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CHINA'S CURRENCY POLICY: WINNERS AND LOSERS OF AN INDIRECT EXPORT SUBSIDY

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ABSTRACT

China's government policy of intervening in currency markets to limit or stop the appreciation of its currency, the renminbi (RMB) or yen, against the U.S. dollar and other currencies has become an issue of concern for many US policy makers. They charge that China's currency policy is intended to make its exports significantly less expensive, and its imports more expensive. Critics contend that the RMB is significantly undervalued against the dollar and that this has been a major contributor to the large annual U.S. trade deficits with China and the loss of U.S. jobs in recent years. Many legislation and bills have been passed in Congress that seeks to address the effects of undervalued currencies (which are largely aimed at China). Some analysts contend that China's industrial policies, its failure to adequately protect U.S intellectual property rights, and its unbalanced economic growth model, are some serious challenges to U.S. economy. The effects of the global economic slowdown have refocused attention on the need to reduce global imbalances especially between China and the United States. Many economists contend that China should take steps to rebalance its economy by lessening its dependence on exports while boosting the level of domestic consumer demand.

KEYWORDS
china, Currency policy.

1. OVERVIEW OF THE CURRENCY ISSUE

Direct intervention of china's government in money market to limit the appreciation of its currency, the renminbi (RMB), or yuan, against the dollar and other currencies has become a major source of problem with many of its trading partners, especially the United States. Analysts contend that China deliberately "manipulates" its currency to get unfair trade advantages over its trading partners. They also said China's undervalued currency has been a major factor in the large annual U.S trade deficits with China and has contributed to widespread job losses in the United States, especially in manufacturing. In February 2010 President Obama, stated that China's undervalued currency puts U.S. firms at a "huge competitive disadvantage," and also concluded that China needed to "go ahead and move towards a market-based system for their currency" and that the United States and other countries felt that "enough is enough."

From July 2005 to July 2008, China's central bank allowed the RMB to appreciate against the dollar by about 21%. However, once the effects of the global economic crisis became apparent in 2008, China halted appreciation of the RMB in an effort to help Chinese industries dependent on trade. From July 2008 to about mid-June 2010, China kept the exchange rate of the RMB relatively constant at 6.83 yen to the dollar. On June 2010, China resumed appreciation of the RMB, and allowed the RMB/dollar exchange rate to rise by 7.6% (to 6.35 yuan per dollar) through November 30, 2011.U.S. officials have criticized this pace as being too slow, especially given China's strong economic growth over the past few years and its rising level of foreign exchange reserves.

Many economists argue that the effects of China's currency policy on the U.S. economy are complex. If the RMB is undervalued (as many contend), then it might be viewed as an indirect export subsidy which artificially lowers the prices of Chinese products imported into the United States. Under this view, this benefits U.S. consumers and U.S. firms that use Chinese-made parts and components, but could negatively affect certain U.S. import-sensitive firms. An undervalued RMB might also have the effect of limiting the level of U.S. exports to China than might occur under a floating exchange rate system. Further complicating the issue is China's large purchases of U.S. Treasury securities, which totaled at least $1.15 trillion as of September 2011. These purchases occur because China's intervention in currency markets causes it to accumulate large levels of foreign exchange reserves, especially U.S. dollars, which are then used to purchase U.S. debt. Such purchases help the U.S. government fund its budget deficit, which helps to keep U.S interest rates relatively low.

These factors suggest that an appreciation of the RMB to the dollar could benefit some U.S. sectors, but could negatively affect others. The effects of the global economic slowdown have refocused attention on the need to reduce global imbalances especially between China and the United States. Many economists contend that China should take steps to rebalance its economy by lessening its dependence on exports while boosting the level of domestic consumer demand. A market-based currency policy is seen as an important factor in achieving this goal. Further RMB appreciation could help promote the development of non-export industries in China, while boosting China's imports, including from the United States.

1.1 2005: CHINA REFORMS THE PEG

The Chinese government brings reforms in its currency policy on July 21, 2005. It announced that the RMB's exchange rate would become "adjustable, based on market supply and demand with and that the exchange rate of the U.S. dollar against the RMB would be adjusted from 8.28 yuan to 8.11, an appreciation of 2.1%. Unlike a true floating exchange rate, the RMB 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. From July 21,
2005 to July 21, 2008, the dollar-RMB exchange rate went from 8.11 to 6.83, an appreciation of
18.7%.The situation at this time might be best described as a "managed float", market forces determined the general direction of the RMB's movement, but the government retarded its rate of appreciation through market intervention.

