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IN FOCUS

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China's Currency Policy

China's policy of intervening in currency markets to control the value of its currency, the renminbi (RMB), against the U.S. dollar and other currencies has been 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 China's "undervalued currency" has been a major contributor to the large annual U.S. merchandise trade deficits with China (which totaled $419 billion in 2018) and the decline in U.S. manufacturing jobs. Legislation aimed at addressing "undervalued" or "misaligned" currencies has been introduced in several congressional sessions. On May 23, 2019, the U.S. Department of Commerce published a notice in the *Federal Register* proposing to make an undervalued currency (as determined by the U.S. Department of Treasury) an actionable subsidy under U.S. countervailing duty proceedings.

Economic Effects of the RMB's Value

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 theoretically might also raise the price of U.S. exports to China. 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.

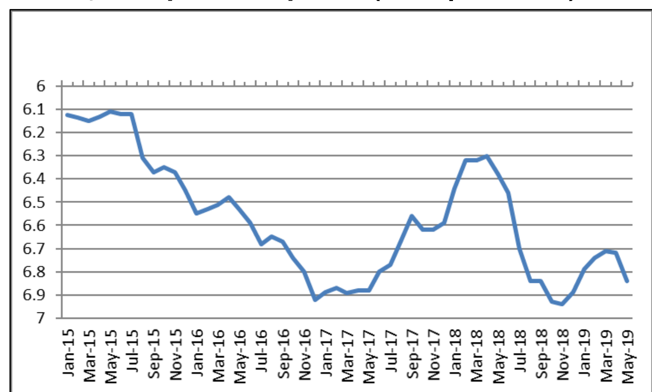
RMB-Dollar-Exchange Rate Trends

China has largely pegged the RMB to the dollar for several years. Each day, China's central bank announces a central parity rate of exchange between the RMB and the dollar (and other currencies), 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 generally remained consistent 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 June 2015, the RMB appreciated by 35.3% on a nominal basis against the dollar.

The yuan-dollar exchange rate has experienced volatility over the past few years. On August 11, 2015, the Chinese central bank announced that the daily RMB central parity rate would become more "market-oriented," However, over the next three days, the RMB depreciated by 4.4% against the dollar and it continued to decline against the dollar throughout the rest of 2015 and into 2016. From August 2015 to December 2016, the RMB fell by 8.8% against the dollar. From January to December 2017, the RMB rose by 4.6% against the dollar.

Since 2018, the RMB's value against the dollar has generally trended downward. Many economists contend that the RMB's recent decline has largely been caused by China's slowing economy and by the uncertainties resulting from the ongoing U.S.-China Section 301 trade dispute, which has led to three rounds of tariff hikes on a significant level of bilateral trade. From March 2018 (when the Trump Administration announced it would pursue punitive measures under Section 301 against China) to May 2019, the RMB depreciated by 8.2%. On May 10, 2019, the Trump Administration increased tariffs on the third tranche of Section 301 tariff hikes (affecting $200 billion worth of imports to China) from 10% to 25% and proposed to raise tariffs on nearly all remaining imports from China. These measures could negatively affect China's economy. Others charge that China has intervened in currency markets to push down the RMB's value in order to offset the impact of U.S. tariff hikes on the U.S. economy.

Figure 1. Average Monthly RMB-Dollar Reference Rates: January 2015-May 2019 (Yuan per Dollar)



Source: Bank of China.

Note: Chart inverted for illustrative purposes.

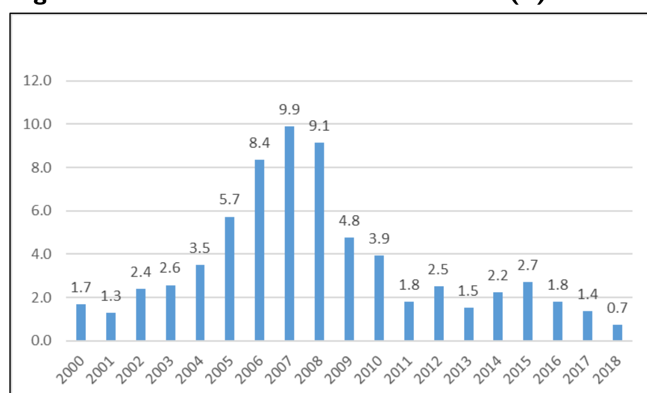
Factors Used by Some Analysts to Assess the RMB's "Valuation"

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 9.9% in 2007. It subsequently began to fall sharply over the next few years (due in part to the impact of the 2008 global economic slowdown and efforts by the government to rebalance the economy), reaching 0.7% in 2018. Economists contend that an important factor in ensuring that large CA surpluses relative to GDP do not reoccur is to reduce China's very high gross savings rate. That rate fell from 52% in 2008 to 45% in 2018, but remains high by international standards.

