

# CRS Report for Congress

Received through the CRS Web

## China's Currency: Brief Overview of U.S. Options

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### Summary

Many are concerned that China's currency is undervalued and that this injures the U.S. economy. The Chinese authorities say they are not manipulating their currency and they want to move as soon as possible to a market-based yuan. A new exchange rate procedure was announced in July 2005 but has not resulted in meaningful changes in the yuan's international value. This report reviews the issues and discusses alternative approaches the United States might take to encourage more rapid reform.

### The Exchange Rate Issue

**The Controversy.** 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) is seriously undervalued.<sup>1</sup> Many charge that China is manipulating the value of its currency in order to gain unfair trade advantage. They believe this has seriously injured the manufacturing sector in the United States and contributed significantly to the U.S. trade deficit. Chinese officials say that they have not fixed the exchange rate of the yuan against 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.

The issue of manipulation is a serious one. The International Monetary Fund (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

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<sup>1</sup> For a comprehensive discussion of the China exchange rate issue, see CRS Report RS21625, *China's Currency Peg: A Summary of the Economic Issues*, by Wayne M. Morrison and Marc Labonte, and CRS Report RL32165, *China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy*, by Wayne Morrison and Marc Labonte. See also CRS Issue Brief IB91121, *China-U.S. Trade Issues*, by Wayne M. Morrison. The term "renminbi" means "people's currency" while "yuan" is the unit of account (one yuan, two yuan, etc.)

of payments adjustment or to gain an unfair competitive advantage over other members.”<sup>2</sup> All members of the IMF are required to comply with the requirements of its Articles of Agreement. Meanwhile, the U.S. Omnibus Trade and Competitiveness of 1988 requires (§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.”<sup>3</sup>

Some scholars say the yuan needs to rise by 40% or more in order to reflect its true value. Other scholars say, by contrast, that the yuan is at most only slightly overvalued. The IMF notes that eight recent econometric studies have produced a range of results showing that the yuan is either slightly overvalued or it is undervalued by perhaps as much as 49%.<sup>4</sup> Higgins and Humpage, two economists with the Federal Reserve Bank of Cleveland, say that determining an equilibrium exchange rate for a developing country, such as China, “is next to impossible.”<sup>5</sup> Data on the Chinese economy are incomplete, uncertain, or unreliable. The IMF says the variation in the results of the eight studies reflects their differing assumptions and the ways they seek to correct for problems in the available data. IMF experts say that, without a detailed analysis of methodology and assumptions, there is no way of knowing whether the results of any of these studies are more accurate than others. Participants in the debate about China’s currency seem to select the studies they quote more because they like their conclusions than because they have determined that their underlying methodology and assumptions are more correct.

**Between Rocks and Hard Places.** The exchange rate between the dollar and the yuan is not determined in a vacuum. Rather, it is a product of the relationship between the U.S. and Chinese economies. Issues larger than the correct valuation of the yuan govern the policy process in both countries. The U.S. savings rate is relatively low compared to that of other countries, such as China and other Asian countries, yet its need for capital and its opportunities for the productive use of capital are greater than those of other countries. The United States must borrow from abroad in order to finance its preferred levels of consumption and investment and its federal budget deficit. It is a core principle of economic analysis that a country which is a net importer of capital from abroad must also be a net importer of foreign goods.<sup>6</sup> Consequently, so long as the United States borrows from abroad or encourages foreign investment in its economy, it will continue to have a balance of trade deficit and an overvalued currency. If the yuan increased substantially in value, imports from China and the flow of loans from China would decline. However, unless the United States reduced correspondingly its level of

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<sup>2</sup> Articles of Agreement of the International Monetary Fund. 60 Stat. 1401, TAIS 1501.

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

<sup>4</sup> Steven Dunaway and Xiangming Li. *Estimating China’s “Equilibrium” Real Exchange Rate*. IMF Working Paper WP/05/202, October 2005. Available from the China page in the country section of the IMF website: [<http://www.imf.org>].

