

May 9, 2005

Dear Member of Congress:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit to you the enclosed briefing paper, *The China Exchange Rate Problem: Facts and Policy Options*. The paper explains the nature of the problem and explores a set of policy options for addressing it.

(1) Exchange rates matter because they affect exports and imports, and in turn impact jobs in export- and import-competing industries. Exchange rates also impact profitability, which affects the level of investment spending, the growth of manufacturing, and the overall economy.

(2) In addition, exchange rates affect decisions about the location of investments. An undervalued yuan encourages business to shift existing production to China and also locate new production facilities there.

(3) The consensus among economists is that China's currency is undervalued against the dollar. The \$162 billion trade deficit with China represents 25 percent of the nation's goods trade deficit, and the deficit with China grew 29 percent in 2004. Given China's large trade surplus with the United States and robust inflows of foreign direct investment, there has been strong market and political pressure for China to revalue upward. Chinese authorities have resisted this pressure by persistently intervening in currency markets to prevent appreciation of the Chinese yuan. The result has been a massive increase in Chinese foreign exchange holdings. (Other countries also run trade surpluses with the United States, but for the most part they have allowed their currencies to appreciate in order to facilitate the re-balancing process. China has not.)

(4) The U.S. Treasury Department has pursued a policy of quiet diplomacy aimed at encouraging China to adopt a flexible exchange rate with free capital movements. Not only has this policy failed to yield results; it is also the wrong policy. Given the weakness in China's domestic banking system, if China were to open up its economy in the way Treasury recommends, there would likely be a collapse of the exchange rate owing to domestic Chinese capital flight. This would generate the opposite of the desired result.

(5) There is a sufficient case for pursuing action against China in both the WTO and the IMF. China's exchange rate policy frustrates the intent of the WTO and can be viewed legitimately as providing an illegal subsidy to exports and imposing an illegal tariff on imports. Its persistent one-sided intervention in foreign exchange markets contravenes the rules governing membership in the IMF.

(6) One outcome that would effectively address this problem would be for China to revalue its currency substantially upward. Absent this, a legislated tariff on Chinese imports is another potential course of action. Such a tariff will pressure China to change its exchange rate, and there is a good chance that China would do so before the tariff took effect.

(8) In addition to pressuring China, the Congress can pass legislation that pressures the Treasury Department to take stronger action against currency manipulation. In particular, the 1988 Trade Act could be amended to include an explicit definition of currency manipulation. Additionally, Congress could eliminate the provision that requires currency-manipulating countries to run a material global trade surplus in addition to a bilateral surplus before the Treasury Secretary initiates corrective action.

We hope this briefing paper will assist the Congress in addressing this vital U.S.-China economic issue. As always, we stand ready to present the Commission's research and analysis to any interested Members or staff on this and other subjects contained in the Commission's mandate.

Sincerely,



C. Richard D'Amato
Chairman



Roger W. Robinson, Jr.
Vice Chairman

Enclosure



THE CHINA CURRENCY EXCHANGE RATE PROBLEM: FACTS AND POLICY OPTIONS

Prepared by the

U.S.-China Economic and Security Review Commission

May 9, 2005

1) Why exchange rates matter

- **Exchange rates affect exports and imports.** An undervalued yuan makes U.S. exports to China more expensive, reducing jobs in industries that export. It also makes imports from China cheaper to U.S. consumers, displacing employment in import-competing industries. Undervaluation of the yuan, estimated at between 15 and 40 percent, is tantamount to a subsidy for imports from China and a large tax on U.S. exports to China.
- An undervalued yuan makes offshore production in China more attractive by lowering foreign costs measured in dollars. This encourages U.S. firms to shift production offshore and to locate new investments in China.
- An undervalued yuan undermines the profitability of U.S. export- and import-competing industries. This reduces investment in these industries, which costs jobs and hinders growth of the U.S. manufacturing sector.
- On the positive side, an undervalued yuan makes Chinese imports cheaper, which is good for consumers. It also benefits firms using imported inputs from China. Many of these firms are retailers and distributors.

