



# China's Currency: A Summary of the Economic Issues

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## Summary

Some Members of Congress charge that China's policy of accumulating foreign reserves (especially U.S. dollars) to influence the value of its currency constitutes a form of currency manipulation intended to make its exports cheaper and imports into China more expensive than they would be under free market conditions. They further contend that this policy has caused a surge in the U.S. trade deficit with China in recent years and has been a major factor in the loss of U.S. manufacturing jobs. Although China made modest reforms to its currency policy in 2005, resulting in a gradual appreciation of its currency (about 19% through December 1, 2009), some Members contend the reforms have not gone far enough and have warned of potential punitive legislative action. Although an undervalued Chinese currency has likely hurt some sectors of the U.S. economy, it has benefited others. For example, U.S. consumers have gained from the supply of low-cost Chinese goods (which helps to control inflation), as have U.S. firms using Chinese-made parts and materials (which helps such firms become more globally competitive). In addition, China has used its abundant foreign exchange reserves to buy U.S. securities, including U.S. Treasury securities, which are used to help fund the Federal budget deficit. Such purchases help keep U.S. interest rates relatively low. For China, an undervalued currency has boosted exports and attracted foreign investment, but has led to unbalanced economic growth and suppressed Chinese living standards.

The current global economic crisis has further complicated the currency issue for both China and the United States. China halted its gradual appreciation of its currency beginning around July 2008; since then it has kept the exchange rate of the renminbi (RMB) or yuan (the base unit of the RMB) to the dollar constant at about 6.83 yuan per dollar. Because China's currency is largely tied to the dollar, and since the dollar has depreciated against a number of major currencies in recent months, China's real (inflation adjusted) trade-weighted exchange rate has depreciated (by 9.5% between February 2009 to October 2009). Some analysts contend that this has induced other countries (especially in Asia) to intervene in currency markets (i.e., to depreciate against the dollar) to help their exporters remain competitive with Chinese exporters. Additionally, the U.S. federal budget deficit has increased rapidly since FY2008, causing a sharp increase in the amount of Treasury securities that must be sold. While the Obama Administration has pushed China to appreciate its currency, it has also encouraged China to continue to purchase U.S. securities. Legislation has been introduced in the 111<sup>th</sup> Congress to address China's currency policy.

China's currency policy appears to have created a policy dilemma for the Chinese government. A strong and stable U.S. economy is in China's national interest since the United States is China's largest export market. Thus, some analysts contend that China will feel compelled to keep funding the growing U.S. debt. However, Chinese officials have expressed concern that the growing U.S. debt will eventually spark inflation in the United States and a further depreciation of the dollar, which would negatively impact the value of China's holdings of U.S. securities. But if China stopped buying U.S. debt or tried to sell off a large portion of those holdings, it could also cause the dollar to depreciate and thus reduce the value of its remaining holdings, and such a move could further destabilize the U.S. economy. Chinese concerns over its large dollar holdings appear to have been reflected in a paper issued by the governor of the People's Bank of China, Zhou Xiaochuan, in March 2009, which called for replacing the U.S. dollar as the international reserve currency with a new global system controlled by the International Monetary Fund. China has also signed currency swap agreements with six of its trading partners, which would allow those partners to settle accounts with China using RMB rather than dollars. However, China will not likely be able to move away from its dependency on U.S. dollar assets until it is willing to make the RMB a tradable currency.

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## Introduction

From 1994 until July 2005, China maintained a policy of pegging its currency, the renminbi (RMB) or yuan, to the U.S. dollar at an exchange rate of roughly 8.28 yuan to the dollar.<sup>1</sup> The Chinese central bank maintained this peg by buying (or selling) as many dollar-denominated assets in exchange for newly printed yuan as needed to eliminate excess demand (supply) for the yuan. As a result, the exchange rate between the yuan and the dollar basically stayed the same, despite changing economic factors which could have otherwise caused the yuan to either appreciate or depreciate relative to the dollar. Under a floating exchange rate system, the relative demand for the two countries' goods and assets would determine the exchange rate of the yuan to the dollar. Many economists contend that for the first several years of the peg, the fixed value was likely close to the market value. But in the past few years, economic conditions have changed such that the yuan would likely have appreciated if it had been floating. The sharp increase in China's foreign exchange reserves (which grew from \$403 billion in 2003 to \$2.27 trillion as of September 2009) and China's large trade surplus with the world (\$297 billion in 2008) are often viewed by critics of China's currency policy as proof that the yuan is significantly undervalued.