1.2 2008: RMB APPRECIATION IS SUSPENDED

China stops its currency appreciation policy around mid-July 2008 because of declining demand and recession resulted from the effects of the global financial crisis. In 2009, Chinese exports and imports fell by 15.9% and 11.3% over 2008 levels. The Chinese government reported that thousands of export-oriented factories were shut down and that over 20 million migrant workers lost their jobs in 2009 because of the direct effects of the global economic slowdown.

1.3 2010: RMB APPRECIATION IS RESUMED

On June 19, 2010, China's central bank, the People's Bank of China (PBC), stated that, based onCurrent economic conditions, it had decided to "proceed further with reform of the RMB exchange rate regime and to enhance the RMB exchange rate flexibility." Many observers contend the timing of the RMB announcement was intended in part to prevent China's currency policy from being a central focus of the G-20 summit in Toronto. From June 2010 to November 30, 2011, the yuan/dollar exchange rate rose from 6.83 to 6.35, an appreciation of 7.6%.

2. REVIEW OF LITERATURE

The current global economic crisis has further complicated the currency issue for both the United States and China. Although China is under pressure from the United States to appreciate its currency, it is reluctant to do so because it could cause further damage to export sector and lead to more layoffs. Potential future substitute of the U.S. dollar as the dominant reserve currency is the Chinese renminbi (RMB, ¥) 6, also called Yuan (CNY). Since 2007, China is the fourth largest economy in the world measured by gross domestic product (GDP), already outrunning the United Kingdom. Currently they are the third largest global trading partner, with an average growth of 25% over the full length of the decade before 2008. Still the growth of the renminbi's global use is limited due to their peg to the U.S. dollar and other restrictions that are put on by the Chinese authorities. Albert Keidel, argued that in present condition of global trading linkages, a country's world surplus – rather than its share of the U.S. trade deficit – is the true measurement of its contribution to global imbalance. Morris Goldstein stated that revaluation of 15 per cent to 30 per cent for the RMB against the U.S. dollar based on the data of China's balance of payments and from the viewpoint of global payment imbalances.

Michael Funke and Jorg Rahn estimated a peak undervaluation of the RMB of around 15 per cent against the U.S. dollar in 2001, but they also argued that there was no evidence of the RMB being substantially undervalued between January 1985 and April 2002. The World Trade Organization (WTO) statistics show that China's share of world exports rose from 2.8 per cent to 5.8 per cent between 1993 and 2003, while shares of Japan and the Asian NIEs fell from 9.6 per cent to 6.3 per cent and 10 per cent to 9.5 per cent respectively.

According to Yu Yongding, since China's export industry is, for the most part, characterized by processing trade, and that manufacturers in the industry have strong adaptability, China's international trade situation would not be fundamentally affected if the value of the RMB rises by a small margin. Yu also stated that the RMB appreciation would force some inefficient exporters to exit from the industry and ease the vicious competition in international markets. As a result, as the terms of trade improve, China's trade surplus would increase. In addition, Chinese companies would be motivated to develop their competitiveness by advancing operational efficiency and not relying only on cheap labor costs. Wen Jiabao argued that gradually establish a market-based and well-managed floating exchange rate system and to keep the RMB exchange rate basically stable at a reasonable and balanced level is the unalterable direction and the goal of China's exchange rate reform that started from 2005.

According to Li Deshui, China would not allow the free float of the RMB in five years due to its fragile financial markets. Tao Dong argued that large and rapid appreciation of the RMB would hurt not only the Chinese exporters but also foreign consumers. Liu Wei at Peking University stated that every 1 per cent growth in GDP could provide 1.7 million employment opportunities in China. To ease the possible unemployment problem he argued that the Chinese government had to maintain continuous economic growth at a high rate.