<sup>5</sup> Patrick Higgins and Owen Humpage. “The Chinese Renminbi: What’s Real, What’s Not.” August 1, 2005, at [<http://www.clevelandfed.org/Research/Com2005/0815.pdf>].

<sup>6</sup> For a further discussion of the causes of the U.S. trade deficit, see CRS Report RL31032, *The U.S. Trade Deficit: Causes, Consequences, and Cures*, by Craig Elwell.

international borrowing, other countries would eventually replace China as major sources of goods and services and borrowed funds.

China, for its part, also has priorities other than an accurate valuation of the yuan. Chinese officials believe they must pursue a policy of export-led growth. They believe their domestic economy is too inefficient and fragmented to generate the employment and the resources necessary for economic reform and for the conversion of their economy to a market-based system rather than one based on state-ownership and state control. They worry in particular that their weak domestic banking system would be unable to allocate capital effectively or to cope with any speculative pressure that might follow the introduction of a more flexible exchange rate system and more open capital markets.

China's central bank sells yuan in order to maintain the value of its currency. In the process, it has accumulated foreign exchange reserves that now total more than \$840 billion (including Hong Kong and Macau). If the bank did not sell yuan, the value of China's currency would rise and choke off exports. On the other hand, accumulating reserves in this manner puts great pressure on China's domestic monetary system. The bank has had to seriously restrict monetary growth and regulate capital inflows in order to prevent inflation from getting out of control. Tight money, in turn, hampers domestic growth and slows the process of economic reform. Chinese officials realize they will have to eventually liberalize the yuan and shift more to a policy of domestic-led growth, but they do not believe they are ready to do this. As long as China is willing to continue accumulating foreign exchange and to accept the domestic consequences, it can continue holding down the international value of the yuan for yet a considerable period of time.

IMF experts say China's current situation is not sustainable in the long run.<sup>7</sup> They counsel, however, that the rise in the value of the yuan should be gradual. Experience shows, they say, that emerging markets do not handle large, rapid exchange rate movements well. In China, they say, rapid change would likely disrupt or bankrupt major segments of the national economy — particularly the banking system — and make reform a long, drawn-out, and painful process.

Roubini and Setser argue, by contrast, that the current situation vis-a-vis the inter-relationship between the Chinese and U.S. economies is not sustainable.<sup>8</sup> Action must be taken promptly to address the core problems in both countries. They say that the United States cannot keep borrowing indefinitely at its current rate and that China cannot continue accumulating reserves or exporting at its current rate without doing serious damage to its economy. If policy makers take action both to reduce the level of U.S. borrowing and to diminish the Chinese levels of exports and reserve accumulation, an orderly and smooth adjustment to the current situation will result. On the other hand, they

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<sup>7</sup> Raghuram Rajan. *Remarks on Global Current Account Imbalances and Financial Sector — Reform with Examples from China*. Address to the Cato Institute, November 3, 2005. Rajan is director of the IMF's research department. Available from the China page on the IMF website, [<http://www.imf.org/external/np/speeches/2005/110305b.htm>].

<sup>8</sup> Nouriel Roubini and Brad Setser. "The Sustainability of US External Deficits and Chinese External Surpluses." November 22, 2005. PowerPoint Slides. Available from the RGEMonitor website at [<http://www.rgemonitor.com/redir.php?sid=1&tgid=10000&cid=108683>].

say, if no action is taken on both fronts, the situation will resolve itself in an abrupt, unpredictable, and disorderly manner, with serious consequences for both countries.

## The Recent Reform

**The New System Announced.** On July 21, 2005, China's central bank announced a new exchange rate system for China's currency. First, the value of the yuan moved from 8.3 to 8.11 to the dollar. Second, the yuan would be referenced, not just to the dollar but to a basket of currencies, and it would be allowed to vary by 0.3% each day above or below a central parity. Third, the central bank said that "the closing price of ... the US dollar traded against the RMB [yuan] ... after the closing ... of the market each working day" would become "the central parity for the ... following working day." This appeared to be an exchange system that economists call a 'crawling peg.'