2) Evidence that China's currency is undervalued

- The U.S. ran a \$651.5 billion goods trade deficit in 2004. Reducing the deficit will require an appreciation of the yuan and other currencies that makes U.S. exports cheaper (more price competitive) and foreign imports more expensive.
- **The deficit with China represents almost 25 percent of the goods trade deficit.** It is the largest deficit with any single country and exceeds both the North American and Western European regional deficits. It is also the fastest-growing component of the deficit except for the OPEC deficit -- which is driven by high oil prices and consumption (see Table 1).

Table 1. Regional Composition of the Goods Trade Deficit

	2004 Goods Trade Balance (\$ billions)	Percent share	2003 Goods Trade Balance (\$ billions)	Percent share	Percent Change 2003-4
Total (census basis)	- \$651.5	100.0%	- \$532.4	100.0%	22.4%
North America	- 110.8	17.0	- 92.3	17.3	20.0
Canada	- 65.8	10.1	- 51.7	9.7	27.3
Mexico	- 45.1	6.9	- 40.6	7.6	11.1
Western Europe	-114.1	17.5	-100.3	18.8	13.8
Euro area	- 82.9	12.7	- 74.1	13.9	11.9
Pacific Rim	-282.5	43.4	-230.5	43.3	22.6
Japan	- 75.2	11.5	- 66.0	12.4	13.9
China	-162.0	24.9	-124.1	23.3	30.5
OPEC	- 71.9	11.0	- 51.1	9.6	40.7
Rest of the World	- 72.2	11.1	- 58.2	10.9	24.1

Source: United States Department of Commerce and Commission calculations.

- **Measured by the import/export ratio (see Table 2), the goods trade deficit with China is the most lopsided of the deficits with all major manufacturing trading partners.**

Table 2. U.S. Import/Export Ratios

Country	2001	2002	2003	2004
China	5.32	5.66	5.36	5.67
Canada	1.33	1.30	1.32	1.35
Mexico	1.29	1.38	1.42	1.41
EU-15	1.38	1.57	1.63	1.62
Japan	2.20	2.20	2.27	2.38

Source: Commerce Department and Commission calculations.

- **Foreign exchange markets are sending clear signals that China should revalue.** There has been constant upward pressure on the yuan for several years that has been reflected in the Chinese government's interventions (to sell yuan and acquire dollar securities to prevent appreciation). Other East Asian governments have also intervened to prevent their currencies from appreciating. (See Table 3 on next page.)

Table 3. Annual Official Chinese, Japanese, Taiwanese, and South Korean Foreign Exchange Purchases (\$ billions)

Year	China	Japan	Taiwan	S. Korea
2000-01	\$46.6 billion	\$40.5 billion	\$15.5 billion	\$6.6 billion
2001-02	74.2	63.7	39.4	18.3
2002-03	116.8	201.3	45.0	33.7
2003 – Nov 04	170.6	166.3		37.2

Source: IMF Financial Statistics and Commission calculations.

- As a result of this foreign exchange market intervention, China's official foreign exchange reserves have risen from \$154.7 billion in 1999 to \$573.9 billion in November 2004 – a 271 percent increase over that six-year period (see Table 4).

Table 4. China's Official Foreign Exchange Holdings

	1999	2000	2001	2002	2003	2004*
China's FX Reserves (\$ billions)	154.7	165.6	212.2	286.4	403.3	573.9

Source: IMF Financial Statistics. * Data to November 2004.

- China claims that it is running only a small global trade surplus, and that this surplus is evidence that the yuan is not undervalued. However, China's data are unreliable. China consistently has underreported its surplus with the United States. An exercise carried out by the Fair Currency Alliance showed that China also underreports its surplus compared to the numbers reported by its top 43 trading partners.
- Data for the first two months of 2005 show that the deficit with China continues to grow far faster than the overall goods trade deficit. For January and February 2005 the overall goods deficit was \$127.2 billion versus \$99.6 billion in 2004, a 27.7 percent increase. For the same period, the China deficit was \$29.1 billion versus \$19.8 billion in 2004, a 47 percent increase.