Zhang Bin Chinese economist suggested that reversing the trend of swift growth in international reserves should be the priority of China's reserve management. Useful methods included boosting domestic demand, modernizing the financial system, reducing the need for saving and allowing the RMB to appreciate. In the long run, optimizing economic structure would be key to addressing the issue. In response to international debates, Chinese Premier Wen Jiabao said that China would further advance the reform and forge a more flexible mechanism which would adapt to changes in market supply and demand. He argued that this reform would represent a systematic project involving many aspects.

3. EFFECTS OF CHINA'S CURRENCY POLICY ON U.S ECONOMY

3.1 TRADE DEFICITS

Several U.S. policymakers and certain business men and labor representatives argued that theChinese government "manipulates" its currency in order to make it significantly undervalued against the U.S. dollar, thus making Chinese exports to the United States less expensive, and U.S exports to China more expensive, rather than exchange rates were determined by market forces. They also stated that a pegged currency may have been appropriate during China's early stages of economic development but today it cannot longer be justified, given the size of China's economy and trade flows, and the impact these have on the global economy. Policy maker also argue that the undervalued currency has been a major factor behind the burgeoning U.S. trade deficit with China, which surged from $10 billion in 1990 to $273 billion in 2010, and is estimated to reach about $295 billion in 2011. Bloomberg Government estimated that a 7% annual real appreciation of the RMB to the dollar would cut the U.S. trade deficit with China in half by 2014

3.2 EFFECT ON U.S. CONSUMERS AND CERTAIN PRODUCERS

Society's economic well-being is usually measured not by howmuch it can produce, but how much it can consume. An undervalued RMB that lowers the priceof imports from China allows the United States to increase its consumption through an improvement in the terms-of-trade. An undervalued RMB is to increase the purchasingpower of U.S. consumers. Imports from China are not limited to consumption goods. U.S. firmsalso import capital equipment and inputs from China to produce finished goods. An undervaluedRMB lowers the price of these U.S. products, increasing their output, and thus making such firms more internationally competitive. An appreciation of China's currency could raise prices for U.S. consumers, lowering their economic welfare, meaning they have less money to spend on other goods and services. In addition, firms that use imported Chinese parts could face higher costs, making them relatively less competitive.

3.3 EFFECT ON U.S. BORROWERS

An undervalued RMB also has an effect on U.S. borrowers. When the United States runs aCurrent account deficit with China, an equivalent amount of capital flows from China to theUnited 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 and also increases the size of the economy in the long run by increasing the capital stock.

3.4 UNEMPLOYMENT

The current high rate of unemployment in the United States appears to have serious concerns over the perceived impact of China's currency policy on the U.S. economy, especially employment. Many have reported that RMB appreciation would boost the level of U.S. jobs. Some analysts contend that there is a direct correlation between the U.S. trade deficit and U.S. job losses. For example, a study by the Economic Policy Institute (EPI) claims that the U.S. trade deficit with China led to the loss or displacement of 2.8 million jobs (of which, 69% were in manufacturing) between 2001 and 2010.The EPI report states that, while U.S imports from China "displace American workers who would have been employed making these products in the United States." U.S. exports to China support U.S. jobs.

3.5 EFFECT ON U.S EXPORTERS AND IMPORT-COMPETITORS

The current exchange rate policy causes the RMB to be less expensive than it would be if it were determined by supply and demand, in result Chinese exports to be relatively inexpensive and U.S. exports to China to be relatively expensive. So U.S. exports and the production of U.S. goods and services that compete with Chinese imports in the short run reduce. Many of the firms are affected in the manufacturing sector. As a result the trade deficit to rise and reduces aggregate demand in the short run, all else equal. A market-based exchange rate can help U.S. exports to boost and provide some relief to U.S. firms that directly compete with Chinese firms.

3.6 INDUCES OTHER EAST ASIAN COUNTRIES

Some analysts reported that China's currency policy encouraging other East Asian economies tointervene in currency markets and keep their currencies weak against the dollar so they can compete with Chinese goods; this action is preventing further depreciation of the dollar relative to other Asian currencies, and thus diminishing U.S. exports throughout Asia. Based on the assumption, that China's currency is undervalued by at least 40% against the dollar. Fred Bergsten stated that Chinese currency would result in a large appreciation of the RMB and other Asian currencies against the dollar which would boost U.S. exports and generate an additional 600,000 to 1.2 million jobs in the United States.20