## China Reforms the Peg

The Chinese government modified its currency policy on July 21, 2005. It announced that the yuan's exchange rate would become "adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket" (it was later announced that the composition of the basket would include the dollar, the yen, the euro, and a few other currencies) and that the exchange rate of the U.S. dollar against the RMB was adjusted from 8.28 to 8.11, an appreciation of 2.1%. Unlike a true floating exchange rate, the RMB would be allowed to fluctuate by up to 0.3% (later changed to 0.5%) on a daily basis against the basket.

After July 2005, China allowed the RMB to appreciate steadily, but very slowly. It has continued to accumulate foreign reserves at a rapid pace, which suggests that if the RMB were allowed to freely float it would appreciate much more rapidly. The current situation might be best described as a "managed float"—market forces are determining the general direction of the RMB's movement, but the government is retarding its rate of appreciation through market intervention. From July 21, 2005 to July 21, 2009, the dollar-RMB exchange rate went from 8.11 to 6.83, an appreciation of 18.7%. The effects of the RMB's appreciation on U.S.-China trade flows are unclear. The price index for U.S. imports from China in 2008, rose by 3.0% (compared to a 0.9% rise in import prices for total U.S. imports of non-petroleum products).<sup>2</sup> In 2008, U.S. imports from China rose by 5.1% over the previous year, compared to import growth of 11.7% in 2007; however, U.S. exports over this period were up 9.5% compared with an 18.1% rise in 2007. The current global economic slowdown has led to a sharp reduction in bilateral trade. During the first nine months of 2009, U.S. exports to, and imports from, China were down by 14% and 15%, respectively.

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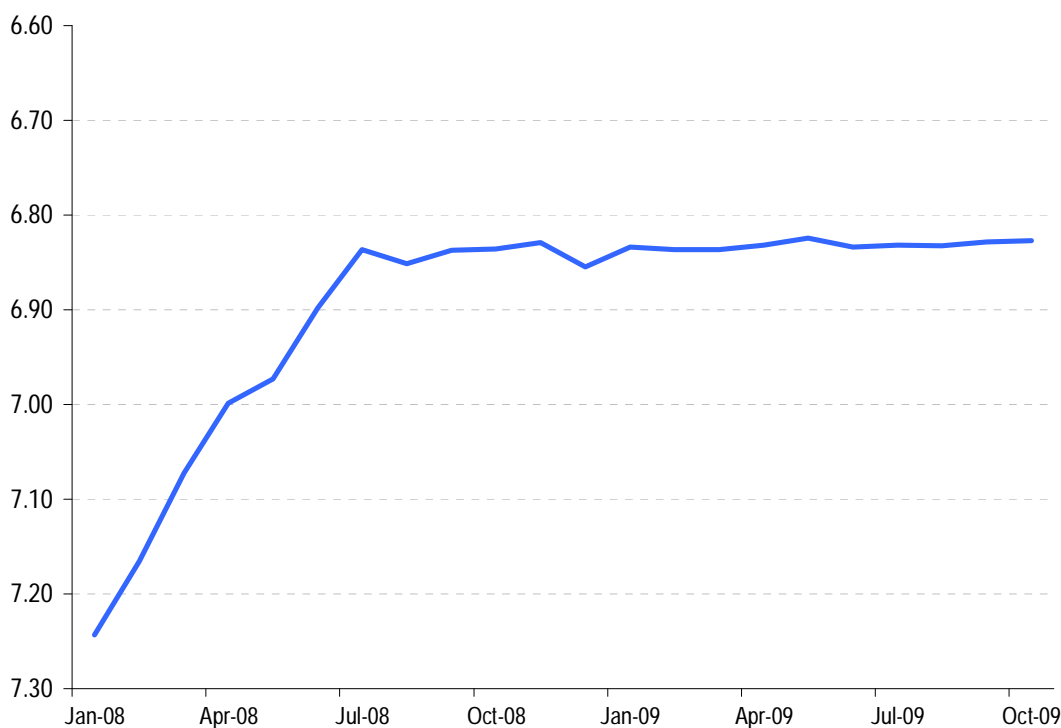
<sup>1</sup> The official name of China's currency is the renminbi (RMB), which is denominated in yuan units. Both RMB and yuan are used to describe China's currency.

