CORRECTING THE CHINESE EXCHANGE RATE:
AN ACTION PLAN

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The Problem

The Chinese renminbi (RMB) is undervalued by about 25 percent on a trade-weighted average basis and by about 40 percent against the dollar.[2] The Chinese authorities buy about $1 billion daily in the exchange markets to keep their currency from rising and thus to maintain an artificially strong competitive position. Several neighboring Asian countries of considerable economic significance – Hong Kong, Malaysia, Singapore and Taiwan – maintain currency undervaluations of roughly the same magnitude in order to avoid losing competitive position to China.

This competitive undervaluation of the RMB is a blatant form of protectionism. It subsidizes all Chinese exports by the amount of the misalignment, about 25 – 40 percent. It equates to a tariff of like magnitude on all Chinese imports, sharply discouraging purchases from other countries. It would thus be incorrect to characterize as "protectionist" a policy response to the Chinese actions by the United States or other countries; such actions should more properly be viewed as anti-protectionist.

Largely as a result of this competitive undervaluation, China's global current account surplus soared to almost $400 billion and exceeded 11 percent of its GDP in 2007, an unprecedented imbalance for the world's largest exporting country and second largest economy. China's global surplus declined sharply during the Great Recession, as its foreign markets weakened, but it

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[2] William R. Cline and John Williamson, "2009 Estimates of Fundamental Equilibrium Exchange Rates," Peterson Institute for International Economics, 2009, Policy Brief 09-10 and Morris Goldstein and Nicholas R. Lardy. July 2009. *The Future of China's Exchange Rate Policy*. Policy Analyses in International Economics 87, Washington: PIIE. The Cline-Williamson estimates are quite conservative because they aim only to reduce China's global surplus to 3-4 percent of its GDP on the view that such levels would be consistent with a sustainable global equilibrium; their estimate of the RMB undervaluation would of course be much greater if the goal were to fully eliminate the country's external surplus, which would be quite reasonable for a developing country that already has accumulated $2.5 trillion of foreign exchange reserves.

remained above 5 percent of China's GDP (almost $275 billion) even in 2009. The International Monetary Fund estimates that the surplus is rising again and, at current exchange rates, will exceed the global deficit of the United States by 2014.[3] In a world where high unemployment and below-par growth are likely to remain widespread for some time, including in the United States, China is thus exporting very large doses of unemployment to the rest of the world – including the United States but also to Europe and to many emerging market economies including Brazil, India, Mexico and South Africa.[4]

China's exchange rate policy violates all relevant international norms. Article IV, Section 1 of the Articles of Agreement of the International Monetary Fund commits member countries to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payment adjustment or to gain unfair competitive advantage over other member countries." Moreover, the principles and procedures for implementing the Fund's obligation (in Article IV, Section 3) "to exercise firm surveillance over the exchange rate policies of members" call for discussion with a country that practices "protracted large-scale intervention in one direction in exchange markets" – a succinct description of China's currency policy over the past seven years. Article XV(4) of the General Agreement on Tariffs and Trade (GATT), which is now an integral part of the World Trade Organization, similarly indicates that "Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this Agreement."

Huge current account imbalances, including the US deficit and the Chinese surplus, of course reflect a number of economic factors (national saving and investment rates, the underlying competitiveness of firms and workers, etc.) other than exchange rates. Successful international adjustment of course requires corrective action by the United States, particularly with respect to its budget deficit and low national saving rate, and other countries as well as by China. But it is impossible for deficit countries to reduce their imbalances unless surplus countries reduce theirs. And restoration of equilibrium exchanges rates is an essential element of an effective global "rebalancing strategy" as agreed by the G-20 over the past year.[5]

The competitive undervaluation of the Chinese RMB and several neighboring Asian countries has a very substantial impact on the United States. As noted, an appreciation of 25-40 percent is needed to cut China's global surplus even to 3-4 percent of its GDP. This realignment would produce a reduction of $100 – 150 billion in the annual US current account deficit.[6]

Every $1 billion of exports supports about 6,000 – 8,000 (mainly high-paying manufacturing) jobs in the US economy. Hence such a trade correction would generate an additional 600,000 –

[3] Olivier Blanchard and Gian Maria Milesi-Ferretti, March 18, 2010 "Global Imbalances: In Midstream?", Washington: IMF, Table 7.

[4] Note that I make no reference to the United States – China bilateral trade imbalance in this statement. Bilateral balances are irrelevant in a world of multilateral trade. It should be noted, however, that China's global surplus exceeded one half of the US global deficit in 2007 and, as noted in the text, is on a trajectory to exceed it by 2014.

[5] The best analysis of the needed Chinese component of this strategy can be found in Nicholas Lardy, "China: Rebalancing Economic Growth," Chapter 1 in Center for Strategic and International Studies and Peterson Institute for International Economics, *The China Balance Sheet in 2007 and Beyond*, May 2007.

[6] William R. Cline and John Williamson, "2009 Estimates of Fundamental Equilibrium Exchange Rates," Peterson Institute for International Economics, 2009, Policy Brief 09-10 show that the Asian undervaluations equate to a trade-weighted overvaluation of about 6 percent of the dollar. Every 1 percent dollar overvaluation leads to a deterioration of $20-25 billion in the US current account balance so correction of the Asian misalignments would strengthen the US position by $120 – 150 billion over the succeeding two to three years.

1,200,000 US jobs. Correction of the Chinese/Asian currency misalignment is by far the most important component of the President's new National Export Initiative. As its budget cost is zero, it is also by far the most cost-effective step that can be taken to reduce the unemployment rate in the United States.