**A Contradictory Announcement.** If the new procedure were allowed to function as announced, the yuan could increase in value by 30% in five months. On July 27, however, the central bank announced that no further changes in the value of the yuan were to be expected. Rather, the authorities said, China's new system would be a "managed float." The central bank would take into consideration the daily changes in the value of the yuan compared to the currencies in the basket. However, it would decide what the exchange value of the yuan should be and when and at what pace further liberalization might occur. The dollar-yuan exchange rate has changed little since then.

**Interpreting the Two Announcements.** The two conflicting announcements (July 21 and 27) can be interpreted at least three ways. First, some would say they show that the internal debate continues between those who want to liberalize the yuan and those who want to keep the value of China's currency below its likely real market value. If this is correct, outsiders need to be cautious about efforts to influence Chinese policy, as they could strengthen the hand of those resistant to change. Second, by contrast, others would say the new system was implemented for appearances only. China was scheduled to discuss its exchange rate policies with the IMF executive board on August 3, and the advent of a new system gave the Chinese something new to present. The IMF board was critical of China's exchange rate policies in 2004, and IMF staff had strongly urged China in 2005 to introduce market forces into China's exchange rate regime. An appearance of change might buy China an additional year to consider its options and lay its plans.

Third, some might say the double announcement was intended to confuse speculators. The old system allowed them a one-way no-risk bet. The likelihood that the yuan would fall in value was minimal, whereas the prospect that it would eventually rise in value offered major rewards to those who owned yuan or yuan-denominated assets. The July 21 announcement seemed to offer speculators an immediate prospect of such rewards. From this perspective, the July 27 announcement and the lack of any subsequent change in the yuan's value was intended to discourage speculation. It introduced the possibility that the authorities might let the value of the yuan decrease (causing losses) and it was vague as to future plans. China is in a difficult situation. It must eventually take the step the speculators expect (raise the value of the yuan), but it must not do anything that would encourage speculators to bring more money into the country.

**Waiting for the Next Shoe.** Since the two announcements in July, analysts have been waiting for the Chinese to announce new steps that would more clearly link the value

of the yuan to market forces. The G-8 urged this at its summit meeting in Scotland in July 2005. The IMF executive board urged this at its annual Article IV discussion of China's economic policies in August 2005. The governing boards of the IMF and World Bank urged this at their joint annual meetings in late September 2005. Japanese economic officials urged China publicly in September to make its exchange rate system more flexible. The U.S. Treasury Secretary urged China vigorously, during a visit in October 2005, to continue the liberalization process. President Bush reiterated this position during a state visit to China in November.

There has been little change since July in China's exchange rate policies. China has also given little indication as to when or under what conditions it will allow the yuan to appreciate in value. Many believe the Chinese authorities will hold off raising the value of the yuan until they believe the domestic economy is stronger. Others claim, though, that urgent action is needed. Setser says that China's emphasis on export-led growth makes it vulnerable to any slowdown in global demand and that more emphasis on domestic growth is needed.<sup>9</sup> As noted before, this would require that China loosen its monetary policy and stop accumulating foreign exchange.

## U.S. Actions

The Omnibus Trade and Competitiveness Act of 1988 (§3004) requires the Secretary of the Treasury to determine, in consultation with the International Monetary Fund, whether countries are manipulating their currency to gain unfair trade advantage. In May 2005, Treasury reported that China was not manipulating the value of its currency.<sup>10</sup> It said that Chinese authorities had assured Treasury Secretary Snow that they were laying the groundwork for a future revaluation of the yuan. He reportedly gave them six months to rectify the situation and he called for an immediate 10% revaluation. No such change took place. In November 2005, Treasury reported that China's actions "are not sufficient and do not represent fulfillment of the Chinese authorities' [earlier] commitment."<sup>11</sup> It said, however, that Chinese authorities had pledged in October 2005 "that they would enhance the flexibility and strengthen the role of market forces in their managed floating exchange rate regime." It also said that "President Hu told President Bush that China would unswervingly press ahead with reform in its exchange rate mechanism." The Chinese authorities should do this, the report concluded, "by the time this report is next issued" (i.e., in six months).