<sup>2</sup> Bureau of Labor Statistics, *Import/Export Price Indexes*, Press Release, January 14, 2009.

China appears to have halted its currency appreciation policy around mid-July 2008 (see **Figure 1**). The RMB depreciated against the dollar slightly in July-August 2008 and in December 2008, but has generally averaged 6.83 yuan per dollar through December 1, 2009. However, because China's currency is largely tied to the dollar, and since the dollar has depreciated against a number of major currencies in recent months, China's currency has depreciated against many (floating) currencies as well, such as the euro.<sup>3</sup> According to the Bank of International Settlements, China's real (inflation adjusted) trade-weighted exchange rate (based on its trade with 57 economies) appreciated by 18.0% from January 2008 to February 2009, but from February 2009 to October 2009 it depreciated by 9.5% (see **Figure 2**).

**Figure 1. RMB Nominal Exchange Rate Against the Dollar: January 2008-October 2009**

Yuan per \$U.S. (Monthly Averages)



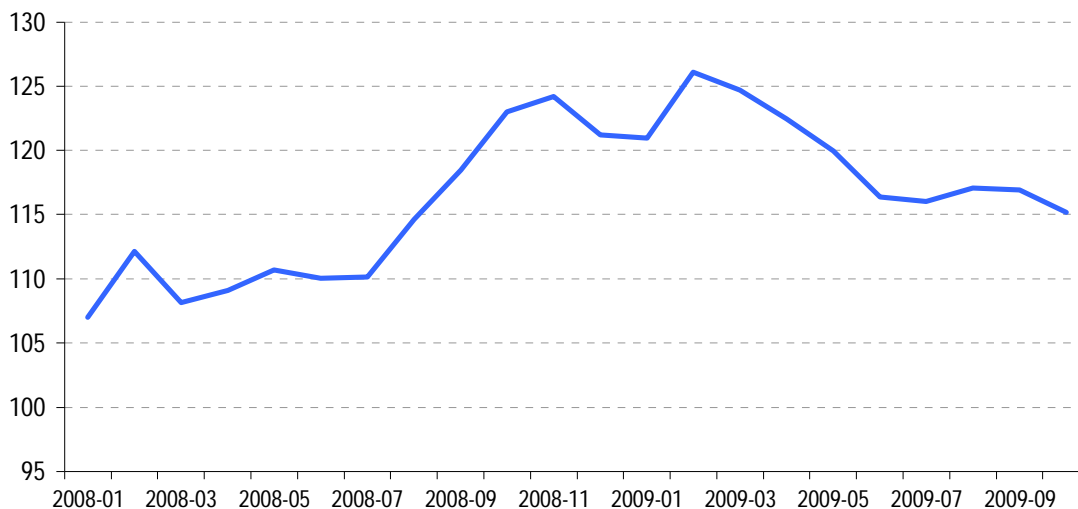
**Source:** Global Insight.

**Note:** Chart inverted for illustrated purposes.

<sup>3</sup> From January to October 2009, the RMB depreciated against the Euro by 11.6%. This means that Chinese exports to the Euro-zone countries are becoming cheaper, while its imports from these countries are becoming more expensive. As a result, the EU has increasingly criticized China's currency policy.

**Figure 2. Change in China's Real Trade Weighted Exchange Rate: January 2008-October 2009**

Index Based on Average Annual 2005 Data (2005=100)



**Source:** Bank of International Settlements

**Notes:** Weights calculated based on China's trade with 57 economies. Inflation calculated using measurements of national consumer price indexes.