3.7 "BEGGAR THY NEIGHBOR" POLICY

Mean's to promote Chinese economic development at the expense of other countries at a time of global economic crisis Some experts stated that a significant appreciation of the RMB would reduce the bilateral trade imbalance between China and the U.S.. For example, the study assumes that RMB appreciation would result in the appreciation of other currencies as well, which would result in a sharp drop in the overall U.S. trade deficit from an estimated $368 billion in 2011 to $59 billion in 2014. Because of these factors, some critics argue that China should be cited by the Department of the Treasury as a country that manipulates its currency in order to gain an unfair trade advantage

3.8 BARRIER IN GLOBAL ECONOMIC RECOVERY

Paul Krugman stated that the undervalued RMB has become a significant drag on global economic recovery, estimating that it has lowered global GDP by 1.4%, and has especially hurt poor countries. Claims about the negative effect of China's exchange rate on U.S. employment and trade are often juxtaposed with the observation that China's economy has grown rapidly over the past three years (real GDP grew at an average annual rate of nearly 10% from 2008 to 2010), while other countries experienced negative or stagnant growth.

4. CHINESE CONTROVERSIAL SUBSIDIES THAT DO HARM THE U.S AND GLOBAL ECONOMY

4.1 NO COMPETITION FOR STATE-OWNED ENTERPRISES

Beijing has different ways to intervene in the market, starting with simply telling companies and banks what to do. The ability to order firms to act, using laws made by the will of Communist Party, is the heart of the biggest of Chinese subsidies: protection against competition through tight regulatory control of market entry and exit. Central government controls nearly all major industries. Like oil and gas, petrochemicals, electric power, and telecommunications, aviation, coal, and shipping him state must control the sector as a whole. Sectors like autos, construction, machinery, metals, and information technology, the state's role is to expand until it controls the sector. It also control insurance, the media, railways, and China's powerful tobacco industry, nearly all banks are state-owned, providing a huge lever to control the rest of the economy.

4.2 STATE-DOMINATED INDUSTRIES IN CHINA

The collective market share of importers, foreign firms based in the PRC, and Chinese private companies is not allowed to expand beyond a certain, often minimal position. There are other examples of regulatory favoritism but there is no greater subsidy than assured market share, in this case of a large market. Further, while SOEs are said to compete with each other, the competition can be difficult to recognize. Provincial SOEs can never lose a competition because they are never allowed to go bankrupt.

4.3 TRADITIONAL SUBSIDIES

The financial subsidies to boost SOEs like access to domestic securities markets is heavily biased in their favor. Because of government-controlled interest rates, ordinary depositors now receive less on their savings than they pay in inflation negative real returns. Banks gain from this low payout but themselves can only charge for borrowing at roughly equal to the rate of inflation. Banks also must place reserves at the central bank, the People's Bank of China, at very low yields, costing revenue. That's why the People's Bank faces a rapidly deteriorating balance sheet due to irresponsible monetary policy.

4.4 SUBSIDIES LAND

Land is in principle state-owned, so that acquiring land for expansion is very easy and comparatively cheap for most SOEs then foreign firms. The size of this subsidy is growing rapidly because land value in the PRC has soared in the past few years. Acquiring land is too much difficult and increasingly expensive for non-state companies. These also face the additional problem of insecure ownership rights provincial governments can gain control of their operating sites, sometimes in order to eliminate or reduce competition for their SOEs.

5. UNITED STATE'S RESPONSE TO CHINA POLICY

5.1 PRESIDENT OBAMA POSITION AND POLICIES

President Obama stated in February 2010 that China's undervalued currency puts U.S. firms at a"Huge competitive disadvantage," and he pledged to make addressing China's currency policy atop priority. President Obama stated in November 2011that China needed to "go ahead and move towards a market-based system for their currency" and that the United States and other countries felt that "enough is enough."

Congress show deep involvement on the China currency issue as long as legislative proposals do not violate U.S. WTO obligations and do not complicate ongoing bilateral and multilateral negotiations with China on the issue. House passed different version of bills and make legislation on these serious issues. Administration official stated that "we share the goal of the legislation in taking action to ensure that our workers and companies have a more level playing field with China, including addressing the under-valuation of their currency.