Congress is considering several bills that would put economic pressure on China if it does not revalue its currency; space does not permit an enumeration of them all.

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<sup>9</sup> Brad Setser. *The Chinese Conundrum: External Financial Strength, Domestic Financial Weakness*. October 31, 2005. Article is available online from the RGE monitor website at [<http://www.rgemonitor.com/redir.php?sid=1&tid=10000&cid=108028>].

<sup>10</sup> U.S. Department of the Treasury. *Report to Congress on International Economic and Exchange Rate Policies, May 2005*. Obtained from [<http://www.ustreas.gov>], the Treasury Department website. See especially pp. 11-14.

<sup>11</sup> U.S. Department of the Treasury. *Report to Congress on International Economic and Exchange Rate Policies, November 2005*. Available from [<http://www.ustreas.gov>], the Treasury Department website. See especially pp. 17-21.

Perhaps best known is a proposal by Senators Graham and Schumer to mandate a 27% special tariff on Chinese goods if the yuan is not increased in value.

## U.S. Options

There are several approaches the United States might use if it wished to encourage China to be quicker in its efforts to revalue the yuan. They are not mutually exclusive, but it might be difficult for the United States to pursue several of them simultaneously. In some instances, close cooperation with other countries would be needed for success.

**Continue Public Pressure.** Success on this front may depend on whether the Chinese are sincere in their protestations that they intend to adopt a market-based system to value the yuan. If China has taken its current position mainly in response to foreign pressure, then additional pressure might lead to further action. On the other hand, if the Chinese authorities are sincere in their statements and desire to proceed as rapidly as they believe appropriate, public pressure might stiffen resistance by the opponents of reform and make it harder for the reformers to achieve their ends.

**Exercise Restraint.** The reciprocal of the above is a policy of restraint. This assumes that the Chinese are sincere in their statements that they desire reform. It also presumes that overt pressure would be counterproductive.

**Restrict Exports.** A special tariff would raise the price of Chinese goods in U.S. markets. This might slow the inflow of Chinese goods or — depending on demand — might raise prices for U.S. consumers. There is no standard for judging how big an increase in the yuan is “enough.” In negotiations, China may not wish to be seen as giving in to foreign pressure. It might take the United States to the World Trade Organization for violating trade rules. If successful, it could levy compensatory duties on its U.S. imports.

**Go to the IMF.** Instead of treating this as a bilateral issue, the U.S. could ask the IMF executive board to press China for reform. So far, other countries have urged but not insisted. If China continues to delay, though, a basis might be laid for stronger action. The IMF has no way to force China to revalue its currency. However, strong public statements in the future might erode international confidence, influence private sector activity, and lay the groundwork for unilateral or joint efforts by countries to pressure China in various ways. The IMF staff was strong, in its 2005 staff report, in suggesting that China needed an exchange rate regime that was more open to market forces.

**Go to the WTO.** The United States could also file a complaint with the World Trade Organization alleging that China is obtaining an unfair trade advantage for its exports by keeping the value of its currency artificially low. From an economic perspective, China is using its restrictive domestic policies as a way of subsidizing its exports through an undervaluation of its currency. The WTO has no authority to address exchange rate issues. However, the IMF and WTO have an agreement that requires the latter to refer exchange rate disputes to the IMF and to accept the IMF’s findings as conclusive. By this means, an IMF finding of manipulation would have “teeth.” In this scenario, the WTO could authorize the United States (and others) to levy compensatory tariffs on Chinese goods if China did not move to increase the value of its currency.