Table 5. Alternative Measures of China's Trade Surplus

	1999	2000	2001	2002	2003
China's trade surplus with the U.S.:					
- Chinese data (\$ billions)	23.5	30.9	29.4	44.1	60.3
- U.S. data (\$ billions)	68.9	84.2	84.1	104.2	124.9
China's global trade surplus:					
- Chinese data (\$ billions)	37.7	35.4	35.3	45.1	
- 43 partner data (\$ billions)	140.4	171.6	170.3	189.9	

Source: Fair Currency Alliance.

3) What has been happening to exchange rates?

An appreciation of the Chinese yuan against the U.S. dollar would help address the U.S. current account trade deficit. Thus far, all major currencies have adjusted upward with the exception of China, which accounts for almost 25 percent of the U.S. goods trade deficit. (See Table 6.)

Table 6. Changes in Major Currency Exchange Rates

	January 2, 2002	January 19, 2005	% Change
Euro	1.11	0.76	31.5%
Japanese yen	132.02	102.52	22.3%
Canadian dollar	1.60	1.23	25.0%
Chinese yuan	8.28	8.28	0.0%

Source: Board of Governors of the Federal Reserve and Commission calculations.

China's failure to adjust its exchange rate is cause for concern:

- **China is the largest contributor to the U.S. current account trade deficit, and therefore adjustment of its currency must be part of the solution.**
- China's failure to adjust is undermining the process of reducing the U.S. current account deficit. This is because it encourages production to move to China from countries whose currencies have appreciated. Consequently, total U.S. imports do not fall as much.
- With the yuan pegged to the dollar, as the dollar weakens against the euro and the yen, China's currency also falls against these currencies. This threatens to cause weakness in the European and Japanese economies, which in turn could pose problems for the global economy.
- China's failure to adjust is causing a "logjam" effect as other East Asian countries (e.g., Taiwan, Korea) refuse to revalue for fear of losing competitiveness vis-à-vis China.

4) The need for policy action

- Some counsel that there is no need for action because the market will eventually correct the undervaluation of the yuan and the trade deficit with China.
- The case against such policy inaction rests on two arguments:
 - First, undervaluation of the yuan causes short- and long-term economic damage to the United States. In many cases, when jobs and manufacturing capacity shift to China, they do not return even if the undervaluation of the yuan is corrected at a later date.
 - Second, the large trade deficit risks the possibility of a sudden loss of confidence in the dollar and United States financial assets. This could cause asset prices to fall and interest rates to rise. Should this happen, there could be major adverse domestic economic fallout that will impose heavy costs on the United States.

5) Official U.S. policy toward China's exchange rate

The U.S. Treasury Department

- The U.S. Treasury Department has been engaged in quiet diplomacy seeking to persuade the Chinese to move to a system of flexible exchange rates and free capital movement.
- The Chinese authorities have made favorable statements about adopting more flexibility in the long run, but there have been no changes yet.
- In its last report (2004), the U.S.-China Commission disagreed with Treasury's support for flexible exchange rates and free capital movement. The Commission believes that this is a recipe for financial turmoil and could even result in a depreciation of the yuan. This is because China's financial system is very weak, and allowing free capital movement (i.e., giving Chinese residents an external option for savings) could result in a huge exodus of domestic capital for both political and economic reasons. Instead, the Commission recommends that in the short term China should substantially revalue its currency peg upward and retain capital controls. As part of the revaluation, China could choose a new peg that uses a basket of currencies rather than just the dollar. China should also work to improve its domestic financial system, thereby paving the way for exchange rate flexibility and capital market openness at some future date.
- Under the 1988 Omnibus Trade and Competitiveness Act, the Secretary of the Treasury is required to "...analyze on an annual basis the exchange rate policies of foreign countries, in consultation with the International Monetary Fund, and consider whether countries manipulate the rate of exchange between their currency and the United States dollar for purposes of preventing effective balance of payments adjustments or gaining competitive advantage in international trade." The Secretary of the Treasury is required to undertake negotiations with those manipulating countries that have material global current account surpluses and significant bilateral trade surpluses with the United States, unless such negotiations would have a serious detrimental impact on vital national economic and security interests.
- In its most recent report on currency manipulation (December 3, 2004) Treasury found "... that no major trading partner of the United States met the technical requirements for designation" under the 1988 Act in the first half of 2004. Treasury notes that many countries do use pegged exchange rates and do intervene, but says that such practices do not necessarily satisfy the statutory test. Treasury also notes that it consulted with the IMF, which agreed with Treasury's conclusions.