5.2 OVERCOME THROUGH DIALOGUE

The Obama Administration has sought to directly engage China on the currency issue through the Strategic & Economic Dialogue (S&ED) and the Joint Commission on Commerce and Trade(JCCT). Secretary of the Treasury Tim Geithner stated: "We hope that China moves to allow the exchange rate to appreciate more rapidly and more broadly against the currencies of all its trading partners.

5.3 USAGE OF MULTI CHANNELS

It has sought to use different channels, such as the Group of 20 (G-20) of leading economies and the IMF, as a means to boost international cooperation on external balances and exchange rate policies and to bring more pressure on China to appreciate its currency. Secretary Geithner issued a proposal aimed at the G-20 meeting of finance ministers and central bank governors on October 23, 2010. The proposal contained three main points:

- G-20 countries should commit to taking steps to reduce external imbalances (Both surpluses and deficits) below a specified share of GDP over the next few Years.
- G-20 countries should commit to refrain from exchange rate policies designed to achieve competitive advantage by either weakening their currency or preventing Appreciation of an undervalued currency. G-20 emerging market countries need to allow their exchange rates to adjust fully with market base system.
- The G-20 should call on the IMF to assume a special role in monitoring progress on these commitments and should publish a semiannual report assessing progress the G-20 countries have made to achieve these goals.

5.4 LEGISLATIVE PROPOSALS

Over the last few years, some legislative proposals have sought to apply U.S. anti-dumping andcountervailing duty measures to address the effects of China's undervalued currency, namely to

Treat it as an export subsidy (countervailing measures) or as a factor that is included in the determination of anti-dumping duties. Several supporters of currency legislation aimed at China hope that the introduction of such legislation and bills will induce China to appreciate its currency more rapidly. Critics of the bill contend that such legislation could antagonize China and induce it to slow the rate of RMB appreciation. S.1619,H.R.639/S.328,S.1130 is some bills that introduced by U.S officials in Congress.

6. CONCLUSION AND POLICY OPTIONS

It is concluded that if the Chinese were to allow their currency to float, it would be determined by private actors in the market based on the supply and demand for Chinese goods and assets relative to U.S. goods and assets. If the RMB appreciated as a result, this would boost U.S. exports and the output of U.S. producers who compete with the Chinese. The U.S. bilateral trade deficit would likely decline (but not necessarily disappear).

When Chinese central bank would no longer purchase U.S. assets to maintain the peg. U.S. borrowers, including the federal government, would now need to find new lenders to finance their borrowing, and interest rates in the United States would rise. This would reduce spending on interest-sensitive purchases, such as capital investment, housing (residential investment), and consumer durables. The reduction in investment spending would reduce the long-run size of the U.S. capital stock, and thereby the U.S. economy. In the present context of a large U.S. budget deficit, some analysts fear that a sudden decline in Chinese demand for U.S. assets (because China was no longer purchasing assets to influence the exchange rate) could lead to a drop in the value of the dollar that could potentially destabilize the U.S. economy and if the relative demand for Chinese goods and assets were to fall at some point in the future, the floating exchange rate would depreciate, and the effects would be reversed.

A move to a floating exchange rate is typically accompanied by the elimination of capital controls that limit a country's private citizens from freely purchasing and selling foreign currency. The Chinese government maintains capital controls because it fears a large private capital outflow would result if such controls were removed. This might occur because Chinese citizens fear that their deposits in the potentially insolvent state banking system are unsafe. If the capital outflow were large enough, a banking crisis in China could result and could cause the floating exchange rate to depreciate rather than appreciate, If this occurred, the output of U.S. exporters and import competing firms would be reduced below the prevailing level, and the U.S. bilateral trade deficit would likely expand. In other words, the United States would still borrow heavily from China, but it would now be private citizens buying U.S. assets instead of the Chinese central bank.

It is also possible for China to maintain the status quo. Even without adjustment to theNominal exchange rate, over time the real rate would adjust as inflation rates in the two countries diverged. The Chinese central bank acquires foreign reserves by printing yuan to finance its trade surplus. As the central bank exchanged newly printed yuan for U.S. assets, prices in China would rise along with the money supply until the real exchange rate was brought back into line with the market rate. This would cause the U.S. bilateral trade deficit to decline and expand the output of U.S. exporters and import-competing firms.

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