## U.S. Concerns Over China's Currency Policy

Many U.S. policymakers and business and labor representatives have charged that China's currency is significantly undervalued vis-à-vis the U.S. dollar (even after the recent revaluation), making Chinese exports to the United States cheaper, and U.S. exports to China more expensive, than they would be if exchange rates were determined by market forces. They further argue that the undervalued currency has contributed to the burgeoning U.S. trade deficit with China (which was \$266 billion in 2008) and has hurt U.S. production and employment in several U.S. manufacturing sectors that are forced to compete domestically and internationally against "artificially" low-cost goods from China. Furthermore, some analysts contend that China's currency policy induces other East Asian economies to intervene in currency markets in order to keep their currencies weak against the dollar in order to compete with Chinese goods. Critics contend that, while it may have been appropriate for China during the early stages of its economic development to maintain a pegged currency, it should let the RMB freely float today, given the size of the Chinese economy and the impact its policies have on the world economy.

## China's Concerns Over Modifying Its Currency Policy

Chinese officials argue that its currency policy is not meant to favor exports over imports, but instead to foster economic stability through currency stability, as many other countries do. They have expressed concern that floating its currency could spark an economic crisis in China and would especially be damaging to its export industries at a time when painful economic reforms (such as closing down inefficient state-owned enterprises) are being implemented. They further contend that the Chinese banking system is too underdeveloped and burdened with heavy debt to be able to deal effectively with possible speculative pressures that could occur with a fully convertible currency.

The global financial crisis has had a significant impact on China's trade and foreign direct investment (FDI) flows. From January to September 2008, China enjoyed nearly double-digit growth in monthly exports and FDI on a year-on-year basis. However, China's exports and imports dropped for 11 consecutive months from November 2008 to October 2009, and FDI declined 9 consecutive months from October 2008 to July 2009. From January-October 2009, China's total exports, imports, and FDI were down by 20.5%, 19.9%, and 12.6%, respectively, over the same period in 2008. Thousands of export-oriented factories reportedly were shut down and, according to the Chinese government, over 20 million migrant workers lost their jobs because of the global economic slowdown.

Chinese officials view economic stability as critical to sustaining political stability; they fear an appreciated currency could cause even more employment disruptions and thus could cause worker unrest. However, Chinese officials have indicated that their long-term goal is to adopt a more flexible exchange rate system and to seek more balanced economic growth through increased domestic consumption and the development of rural areas, but they claim they want to proceed at a gradual pace. During the China-EU summit held in November 2009, Chinese Premier Wen Jiabao stated that a stable yuan was beneficial to a global economic recovery. He said that "China will further improve the yuan exchange rate formation mechanism, acting on its own initiative and in a controllable and gradual manner, and keep the yuan exchange rates basically stable at a reasonable and balanced level."<sup>4</sup> However, Wen complained that "some countries demand the yuan's appreciation, while practicing various trade protectionism against China. It's unfair and actually limits China's development."<sup>5</sup> China's media reported unnamed government officials as stating that "it would be difficult to make the case of an immediate renminbi appreciation in a country where 40 million people live on less than 1 U.S. dollar a day."<sup>6</sup>

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<sup>4</sup> *People's Daily Online*, November 30, 2009.

<sup>5</sup> *Xinhua News Agency*, December 1, 2009.

<sup>6</sup> *Ibid.*

## **Implications of China's Currency Policy for its Economy**

If the RMB is undervalued vis-à-vis the dollar (estimates range from 15% to 40% or higher), then Chinese exports to the United States are likely cheaper than they would be if the currency were freely traded, providing a boost to China's export industries.<sup>7</sup> Eliminating exchange rate risk through a managed peg also increases the attractiveness of China as a destination for foreign investment in export-oriented production facilities. However, an undervalued currency makes imports more expensive, hurting Chinese consumers and Chinese firms that import parts, machinery, and raw materials. Such a policy, in effect, benefits Chinese exporting firms (many of which are owned by foreign multinational corporations) at the expense of non-exporting Chinese firms, especially those that rely on imported goods. This may impede the most efficient allocation of resources in the Chinese economy. Another major problem resulting from currency intervention is that the Chinese government must expand the money supply in order to keep purchasing dollars, which has promoted the banks to adopt easy credit policies.<sup>8</sup> In addition, in the past, "hot money" has poured into China from investors speculating that China will continue to appreciate the RMB. At some point, these factors could help fuel inflation, overinvestment in various sectors, and expansion of nonperforming loans by the banks—each of which could threaten future economic growth.<sup>9</sup>

