

# CHINA BALANCE SHEET

## EXCHANGE RATE

The direction that China and U.S.-China relations take will define the world's future. For the United States, a rising China increasingly affects American prosperity and security, calling for some clear-eyed thinking and tough economic, political, and security choices. As the twenty-first century unfurls, the stakes have never been higher for getting U.S. policy toward China right. By untangling the complex, sometimes contradictory, strands of this vast and dynamic country, *China: The Balance Sheet* lays the foundation for informed and effective U.S. policy toward China, the world's emerging superpower.

### BACKGROUND

- **The Chinese renminbi (RMB) is undervalued by 20 percent to 40 percent on average and by even more against the dollar.** This distortion adds substantially to the competitiveness of Chinese products in international trade.
- Some other Asian countries are reluctant to let their exchange rates rise against China's because of the adverse effects on their own competitiveness. **RMB undervaluation thus promotes undervaluation of other important currencies against the dollar.** A substantial RMB revaluation is essential to moderate the huge global trade imbalances centered on the **U.S. current account deficit, which reached \$857 billion (6.5 percent of GDP) in 2006.**
- **Most countries let their currencies fluctuate largely in response to market forces. China, however, over the past few years on average has purchased about \$20 billion per month in the exchange markets to resist market pressures for a stronger RMB.** Those pressures emanate from China's large and rapidly growing trade surpluses, substantial inflows of foreign direct investment and in some years speculative capital inflows betting on eventual RMB revaluation. **Because of this intervention since 2002, during a period when the dollar was declining against most other currencies, the RMB has actually fallen in value against most currencies and enabled China to become even more competitive.**

For further information, see Chapter 4:

“China in the World Economy: Opportunity or Threat?”

*China: The Balance Sheet: What the World Needs to Know Now about the Emerging Superpower*

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## CURRENT SITUATION

- Two issues arise: the level of the exchange rate of RMB and the currency regime implemented by China. The U.S. government, G-7, and IMF have tended to focus on the regime, arguing that China should let its currency fluctuate in response to market forces. **The Chinese, while agreeing that a floating currency is desirable in the long run, have responded that such a change now could produce a large movement of money out of the country that would further weaken China's banking system and jeopardize its economy.** This position, however, confuses two issues -- floating the currency and the relaxation of capital controls. It is quite feasible to do the former but not the latter.
- **The immediate need is for a substantial rise in the value of the RMB rather than a relaxation of capital controls.** A rise in the rate can be achieved by one or more revaluations or by allowing the currency to float upward. China has taken several small steps in that direction, revaluing by 2.1 percent in July 2005 and letting the currency creep upward a bit further since. The accumulated appreciation of RMB against the US dollar until mid-March 2007, including the initial 2.1 percent, was 6.5 percent. Through early 2007, however, China continued to intervene massively to keep the RMB from rising substantially.
- China resists currency appreciation for several reasons. **It values the "stability" offered by its fixed peg to the dollar** (although the wide fluctuations of the dollar against most other currencies instead produce a very unstable RMB). It hesitates to inject a new uncertainty into its economic outlook. **It worries that any reduction in its trade competitiveness would add to its transitional unemployment.** It also apparently doubts that the United States or the relevant international organizations (IMF, WTO) will force it to move, essentially viewing currency undervaluation as an off-budget job and export subsidy that avoids effective international reaction.

## IMPLICATIONS

- **China will have to phase in a faster expansion of domestic consumption and government spending to offset the dampening of its economic growth from the decline in its trade surplus that is the intended result of currency appreciation.** Fortunately, sharp increases in government spending on health care, education, and pensions are needed in any event because such benefits, which were previously provided by state-owned enterprises, are now grossly inadequate and social unrest has resulted from their elimination.
- A sizable revaluation of the RMB, however, is essential for three reasons. **It would moderate China's own surplus against the United States and the rest of the world. It would enable other Asian surplus countries to let their currencies rise against the RMB** (and hence against the dollar) and thereby participate constructively in the global adjustment process. **It would head off protectionist pressures against China in both the United States and Europe,** pressures likely to erupt in the near future in the absence of substantial revaluation.