China's FERs rose from $166 billion in December 2000 to a peak of $3.99 trillion in June 2014, but subsequently declined to $3.09 billion as of April 2019. In 2018, China's FERs were equivalent to 23% of its GDP. Some of China's FERs gone toward the purchase of U.S. Treasury securities. China's holding of these securities rose from $118 billion in December 2002 to a peak of $1,317 billion in November 2013, but they declined to $1,121 billion as of March 2019 (a $196 billion decline from their peak).

Figure 2. China's CA as a Percent of GDP (%)



Source: International Monetary Fund.

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 "real effective exchange rate" (REER). 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, from November 2013 to November 2015, the RMB's REER rose by 11.9% against a basket of 61 currencies, even though, on a nominal basis, the RMB depreciated by 4.6% against the dollar. The RMB's relative peg to the dollar has often meant that as the U.S. dollar has appreciated in global markets, so has the RMB (even when the RMB has depreciated against the dollar). In December 2015, China announced that would establish a new currency index rate (based on 13 foreign currencies) to help re-orient markets away from the dollar by measuring the weighted change in the currency basket. From December 2015 to December 2017, the RMB's REER fell by 6.5%, indicating a broad depreciation of the RMB. From January to December 2018, the RMB's REER appreciated by 0.5% while the U.S. dollar's REER appreciated by 10.8%, indicating that the strength of the dollar globally (REER basis) has likely been the main cause the RMB's decline against the dollar on a nominal basis.

Assessments of the RMB's Value

Assessments of the RMB's market valuation against the dollar and other currencies differ. In July 2011, the International Monetary Fund (IMF) publicly stated that it believed that the RMB was "substantially below the level consistent with medium-term fundaments," with estimates ranging from 3% to 23%. However, in 2015 the IMF assessed the RMB to be "no longer undervalued," and each year from 2016-2018, it said that the RMB was "assessed as broadly in line with fundamentals." In February 2016, the Trade Facilitation and Enforcement Act of 2015 (P.L. 114-125) went into effect. It included several new provisions on monitoring and addressing foreign exchange rates and listed new enhanced factors for the Treasury Department to consider when determining if any country should be listed as a currency manipulator in its semi-annual report. Treasury established certain benchmarks to determine which countries would be subject to enhanced analysis (and subject to a monitoring list), including those having a bilateral trade surplus larger than $20 billion, having a current account surplus of more than three percent of GDP, and engaging in persistent one-sided intervention in foreign exchange markets resulting in net purchases equal to two percent or more of GDP over the past year. The law also established new remedies in regards to countries that do not adopt appropriate policies to correct the identified undervaluation and surpluses, prohibitions of financing by the Overseas Private Investment Corporation (OPIC) in that country, restrictions on U.S. government procurement; additional efforts by U.S. officials to urge IMF action, and taking into account such currency policies before initiating or entering into any bilateral or regional trade agreement negotiations. China met two out of the three criteria (large trade surplus and current account surplus at over three percent of GDP) for enhanced analysis in Treasury's April 2016 report. The report urged China to continue to rebalance the economy by boosting private consumption and said that "the RMB should continue to experience real appreciation over the medium-term."

Treasury's October 2016 report stated that China had met only one of the criteria (large trade surplus). Treasury's October 2018 report stated that China's currency interventionist policies from 1988 to 2007 promoted and sustained a "significant undervaluation" of the RMB, which imposed "significant and long-lasting hardship on American workers and companies." It stated that while the RMB on a REER basis had appreciated over the past decade, (reducing China's CA surplus), the RMB on a nominal basis had, over the past few months, depreciated against the dollar to levels last seen a decade ago. Treasury said that the bilateral imbalances were in part caused by China's distortive economic and trade policies, which limit foreign investment and imports. While Treasury expressed long-standing frustration with China over its failure to make its currency practices more transparent, it concluded that direct intervention by China's central bank was limited. Treasury said China would continue to be on its monitoring list of economies that merit close attention to their currency practices but did not designate it as a currency manipulator.

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