## **Implications of China's Currency Policy for the U.S. Economy**

### **Effect on Exporters and Import-Competitors**

When exchange rate policy causes the RMB to be less expensive than it would be if it were determined by supply and demand, it causes Chinese exports to be relatively inexpensive and U.S. exports to China to be relatively expensive. As a result, U.S. exports and the production of U.S. goods and services that compete with Chinese imports fall, in the short run.<sup>10</sup> Many of the

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<sup>7</sup> Some contend that China's currency intervention is effectively a subsidy for its exporters. See, speech by Federal Reserve Chairman Ben S. Bernanke at the Chinese Academy of Social Sciences, Beijing, China: "the Chinese Economy: Progress and Challenges," delivered on December 15, 2006, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20061215a.htm>.

<sup>8</sup> Prior to the current global economic slowdown, easy monetary policies were contributing to inflationary pressures in China.

<sup>9</sup> By pegging its currency, China substantially weakens its ability to use monetary policy to fight rising inflation. This is because raising interest rates would encourage greater inflows of capital from abroad. The government would be forced to increase the money supply in order to purchase the inflows of dollars needed to maintain its exchange rate target.

<sup>10</sup> Many such firms contend that China's currency policy constitutes one of several unfair trade advantages enjoyed by Chinese firms, including low wages, lack of enforcement of safety and environmental standards, selling below cost (dumping) and direct assistance from the Chinese government.



affected firms are in the manufacturing sector.<sup>11</sup> This causes the trade deficit to rise and reduces aggregate demand in the short run, all else equal.<sup>12</sup>

Some analysts contend that China's currency policy should be addressed under U.S. laws dealing with unfair trade practices. For example, H.R. 2378 (Tim Ryan), S. 1027 (Stabenow), and S. 1254 (Schumer) would require the Treasury Department to identify currencies that are fundamentally misaligned and to designate currencies for "priority action" under certain circumstances. Such action would include factoring currency undervaluation in U.S. anti-dumping and countervailing cases, banning federal procurement of products or services from the designated country, and filing a case against that country in the World Trade Organization.<sup>13</sup>

## **Effect on U.S. Consumers and Certain Producers**

A society's economic well-being is usually measured not by how much it can produce, but how much it can consume. An undervalued RMB that lowers the price of imports from China allows the United States to increase its consumption through an improvement in the terms-of-trade. Since changes in aggregate spending are only temporary, from a long-term perspective the lasting effect of an undervalued RMB is to increase the purchasing power of U.S. consumers. Imports from China are not limited to consumption goods. U.S. producers also import capital equipment and inputs to final products from China. An undervalued RMB lowers the price of these U.S. products, increasing their output, and thus making such firms more internationally competitive.

## **Effect on U.S. Borrowers**

An undervalued RMB also has an effect on U.S. borrowers. When the United States runs a current account deficit with China, an equivalent amount of capital flows from China to the United States, as can be seen in the U.S. balance of payments accounts. This occurs because the Chinese central bank or private Chinese citizens are investing in U.S. assets, which allows more U.S. capital investment in plant and equipment to take place than would otherwise occur. Capital investment increases because the greater demand for U.S. assets puts downward pressure on U.S. interest rates, and firms are now willing to make investments that were previously unprofitable. This increases aggregate spending in the short run, all else equal, and also increases the size of the economy in the long run by increasing the capital stock.

Private firms are not the only beneficiaries of the lower interest rates caused by the capital inflow (trade deficit) from China. Interest-sensitive household spending, on goods such as consumer durables and housing, is also higher than it would be if capital from China did not flow into the United States. In addition, a large proportion of the U.S. assets bought by the Chinese,

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<sup>11</sup>U.S. employment in manufacturing as a share of total nonagricultural employment fell from 31.8% in 1960, to 22.4% in 1980, to 9.72% as of November 2008. This trend is much larger than the Chinese currency issue and is caused by numerous other factors, including productivity gains in manufacturing and the rise of employment in the service sector.

