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Editors: Jacek Foks (Editor-in-Chief), Łukasz Adamski, Beata Górka-Winter, Leszek Jesień, Agnieszka Kondek (Executive Editor), Łukasz Kulesa, Marek Madej, Ernest Wyciszkiewicz

Problem of an Undervalued Exchange Rate of the Chinese Currency

by Artur Gradziuk

The fixed, undervalued exchange rate of the yuan to the dollar has helped China boost its exports and alleviate the impact of the global economic crisis. Many countries, the United States in particular, contend that China's undervalued currency has had negative impact on the global economy. Aware that the Chinese government will refuse to budge on the exchange rate policy issue in response to outside pressures, the US has eased its criticism of China in recent weeks. However, the pressure on the exchange rate policy could increase if the decision to revalue the yuan is put off.

Origins of the Problem. Throughout 1994–2005 China maintained a fixed exchange rate of the yuan (renminbi—RMB) to the US dollar. After a slight revaluation, from RMB8.7 to RMB8.28, the exchange rate remained constant throughout 1997–2005. Until 2001 the nominal exchange rate of the yuan was close to the real effective exchange rate and the RMB appreciated against other currencies alongside the dollar. Yet since 2002 the sustained high productivity growth in China's export sector and the depreciation of the dollar have been making the RMB more and more undervalued, boosting the competitiveness of China's exports that led to the soaring growth of China's trade surplus and foreign exchange reserves.

The growing imbalance in China–US trade has become a major issue in the two states' bilateral relations. In 2003 Senators Charles Schumer (a Democrat) and Lindsey Graham (a Republican) proposed a bill that would impose a 27.5% tariff on Chinese goods, to be passed if negotiations with the PRC government on the revaluation of the RMB failed. Although the bill never came up for a vote, it sparked debate on the RPC's exchange rate policy and it contributed to elevating the issue.

In 2005 China lifted the peg of RMB to the US dollar for a managed floating exchange rate of RMB to a basket of major currencies. By 2008 the RMB-to-dollar exchange rate strengthened by nearly 21%, from RMB8.28 to RMB6.83. Yet, as the appreciation of the RMB slowed neither the pace of growth of Chinese exports nor of China's largest partners' trade deficits, accusations that the RMB was undervalued persisted.

The global financial crisis prompted the PRC government to revise again its currency policy. Since July 2008 the exchange rate of the RMB to the US dollar has been pegged at RMB6.83. The paramount reason for keeping the exchange rate of the RMB at a fixed, artificially low level is the desire to boost China's exports, which at the turn of 2008 suffered a steep, two-digit decline in the wake of the collapse of demand in the US and the EU—a plunge that cost China some 20 million lost jobs.

Effects and Reactions. In 2009 China registered an economic growth of 8.9%. Among the world's largest economies, China was the one to have coped the best with the economic crisis, the undervalued RMB having been an important element of the Chinese government's crisis-combating efforts. In other countries, which were hit harder by the downturn, the PRC's exchange rate policy has been increasingly denounced as impeding global macroeconomic rebalancing and other countries' recovery.

The United States has been the foremost critic of the PRC's currency policy. Early in 2009 candidate for the position of Secretary of the Treasury Timothy Geithner in a written testimony to the Congress stated that China was manipulating its currency. Although such allegations have been less blunt since Barack Obama took the office of President—because of the desire to deepen bilateral cooperation on other important global issues—the exchange rate of the RMB has turned from an issue relating strictly to economic relations to an important element of the political relations of the two states. In 2009 US diplomatic efforts to modify the PRC's currency policy proved largely ineffectual.

The issue acquired additional relevance early in 2010, as the US Congress set out to overtly pressure the Department of the Treasury to acknowledge in its special report that China was "currency manipulator," a finding which would warrant the imposition of tariff restrictions on imports from China. The release of the report, originally scheduled for 15 April, has been put off in connection with the approaching visit by the PRC President Hu Jintao to the US and because of the belief that, if China was pronounced a "currency manipulator," this could make the Chinese authorities' stance even more inflexible.

Although the new EU Trade Commissioner Karel De Gucht publicly pronounced the exchange rate of the RMB artificially low, the EU has been less critical than the US of China's currency policy. One of the reasons it that the RMB being pegged to the dollar rather than to the euro, as the EU currency depreciates against the dollar so it does against the RMB. The exchange rate of the RMB is the subject of regular consultations between the PRC and the EU, yet the EU regards the improvement of access for EU goods, services and investment to the Chinese market as a much more important matter. Other countries have tended to refrain from criticizing China's exchange rate policy, even though in April 2010 the heads of the central banks of Brazil and India declared that the strengthening of the RMB was one of the prerequisites for rebalancing the global economy. The developing countries, directly affected as they are by the PRC's currency policy, have nevertheless practiced restraint so as not to jeopardize the development of their relations with so important a partner.

Prospects. The actions the US could take towards China range from the imposition of a countervailing tariff (on the assumption that the undervalued exchange rate of the RMB is effectively an export subsidy) to the filing of complaint with the WTO (in which case the resolution of the dispute could take several years) or the imposition of an across-the-board steep tariff on Chinese goods (an action which, being contrary to the WTO agreements, could lead to retaliatory measures by China and to the escalation of the conflict). Yet, by postponing the release of the report which will identify China as a "currency manipulator" the US has acted on the assumption that addressing the question of the RMB exchange rate on a multilateral forum would be a more effective way to induce China to revise its currency policy. One such forum is the G20—yet it takes decisions on the basis of consensus and a consensus on the Chinese currency policy will be difficult to achieve. Another forum is the WTO—but under the existing agreements this organization has limited powers over exchange rate issues and it can hardly be expected to develop, under the Doha Round, the clearer currency policy principles. As for the IMF, its capability to influence the exchange rate of the RMB is fairly limited too, despite the Managing Director of the IMF opinion that the Chinese currency is undervalued. The loan conditionality is the IMF's instrument to compel changes in the borrowing country, but in the case China—a country in a stable financial condition—this instrument will not be applicable. The development of norms on the Fund members' currency policies, though not unlikely, can hardly be expected to occur in a near term.

So far China has resisted the pressures to revalue the RMB. Its main argument for the fixed exchange rate has been the need to sustain exchange rate stability in view of the volatility of the financial market. This is claimed to be beneficial both to China and to the global economy. While the undervalued RMB helped China mitigate the decline in exports during the crisis, the growth of inflationary pressure has now emerged as a side-effect of this policy. The revision, if any, of the currency policy is a serious dilemma for the Chinese government which is taking into consideration both the Ministry of Commerce's arguments concerning the repercussions of the revaluation of the RMB for employment in the export sector and the central bank's warnings that maintaining a fixed exchange rate to the dollar adds to the risk of inflation. US pressures have not been conducive to decisions to strengthen the RMB exchange rate. From China's perspective, to revise the currency policy under an external pressure would be the worst possible scenario, for this could be seen by the Chinese society as a sign the authorities' weakness. Accordingly, the easing of U.S. criticism will make it possible to take a decision on the exchange rate of the RMB based on internal economic considerations. Such decision seems likely in the context of statements by some PRC officials concerning plans to modify the currency policy (though without any specific timetable). If China delays action on lifting RMB's peg to the US dollar, about stronger outside pressures could be expected, not just from the U.S. but from other countries as well.