U. S. Trade Representative (USTR) / Executive Office of the President

- USTR policy on China's exchange rate matches that of the Treasury Department. USTR believes that China's fixed exchange rate, and the way it is managed, is WTO legal. "There's really no WTO obligation not to have a fixed exchange rate. (Robert Zoellick, February 26, 2004)."
- However, the real issue is not the fixed exchange rate, but rather China's intervention in the currency market to maintain an undervalued yuan.
- In September 2004, USTR summarily rejected a Section 301 petition by the Fair Currency Alliance for protection against the injury caused by China's undervalued exchange rate.

The International Monetary Fund (IMF)

- The Treasury Department reports that the IMF concurs with its views on Chinese currency manipulation.
- In its Staff Report for the 2004 Article IV consultation with China, the IMF recommends that China adopt greater exchange rate flexibility which "...would enhance China's ability to pursue an independent monetary policy, as well as adjust to economic shocks and major structural changes." These views are the same as those of Treasury.

6) What can be done about China's currency manipulation?

- There are two international forums for addressing China's currency manipulation – the IMF and the World Trade Organization.

The IMF approach

- IMF Article IV, Section 1(iii), states that members should "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." Section 1(iv) then instructs members to "follow exchange policies compatible with the undertakings of this section."

The full IMF “*Principles for Guidance of Members’ Exchange Rate Policies*” are as follows:¹

“A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or gain unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.”

China can be faulted for violating principles A and C, while market conditions have not warranted intervention under principle B.

- The full IMF “*Principles for Fund Surveillance over Exchange Rate Policies*” are as follows:²

“1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

- (i) protracted large-scale intervention in one direction in the exchange market;
- (ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;
- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

¹ *Selected Decisions and Selected Documents of the International Monetary Fund*, twenty-third issue, Washington DC, June 1998, p.11-12.

² *Ibid.* p.12

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) 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; and

(vi) unsustainable flows of private capital.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.”

- **China’s policy appears to violate a number of IMF principles, including “(i) protracted large-scale intervention in one direction in the exchange market,” “(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions,” and “(vi) unsustainable flows of private capital.”**
- **This suggests that one avenue of dealing with China is to lodge a complaint with the IMF regarding China’s policy.**
- **However, the IMF is clearly strongly influenced by the U.S. government’s position. Hence, it is willing to concur with the Treasury’s finding of no manipulation by China despite the fact of China’s protracted one-way intervention in the exchange market.**

The World Trade Organization (WTO) approach

- **There are also strong grounds for believing that China's exchange rate policy is inconsistent with its WTO obligations.** There are two approaches to arguing this inconsistency.
- The first approach pertains to GATT Article XV which deals with "exchange rate arrangements." GATT members are required not to take exchange rate actions that "frustrate the intent of the agreement." That intent is defined as "entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade." This makes exchange rate manipulation to gain unfair competitive advantage WTO-illegal. This GATT Article XV approach clearly involves the IMF which likely would be asked by any WTO dispute settlement panel about its views on China's currency practices. To date, by endorsing the U.S. Treasury's report, the IMF has implicitly ruled in favor of China.
- A second approach pertains to GATT Articles VI and XVI which prohibit export subsidies (Article XVI) and hold that some "currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties (Article VI)." This is the approach that was taken by the China Currency Coalition in its 301 Petition filing. However, the WTO may look to the IMF's assessment of China's currency practices in this case as well, and to date it has sided with China.
- In summary, there are two grounds for bringing a WTO case on currency manipulation. The IMF's assessment of China's currency practices will be an important element of either argument, particularly an Article XV case, and the U.S. therefore needs to pursue its concerns in both fora.

