# Issue Brief

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The China Currency Dispute

The U.S. trade deficit with China stood at approximately $213,548,600,000 at the end of 2006. China's international reserves accumulation was estimated to be more than $1,066,000,000,000 as of January 1, 2007. What do these numbers say about China's currency and its exchange rate against the U.S. Dollar?

## Background

While the *renminbi* (RMB) is no longer pegged to the U.S. Dollar, the Chinese government operates what it calls "a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies." The RMB is still controlled in that it may only fluctuate up to 0.3 percent on either side of the "central parity rate," set each day. The Chinese government has intervened from time to time in the currency market to manage the RMB's exchange rate by exchanging RMB for foreign currency and accumulating foreign exchange reserves. Since it went off the peg to the U.S. Dollar in July 2005, the RMB has appreciated 6.5% relative to the U.S. Dollar.

## Controversy

*Critics' View*

Critics of China's currency regime point to three factors as evidence that the Chinese government is manipulating its currency: (i) its high, and rising bilateral trade surplus with the United States; (ii) its high, and rising global current account surplus; and (iii) its high, and rising international reserves accumulation.

These critics contend that the RMB is undervalued, relative to the U.S. Dollar by between 15 and 40 percent, or an average of 27.5 percent. Undervaluation operates as a subsidy by the Chinese government to Chinese companies by making Chinese products less expensive in U.S. and foreign markets. As a result, the United States trade deficit with China has widened and tens of thousands of U.S. jobs, primarily in the manufacturing sector, have disappeared. Groups have called on the U.S. government to force China to adopt a more flexible exchange rate policy—even a freely-floating exchange rate policy—and to penalize China for past and current currency manipulation.

*Chinese Government View*

The Chinese government has denied that it is manipulating the RMB, and has stated that the exchange rate will become more flexible in a gradual process. They maintain that there will be no surprise adjustments to the exchange rate to satisfy pressure from outside China. Over the past few years, the Chinese government has implemented steps that are preconditions for greater exchange rate flexibility: (i) liberalizing the capital account; (ii) reforming the financial sector; and (iii) developing new financial products.

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*U.S. Government Reaction*

The U.S. Government has acted only indirectly to encourage the Chinese government to adopt a more flexible exchange rate regime. For example, in December 2006, the U.S. and Chinese governments held the first Strategic Economic Dialogue, a goal of which is increasing China's exchange rate flexibility. The U.S. Treasury Secretary and other U.S. government officials have raised this issue with their Chinese counterparts in private discussions. The Office of the U.S. Trade Representative has not taken action against China's currency manipulation, and the U.S. Treasury Department does not list China as a currency manipulator.

Pressure for direct action has been growing since the 2006 mid-term Congressional elections. The Democratic majority has made trade issues, including China's currency manipulation, a primary concern. Congressional hearings on this subject are expected to begin in March. As of the date of this update, at least three bills, H.R. 1002, the *Currency Harmonization Initiative Through Neutralizing Action Act* (H.R. 321), *Fair Currency Act of 2007* (H.R. 782) address China's currency manipulation, and at least one bill, S. 571 would withdraw permanent normalized trade relations from China. The former set of bills would brand China's currency manipulation as an unfair subsidy, place a tariff of at least 27.5 percent on Chinese imports, require the U.S. to initiate action against China through the World Trade Organization and other actions.

## Outlook

The issue of China's currency regime is reaching a tipping point in the United States, and some form of action appears likely in the near future. Any action, however, is likely to be met with significant resistance from the Chinese government, and weigh on bilateral relations in the near future.

Moving to a more flexible—or even freely floating—exchange rate would benefit China. A more flexible exchange rate would assist the Chinese government's own goal of rebalancing growth towards domestic consumption and improving investment efficiency. Greater exchange rate flexibility would help reform China's financial sector stabilize prices. A more flexible exchange rate also will help China's economy by reducing its current account surplus and foreign reserve accumulation.

There are risks, however in moving China to a more flexible exchange rate regime. For example, many of the nations affected by 1997's Asian Financial Crisis had recently liberalized their exchange rates, and China's financial system contains many of the same weaknesses present in the financial systems affected by the Asian Financial Crisis. Also, a more flexible exchange rate regime may cause the Chinese government to purchase fewer U.S. government bonds, and possibly cause an increase in U.S. interest rates.

This is an issue that calls for bilateral engagement. A sound strategy for such engagement would be increasing the flexibility of China's exchange rate regime as quickly as practicable, but in a manner that reflects the fact that China's financial system is too weak to resist the increased pressures presented by a liberalized exchange rate regime. China should comply with to the trading rules to which it has agreed, but in a manner that does not unnecessarily destabilize it or the global economy.

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More Reading

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Warwick J. McKibbin, Chinese Currency Revaluation?, The Brookings Institution, http://www.brookings.edu/views/articles/mckibbin/20050610.pdf.

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