<sup>12</sup> Putting exchange rate issues aside, most economists maintain that trade is a win-win situation for the economy as a whole, but produces losers within the economy. Economists generally argue that free trade should be pursued because the gains from trade are large enough that the losers from trade can be compensated by the winners, and the winners will still be better off.

<sup>13</sup> The bills would require the Commerce Department to factor in the rate of undervaluation of a country's currency when determining the level of government subsidy for countervailing cases or the level in which products are sold at below fair market value for anti-dumping cases.

particularly by the central bank, are U.S. Treasury securities, which fund U.S. federal budget deficits. According to the U.S. Treasury Department, China held \$799 billion in U.S. Treasury securities as of September 2009, making it the largest foreign holder of such securities. If the U.S. trade deficit with China were eliminated, Chinese capital would no longer flow into this country on net, and the government would have to find other buyers of U.S. Treasuries. This could increase the government's interest payments.

## **Net Effect on the U.S. Economy**

In the medium run, an undervalued RMB neither increases nor decreases aggregate demand in the United States. Rather, it leads to a compositional shift in U.S. production, away from U.S. exporters and import-competing firms toward the firms that benefit from Chinese capital flows. Thus, it is expected to have no medium or long-run effect on aggregate U.S. employment or unemployment. As evidence, one can consider that the United States had a historically large and growing trade deficit throughout the 1990s at a time when the economy was strong and unemployment reached a three-decade low. However, the gains and losses in employment and production caused by the trade deficit will not be dispersed evenly across regions and sectors of the economy: on balance, some areas will gain while others will lose. And by shifting the composition of U.S. output to a higher capital base, the size of the economy would be larger in the long run as a result of the capital inflow/trade deficit.

Although the compositional shift in output has no negative effect on aggregate U.S. output and employment in the long run, there may be adverse short-run consequences. If output in the trade sector falls more quickly than the output of U.S. recipients of Chinese capital rises, aggregate spending and employment could temporarily fall. This is more likely to be a concern if the economy is already sluggish than if it is at full employment. Otherwise, it is likely that government macroeconomic policy adjustment and market forces can quickly compensate for any decline of output in the trade sector by expanding other elements of aggregate demand. The deficit with China has not prevented the U.S. economy from registering high rates of growth in the past.

## **The U.S.-China Trade Deficit in the Context of the Overall U.S. Trade Deficit**

While China is a large trading partner, it accounted for only 16.1% of U.S. merchandise imports in 2008 and 33% of the sum of all U.S. bilateral trade deficits.<sup>14</sup> Over a span of several years, a country with a floating exchange rate can consistently run an overall trade deficit for only one reason: a domestic imbalance between saving and investment. Over the past two decades, U.S. saving as a share of gross domestic product (GDP) has been in gradual decline. On the one hand, the United States has high rates of productivity growth and strong economic fundamentals that are conducive to high rates of capital investment. On the other hand, it has a chronically low (until recently) household saving rate and a negative government saving rate as a result of the budget deficit. Large U.S. trade deficits will likely persist as long as Americans save little and

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<sup>14</sup> This figure is somewhat misleading because the United States runs trade deficits with some countries and surpluses with others. A different approach would be to sum up the balances of those countries in which the United States ran a trade deficit with. In 2008, the United States ran trade deficits with 91 countries, totaling \$951.9 billion; the U.S. trade deficit with China was equal to 27.9% of this amount.

foreigners are willing to use their saving to finance profitable investment opportunities in the United States.<sup>15</sup> The returns to foreign-owned capital will flow to foreigners instead of Americans, but the returns to U.S. labor utilizing foreign-owned capital will flow to U.S. labor.