A legislated tariff approach

- An undervalued exchange rate implicitly provides China with an export subsidy while imposing a tariff on U.S. exports to China. One possible action to compel China to revalue its currency is to impose an across-the-board tariff on Chinese imports into the United States. Such action could be defended under U.S. WTO obligations if taken under the Article XXI national security clause.
- **The best outcome would be for China voluntarily to revalue its currency** and, thereafter, peg it to a trade-weighted basket of currencies that includes the dollar, the euro, and the yen. However, if China were not to take such action in response, a tariff on Chinese imports may constitute a second-best outcome. Such a tariff has both benefits and costs.

- **The principal purpose of a legislated tariff on imports would be to pressure China to change its exchange rate.** There are precedents suggesting that pressure tactics work. In the 1980s the threat of Congressional action restricting auto imports persuaded Japanese companies to reduce imports and shift production to the United States. A more recent example is China's agreement to repeal its discriminatory application of a Value-Added Tax (VAT) on semi-conductors, after a WTO action had been initiated.
- **A tariff will have somewhat different effects from an exchange rate revaluation, but the net effects still are likely to be positive.**

(1) A tariff will sharply raise the price of imports, imposing pressure on China to change its policy and revalue. The rise in import prices will be larger than if China revalued. This is because revaluation would make imported inputs (of which China is a heavy user) cheaper, thereby helping to keep costs down. With a punitive tariff, Chinese sales prices would rise but Chinese companies would receive no relief on the cost of imported inputs. This will place stiff pressure on China to change its policy or face an export collapse.

(2) Unlike a currency revaluation, a tariff will not help U.S. exporters as their prices in China will be unchanged.

Benefits

- The primary objectives – and principal benefits – of increasing the exchange rate for the yuan are to increase exports of U.S. products, reduce the trade imbalance between the U.S. and China, promote job growth in the U.S., and secure a higher U.S. standard of living. Consequently, these are the ultimate objectives and benefits of imposing a tariff designed to persuade China to change its exchange rate.
- A major benefit of imposing a tariff is that dealing so firmly with China will send a signal to other East Asian countries (such as Japan, South Korea, and Taiwan) that undervalue their currencies by manipulation that such practices are no longer acceptable. In this fashion, the U.S. may be able to engineer a revaluation of currencies across the entire East Asia region, which is a policy goal.
- A further benefit of the tariff approach is that it paradoxically could head off moves to protectionism by solving the core currency problem. Right now, support for trade is ebbing in part because of China's mercantilist trade policies.
- Finally, there is a good chance that the mere passage of import tariff legislation by Congress will bring China to the table quickly, resulting in a speedy and

satisfactory resolution of the problem. China cannot afford a trade war with the United States.

Costs

- On the cost side, the sharp rise in Chinese import prices will raise U.S. consumer prices and thereby adversely affect inflation.
- A second cost is that China might retaliate. However, if China wishes to do so while abiding by WTO rules, it would have to file a case in the WTO. This means that the currency issue would be brought before the WTO for consideration, which would be desirable.

Other legislative action

- In addition to taking action aimed directly at China, Congress also can take action designed to compel the Administration to be more aggressive in its dealings on the currency question with China.

In particular, legislation can improve the process by which the Treasury assesses and reports upon the issue of currency manipulation. Under current law the Treasury reports only whether it does or does not find there is currency manipulation, and it has no obligation to justify the findings.

- Redefine currency manipulation: The 1988 Omnibus Trade Act could be amended to include an explicit definition of currency manipulation. This definition could be the same as the IMF's: "protracted large-scale intervention in one direction in the exchange market."
- Remove a material global trade surplus as a requirement for Treasury action: The 1988 Omnibus Trade Act could be amended so that in the event a country is found to be manipulating its exchange rate, it is no longer required that the country be running a material global trade surplus in addition to a significant bilateral surplus for the Secretary of the Treasury to take action.
- Determine reasons for trade data discrepancies: The Treasury Department could be instructed to examine and report to the Congress concerning China's trade surpluses with its trading partners, and specifically investigate why China's reported trade surpluses with the U.S. and other countries differ from the surpluses reported by the trading partners. Quantifying these differences would give policymakers a clearer picture of China's trade balance.