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## Diffusing Tensions over China's Exchange Rate Policy

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Tensions in U.S.–China relations have been rising recently. Trade spats, alleged Chinese hacking attacks directed at American companies, differences over Internet freedom standards, U.S. arms sales to Taiwan, and the pending meeting between Obama and the Dalai Lama are all souring the world's most important bilateral relationship. An old and especially intractable issue is now being added to this long list: the management of China's currency, the yuan or renminbi.

Although this issue has caused considerable friction in U.S.–China relations in the past, it promises to be even more combustible this year. Facing high unemployment and crucial midterm elections in the fall, Washington is under pressure to coax Beijing to adopt a more flexible exchange rate. Beijing, on the other hand, is ever more anxious to keep the yuan's exchange rate vis-à-vis the U.S. dollar stable in these turbulent times. In addition, the United States has less leverage over China than at any time since 1978. This sets both sides up for an ugly spat that could potentially undermine the broader relationship.

Since 1994, Beijing has viewed “exchange rate stability” as a top priority. The yuan-U.S. dollar exchange rate was kept stable with a fixed peg, even during the tumult of the Asian Financial Crisis. Beijing only took the yuan off its peg to the U.S. dollar in July 2005 after realizing that exchange rate flexibility could aid efforts to control inflation.

Officially, the yuan moved to a managed floating exchange rate based on market forces with reference to a basket of currencies dominated by four currencies: the U.S. dollar, the euro, the yen and the South Korean won. Despite the managed float, the yuan's trajectory from 2005 to 2008 was one of a gradual but stable appreciation vis-à-vis the U.S. dollar. The yuan appreciated twenty-one percent compared to the U.S. dollar in this time period but was then pegged again at a more or less fixed rate to the U.S. dollar in July 2008.

It is this re-pegging that is causing a renewed attention to China's exchange rate management in the United States. Many American economists and, above all, politicians hold that the yuan is undervalued by twenty-five to forty percent compared to the U.S. dollar. How much a revaluation would really help in terms of balancing China's trade with the United States and Europe, nevertheless, is open to question. Because China's strong competitive advantages are based on substantial increases in productivity and international market penetration, minor currency revaluations will not likely diminish China's export prowess. Certainly, a

**Christopher A. McNally, a Fellow at the East-West Center, argues that mounting political pressures in Washington and the imperative to keep the exchange rate stable in Beijing set “both sides up for an ugly spat that could potentially undermine the broader relationship.”**



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substantial one-off revaluation (more than ten percent) that could dent China’s export machine is out of the question, since it would undermine China’s export sector and create destabilizing inflows of “hot money” to China.

In fact, the yuan, due to its peg to the dollar, experienced substantial exchange rate volatility over the past eighteen months. It appreciated strongly against the euro in late 2008 and early 2009 before dropping back. It is now appreciating again vis-à-vis the euro. Only against the yen has the Chinese yuan been consistently weak. An overall trend of yuan depreciation is not that obvious, but this is not really the fundamental problem. The biggest problem for China is one of public image.

While the People’s Bank of China announced in 2005 its new policy of a managed float with reference to a basket of currencies, the yuan’s only real point of reference has been the U.S. dollar. Even with respect to the U.S. dollar, it is difficult to argue that market forces have played a major role in the yuan’s exchange rate, especially after its re-pegging in 2008. China’s exchange rate is clearly “managed,” or as some politicians in the United States and other Chinese trading partners would argue, “manipulated.”

As in other areas of Chinese governance, Beijing has given short shrift to transparency when managing the yuan’s exchange rate. No details are available on the weightings of individual currencies in the reference basket for the yuan. Furthermore, the composition of China’s foreign exchange reserves, which underpin the yuan’s value, is a closely held state secret. Beijing wants to give itself maximum leeway, but the way the yuan has been managed gives rise to allegations of currency manipulation to gain unfair trade advantages.

Given the rising tempers on both sides of the Pacific, it would make more sense for Beijing to remove once and for all the lack of transparency and the aura of manipulation surrounding the yuan’s exchange rate management. Even a one-off revaluation of five percent, as has been rumored, will not dispel this fundamental lack of transparency. To diffuse this most contentious issue in current Chinese economic policy, Beijing should clarify the composition and weightings of its currency basket, perhaps widen the band within which the yuan floats, and move to what was the stated goal in 2005: a floating rate based on market forces with a reference to a clearly delineated basket of currencies.

In fact, if the basket is simple and based on major trading currencies, such as the U.S. dollar, the euro and the yen, with minor shares for the currencies of other Chinese trading partners, then such an arrangement could contribute to international exchange rate stability, diminish China’s dependence on the U.S. treasury market to store its foreign exchange reserves, and diffuse international tensions over China’s exchange rate policy—a win-win-win proposition.

The brewing battle over the yuan’s exchange rate could easily cause intransigence in both Washington and Beijing. It is thus in China’s interest to settle this issue more effectively than in the past. If the yuan were to float in a band vis-à-vis a basket of currencies rather than just the U.S. dollar, this could diffuse a lot of pressures in Washington and allow both sides to focus on the host of other intractable issues challenging the management of U.S.-China relations.