More than half of China's exports to the world are produced by foreign-invested firms in China, many of which have shifted production to China in order to gain access to low-cost labor. (The returns to capital of U.S.-owned firms in China flow to Americans.) Such firms import raw materials and components (much of which come from East Asia) for assembly in China. As a result, China tends to run trade deficits with East Asian countries (such as Taiwan, South Korea, and Japan) and trade surpluses with countries with high consumer demand, such as the United States. These factors imply that much of the increase in U.S. imports (and hence, the rising trade deficit with China) is largely the result of China becoming a production platform for many foreign companies, rather than unfair Chinese trade policies. It is not clear to what extent a sharp appreciation of the RMB would have on various U.S. industries in terms of increased production and employment. Many analysts contend that a significant share of production would shift from China to other low-cost Asian producers, rather than to the United States.<sup>16</sup>

## China's Policy Dilemma Over its Currency Policy

The impact of the global financial crisis has raised concerns in the United States over the future course of China's currency policy. Prior to the crisis, there were high expectations among many analysts that China would continue to appreciate its currency and implement financial reforms to pave the way towards eventually adopting a floating currency. However, the global economic slowdown has induced China to halt its currency appreciation and other reforms. Chinese officials currently view a stable exchange rate with the dollar as benefitting China in a number of ways:

- **Exports and Foreign Direct Investment.** Keeping the exchange rate with the dollar stable may help to stem further declines in exports and FDI and thus halt further factory closings and layoffs in such sectors.
- **China as a "Responsible Stakeholder."** Over the past several years, Chinese leaders have sought to portray China as a responsible stakeholder (and increasingly a leader) on global economic issues. Chinese officials contend that during the 1997-98 Asian crisis, when several other nations sharply devalued their currencies, China "held the line" by not devaluing its currency, which might have prompted a new round of destructive devaluations across Asia. This policy was highly praised at the time by U.S. officials, including President Clinton. Although devaluing the RMB against the dollar could help China's trade sector, it could cause other economies in the Asia to devalue their currencies, which could

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<sup>15</sup> Most economists believe that the United States runs a trade deficit because it fails to save enough to meet its investment needs and must obtain savings from other countries with high savings rates. China has one of the world's largest savings rate.

<sup>16</sup> Some analysts contend that China's currency policy has a much greater negative impact on the economies of developing countries that compete with China than the U.S. economy. Paul Krugman in an October 22, 2009, New York Times Op-Ed states: "By pursuing a weak-currency policy, China is siphoning some of that inadequate demand away from other nations, which is hurting growth almost everywhere. The biggest victims, by the way, are probably workers in other poor countries."

further undermine economic stability in the region and negatively affect China's relations with its neighbors.

- **Avoiding Trade Tensions.** Chinese officials appear to be deeply concerned over “growing protectionism” in the United States and elsewhere. They are keenly aware that numerous congressional proposals have been introduced in the past which would take tough action against China's currency policy.
- **Protecting the Value of China's Investments.** China is believed to hold more than \$1 trillion in U.S. securities. A major concern for Chinese officials as it has gradually appreciated the currency (until recently) has been the decline in value of these assets brought about by that appreciation. Thus, halting the appreciation of the RMB halts further losses from U.S.-held assets.

There may be a number of reasons why holding the exchange rate constant may not be beneficial to China:

- **Continued Reliance on Exports and Fixed Investment.** Numerous economists contend that China needs to rebalance its economy by lessening its dependence on exports and fixed investment (which has been largely driven by China's currency policy) doing more to promote domestic consumption, improve the social safety net, and boost living standards among the poor. Such analysts contend that an appreciation of the RMB to “market levels” is a key factor to attaining a more balanced economy by eliminating economic distortions caused by an undervalued currency. Many have expressed concern that the Chinese government's policy of keeping a stable exchange rate with the dollar, coupled with numerous new policies to promote exports, indicates that the government intends to maintain its over-reliance on exporting for economic growth.
- **Holding the Line May Not be Enough to Stop Congressional Action or Increased Tensions with its Trading Partners.** Although China allowed its currency to appreciate somewhat after 2005, it did not stem the tide of congressional criticism over its exchange rate policy. China has constantly argued that it has been increasingly making its exchange rate system more flexible. Halting appreciation of the RMB has been viewed by some Members as an abandonment of China's commitments to reform the currency. Keeping the exchange rate with the dollar roughly the same could prompt Congress to act on currency legislation. In addition, as noted earlier, while the RMB's nominal exchange rate with the dollar has remained stable, it has actually depreciated on a real trade weighted basis since February 2009 and is of growing concern with many of China's trading partners.
- **The View That China Could Do More to Promote Global Recovery.** Chinese officials have stated that their biggest contribution to a global economic recovery is to maintain its rapid economic growth. To that end, the government is in the process of implementing a \$586 billion stimulus plan (announced in November 2008), a large share of which will go into infrastructure projects. It is not clear to what extent the stimulus package will promote imports. Some analysts have contended that if China combined domestic spending with more market opening measures, including adopting a more flexible exchange rate policy, it would

