

## The China Currency Conundrum

Charles Freeman

November 26, 2007

Many observers have been convinced for several years that China's currency, the renminbi (RMB), is undervalued. Given the relative strength of the Chinese economy, the extent to which Beijing has to intervene in financial markets to maintain the value of the RMB at current levels, and other factors, this conclusion is now widely accepted, including by many at the highest echelons of the Chinese government. What is not widely accepted or understood is the impact of China's currency value either on China or on other markets, including the United States.

### Q1: Why does China peg its currency to the U.S. dollar?

**A1:** For most of the nearly 60-year history of the People's Republic, China tightly controlled the RMB (of which the principal unit is the yuan), reflecting China's underlying command economy in which wages and prices were fixed. In 1994, as the economy began to open up and market forces were introduced, the authorities in Beijing formally pegged the RMB to the U.S. dollar. During the Asian financial crisis in the late 1990s, Beijing held firm to the dollar peg, earning kudos for forestalling a successive wave of devaluations by other Asian currencies. By the early part of this century, however, after China's World Trade Organization entry and a booming economy, a rigidly pegged RMB began to less clearly reflect the values of the Chinese economy than it did in China's previous, less market-oriented incarnation. This particularly showed as China began to run overall global current account surpluses at record levels without any subsequent appreciation in the RMB.

### Q2: How does the currency issue play in China?

**A2:** In the last several years, the rigidity of China's currency regime has hamstrung Beijing's economic leadership as they have sought to manage the occasionally overheating economy. Without a flexible currency regime, they are limited in their ability to raise interest rates (which would attract outside speculators and push the RMB higher), so they have been forced to wield crude administrative controls to slow economic activity—such as cutting off power supplies to factories or mandating work stoppages—that are highly subject to local abuse. In recent months, China has been dealing with inflationary pressures that are due in part to the failure to allow an appreciation of the RMB to market levels.

There is broad agreement in Beijing that China's currency regime needs to be reformed to keep pace with the rest of its economy. Unfortunately, not all elements of China's society are keeping pace with that economy, and Beijing, which worries above all about stability, is primarily concerned with making sure that any currency reform, even if needed to reflect the cutting-edge nature of its globalized economy, does not create instability in its less-developed economic sectors. The consensus in Beijing is therefore that any reform in the way that the RMB is valued and traded will proceed with only the most minimal of impacts on China's society as a whole. This frustrates some policymakers in Beijing, who struggle to manage twenty-first century monetary issues with twentieth century tools in order to keep the lid on nineteenth century social ills. It certainly frustrates foreign policymakers and those that would like Beijing's decisionmaking to conform to U.S. political timetables.

### Q3: Why is China's currency such a big political issue in the United States? Does an undervalued RMB mean lost U.S. manufacturing jobs?

**A3:** In the United States, an undervalued RMB is understood to distort global investment patterns and other financial flows. However, the widely held view that the RMB's value is a primary competitive advantage for China's manufacturing economy, and thus a significant factor in the U.S. bilateral trade deficit with China, may overstate the problem. For a number of reasons, China's currency is an important issue with which U.S. policymakers should grapple. The value of the RMB is certainly on the rise and will ultimately settle at a level approaching what market conditions would otherwise dictate. But fanning public expectations that a major revaluation of the RMB will lead to significant adjustments to the trade deficit, or more fundamentally, to the return of manufacturing jobs to beleaguered parts of the United States, may be dangerous, given that those expectations seem destined to be dashed.

## CRITICAL QUESTIONS

In 2003, the U.S. trade deficit with China exceeded \$100 billion for the first time, by U.S. Department of Commerce statistics. In 2007, that deficit will exceed \$230 billion. The bulk of imports from China to the United States are manufactured goods. With the U.S. manufacturing sector having shed some 3 million jobs in the past six years, many commentators view imports from China as replacing products that would have been manufactured in the United States. In this environment, it is not surprising that U.S. manufacturers would be concerned about any advantage Chinese exporters might have over U.S. production. Clearly, if the RMB is undervalued, it ensures that Chinese products will cost less on global markets than they otherwise would and that the RMB's value acts as a de facto export subsidy for Chinese manufacturers. Given the complexity of the market, it is difficult, if not impossible, to gauge the extent of the subsidy. In addition, evidence suggests that even taking into account relatively high estimated values for the RMB, the landed costs of many competitive products produced in China are still below those at which they can be competitively produced in the United States under similar conditions. Ultimately, most of the products imported from China into the United States have replaced products imported from other countries. This suggests that even if China revalued the RMB to the extent that bilateral trade patterns changed, production in China would not revert to the United States but would instead go to third country markets and be sourced from there.

**Q4: So why should the Congress and the administration spend so much time addressing the China currency question?**

**A4:** The ability of China's policymakers to have a flexible RMB regime is important because without it, they are left without a critical monetary policy tool to manage their own economy. They are left to manage boom-bust cycles of one of the world's leading economic engines with crude administrative tools and are hamstrung by their own currency policy. If China was still a command economy cut off from the rest of the world, its currency policy would not be of particular importance to the United States. After 25 years of integration with the global economy, however, what transpires in China's economy is of critical importance to the rest of the world. In monetary terms, if China catches a cold, the rest of the world will get sick too. A flexible currency is one way China can help inoculate itself.

*Charles Freeman holds the Freeman Chair in China Studies at the Center for Strategic and International Studies in Washington, D.C.*

***Critical Questions*** is produced by the Center for Strategic and International Studies (CSIS), a private, tax-exempt institution focusing on international public policy issues. Its research is nonpartisan and nonproprietary. CSIS does not take specific policy positions. Accordingly, all views, positions, and conclusions expressed in this publication should be understood to be solely those of the author(s).

© 2007 by the Center for Strategic and International Studies.