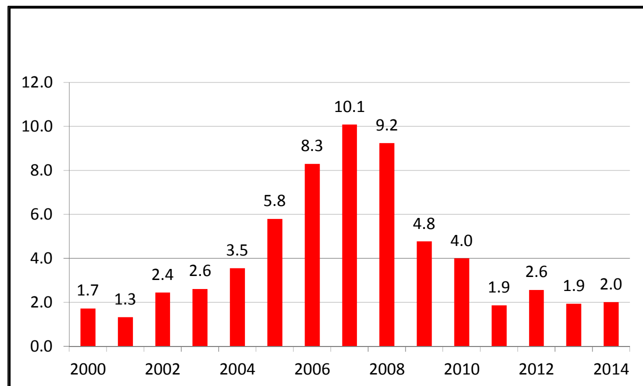
Factors Used by Some Analysts to Assess the RMB's Valuation

China's large trade surpluses and accumulation of foreign exchange reserves (FERs) have been cited by some analysts as indicators of China's currency intervention. China's current account (CA) surplus (which includes the balance of

trade in goods and services, plus net income and net transfers) as a percent of gross domestic product (GDP) rose from 1.7% in 2000 to a historic peak of 10.1% in 2007. It subsequently fell to 2.0% in 2014. The IMF projects that level may rise to 3.0% by 2020.

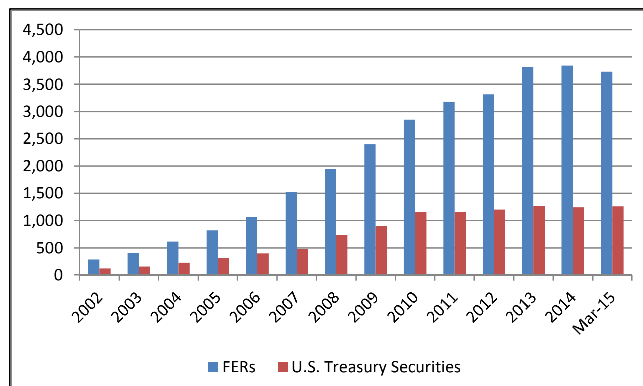
China's FERs rose from $166 billion in December 2000 to a peak of $3.99 trillion in July 2014. Critics note that China's FERs are very large relative to the size of the economy (in 2014, they were equal to 37.1% of GDP) and that these levels are well beyond the amount of FERs that might be needed as insurance against an economic crisis, leaving little economic rationale for the large holdings. From December 2004 to December 2013, China's FERs grew at an average annual rate of $342 billion. However, from July 2014 to March 2015, China's FERs declined by $262 billion (to $3.73 trillion). A significant amount of Chinese of FERs have been used to purchase U.S. Treasury securities. China's holdings rose from $118 billion in 2002 to $1.26 trillion as of March 2015. China is currently the largest foreign holder of U.S. Treasury securities.

Figure 2. China's Current Account Balance as a Percent of GDP: 2000 to 2014 (%)



Source: IMF, World Economic Outlook, April 2015.

Figure 3. China's Foreign Exchange Reserves and Holdings of U.S. Treasury Securities: 2002-March 2015 ($Billions)



Source: Chinese State Administration of Foreign Exchange and U.S. Department of the Treasury.

Some analysts argue that the decline of China's CA surplus and FERs may indicate the RMB is no longer as undervalued as it once was and that the level of Chinese currency intervention has diminished. On February 19, 2015, *Reuters* quoted U.S. Treasury Under Secretary for International Affairs, Nathan Sheets, as stating that, since July 2014, China has essentially refrained from foreign exchange purchases.

U.S. Engagement with China

U.S. officials have sought to engage China over its currency for the past several years. In April 2005 then-U.S. Treasury Secretary John Snow asserted at a G-7 meeting that China was "ready now to adopt a more flexible exchange rate." Currency issues were a main topic of the U.S.-China Strategic Economic Dialogue (SED), a framework that was established in 2006 under the Bush Administration to enable senior Chinese and U.S. officials to address long-term strategic and economic challenges. Such discussions continued under its successor framework, the U.S.-China Strategic and Economic Dialogue (S&ED). For example, during the July 2014 S&ED session, China pledged that it would continue moving to a market-determined exchange rate, increase exchange rate flexibility, reduce foreign exchange intervention (as conditions permit), and enhance the transparency of its foreign exchange holdings, and take steps to boost private consumption. China has also taken a number of steps to boost the internationalization of the RMB. According to Swift, a transactions company, 50 countries are now using the RMB for more than 10% of their payments value with China and Hong Kong.

Recent Assessments of the RMB's Value

There is little consensus among economists on how close the RMB's exchange rate may (or may not) be to its "market value," or the extent China currently may be intervening in currency markets to affect the RMB's exchange rate (since China does not publicize this information). To illustrate: in February 2014, Lombard Street Research (an economic forecasting firm) estimated that the RMB has been "overvalued since 2012." In May 2014, Martin Kessler and Arvind Subramanian with the Peterson Institute for International Economics (PIIE) estimated that the RMB in 2014 was "fairly valued." In July 2014, the International Monetary Fund (IMF) assessed the RMB to be "moderately undervalued" with a range of 5-10%. In April 2015, the U.S. Department of the Treasury said that the RMB remained "significantly undervalued."

Issues for Congress

The effects of the recent global economic crisis have refocused attention by many economists on the need to continue efforts to reduce global imbalances in savings, investment, and trade in order to help avoid future crises. As part of that goal, such economists have encouraged China to lessen its dependence on exports and fixed investment as the main drivers of its economic growth, while boosting the level of domestic consumer demand. The adoption of a market-determined exchange rate mechanism could be an important component to achieving this goal. It could help boost Chinese imports (including from the United States), increase competition in China, reduce distortions in the economy, and accelerate the pace of financial reforms.

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