greatly boost China's imports and stimulate economic recoveries in other countries (and also improve living standards in China).<sup>17</sup>

Although the Obama Administration has pressed China to appreciate its currency, it has also encouraged China to continue purchasing U.S. debt instruments.<sup>18</sup> During her first visit as Secretary of State in early 2009, Hillary Clinton was reportedly quoted as saying,

Well, I certainly do think that the Chinese government and the central bank here in China is making a very smart decision by continuing to invest in treasury bonds for two reasons. First, because it's a good investment. It's a safe investment. Even despite the economic challenges sweeping over the world, the United States has a well-deserved financial stability reputation. And, secondly the Chinese know that, in order to start exporting again to its biggest market, namely, the United States, the United States has to take some very drastic measures with this stimulus package, which means we have to incur more debt. It would not be in China's interest if we were unable to get our economy moving again. So, by continuing to support American Treasury instruments, the Chinese are recognizing our interconnection.<sup>19</sup>

China's currency policy appears to have created a policy dilemma for the Chinese government. A strong and stable U.S. economy is in China's national interest since the United States is China's largest export market. Thus, some analysts contend that China will feel compelled to keep funding the growing U.S. debt. However, Chinese officials have expressed concern that the growing U.S. debt will eventually spark inflation in the United States and a depreciation of the dollar, which would negatively impact the value of China's holdings of U.S. securities. But if China stopped buying U.S. debt or tried to sell off a large portion of those holdings, it could also cause the dollar to depreciate and thus reduce the value of its remaining holdings, and such a move could further destabilize the U.S. economy. Chinese concerns over its large dollar holdings appear to have been reflected in a paper issued by the governor of the People's Bank of China, Zhou Xiaochuan on March 24, 2009, which called for replacing the U.S. dollar as the international reserve currency with a new global system controlled by the International Monetary Fund.<sup>20</sup> China has also signed currency swap agreements totaling 650 billion yuan (or about \$95 billion) with Hong Kong, Argentina, Indonesia, South Korea, Malaysia, and Belarus, which would allow those partners to settle accounts with China using the RMB rather than the dollar in order to facilitate bilateral trade and investment.<sup>21</sup> It is not clear if such a move signifies a gradual effort on the part of the Chinese government to eventually make the RMB an internationally traded currency. Most trade analysts contend that it would take several years before China would be willing and able to make the RMB a fully tradable currency or a major reserve currency.

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<sup>17</sup> Many Chinese have become increasingly critical of China's currency policy because the large levels of foreign exchange reserves generated by that policy are invested in overseas assets with relatively low (and sometimes negative) returns.

<sup>18</sup> If China were to sharply appreciate the RMB against the dollar, it could lessen the government's need to purchase U.S. dollars, and thus could affect the level of future purchases of U.S. securities. Some analysts contend that this could push up U.S. interest rates, while other analysts contend that other buyers (both domestic and foreign) would step in to buy U.S. Treasury securities and that U.S. interest rates would remain unchanged.

<sup>19</sup> Secretary Clinton, Interview With Yang Lan of Dragon TV, Beijing, China, February 22, 2009.

<sup>20</sup> For copy of the proposal, see the Chinese People's Bank of China website at <http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178>.

<sup>21</sup> Under a currency swap arrangement, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date. See, the Federal Reserve Bank of New York, *the Basics of Foreign Trade and Exchange*, available at <http://www.ny.frb.org/education/fx/foreign.html>.

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