China did let its exchange rate appreciate gradually from July 2005 until the middle of 2008 (and rode the dollar up for a while after it re-pegged in the fall of 2008). During that time, the maximum increase in its trade-weighted and dollar values was 20-25 percent (which represented good progress although it still left an undervaluation of roughly a like amount at that time). It has since depreciated again significantly, riding the dollar down, so that its net rise over the past five years is only about 15 percent. Moreover, despite China's declared adoption of a "market-oriented" exchange rate policy in 2005, its intervention to block any further strengthening of the RMB against the dollar is about twice as great today ($30 – 40 billion per month) as it was then ($15 – 20 billion per month); on that metric, China's currency policy is now about half as market-oriented as it was prior to adoption of the "new policy."

The present time is highly opportune for China to begin the process of restoring an equilibrium exchange rate. The Chinese economy is booming, indeed leading the world recovery from the Great Recession (and China deserves great credit for its effective crisis response strategies). Inflation is now rising and the Chinese authorities have begun to take monetary and other measures to avoid renewed overheating; currency appreciation would be an effective and powerful tool to this end by lowering the price of imports and dampening demand for exports.[7] Appreciation of the RMB at this time would in fact serve both the internal and external policy objectives of the Chinese authorities, as part of their long-stated intention and international commitment to rebalance the country's economic growth away from exports and toward domestic (especially consumer) demand.

An Action Plan

The case for a substantial increase in the value of the RMB is thus clear and overwhelming. Some observers believe that China is in fact preparing to shortly renew the gradual appreciation of mid-2005 to mid-2008 (5 – 7 percent per year) or even to announce a modest (5-10 percent) one-shot revaluation (with or without resuming the upward crawl in addition). On the other hand, Premier Wen Jiabao recently denied that the RMB was undervalued at all and accused other countries (!) of seeking to expand exports and create jobs by unfairly depreciating their exchange rates.[8]

Unfortunately, the two preferred strategies for promoting Chinese action – sweet reason and implementation of the multilateral rules, especially in the IMF – have to date had limited success. Both efforts should continue, however, and it is particularly important that any stepped-up initiatives toward China be multilateral in nature. The Chinese are much more likely to respond positively to a multilateral coalition rather than bilateral pressure from the United States, especially if that coalition contains a number of emerging market and developing economies whose causes the Chinese frequently claim to champion. Moreover, the multilateral efforts have been half-hearted at best and

[7] China effectively sterilizes most of the monetary effect of its exchange-market intervention so the large capital inflow and upward pressure on the RMB do not have any of the usual inflationary (and hence real currency appreciation) impact.
[8] This was apparently the first time that a high Chinese official has asserted that there is no RMB undervaluation, a substantial step backward if correct.

it is especially important for the United States to exhaust that route before contemplating more severe unilateral steps.

Much of the blame for this failure of policy to date falls on the US Government, which has been unwilling to label China the currency manipulator that it has been so clearly for a number of years. The unwillingness of the United States to implement the plain language of the Trade Act of 1988 has substantially undermined its credibility in seeking multilateral action against China in the IMF, the WTO, the G-20 or anywhere else. A sensible and effective strategy must begin by reversing that feckless position.

Hence I would recommend that the Administration adopt a new three-part strategy to promote early and substantial appreciation of the exchange rate of the RMB:

1. Label China as a "currency manipulator" in its next foreign exchange report to the Congress on April 15 and, as required by law, then enter into negotiations with China to resolve the currency problem.[9]

2. Hopefully with the support of the European countries, and as many emerging market and developing economies as possible, seek a decision by the IMF (by a 51 percent majority of the weighted votes of member countries) to launch a "special" or "ad hoc" consultation to pursue Chinese agreement to remedy the situation promptly. If the consultation fails to produce results, the United States should ask the Executive Board to decide (by a 70% majority of the weighted votes) to publish a report criticizing China's exchange rate policy.[10]

3. Hopefully with a similarly broad coalition, the United States should exercise its right to ask the World Trade Organization to constitute a dispute settlement panel to determine whether China has violated its obligations under Article XV ("frustration of the intent of the agreement by exchange action") of the WTO charter and to recommend remedial action that other member countries could take in response. The WTO under its rules would ask the IMF whether the RMB is undervalued, another reason why it is essential to engage the IMF centrally in the new initiative from the outset. [11]

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[9] It would be desirable to also label the four other Asian economies that clearly manipulate their exchange rates to maintain a close relationship to the RMB: Hong Kong, Malaysia, Singapore and Taiwan. They should in fact be covered by all elements of the recommended three-part strategy. However, including them would complicate the strategy considerably and deflect attention away from China as the central actor (and Taiwan, the most important in economic terms, is not a member of the IMF). It can be safely assumed that all four will let their currencies follow the RMB upward, however, so success in achieving its appreciation should take care of the others more or less automatically and should suffice. Alternatively, they could get together (perhaps with other countries in the region) to work out an "Asian Plaza" agreement that would realign exchange rates among them.

[10] These procedures are spelled out in detail by Morris Goldstein, the former Deputy Director of the Research Department of the Fund, in "The IMF as Global Umpire for Exchange Rate Policies," in Michael Mussa, ed, *C. Fred Bergsten and the World Economy*, Washington: PIIE, 2006, esp. pp. 330 – 331. See also the extensive discussion by Mussa, the chief economist of the Fund for 10 years (1991 – 2001), in "IMF Surveillance over China's Exchange Rate Policy" in Morris Goldstein and Nicholas Lardy, eds, *Debating China's Exchange Rate Policy*, Washington: PIIE, 2008, esp. pp. 328 – 332. These procedures need to be strengthened, as argued by both Goldstein and Mussa, but those presently in place will have to suffice in dealing with the current problem.

[11] The Managing Director of the IMF has repeatedly stated, most recently in a major speech to the European Parliament last week, that the RMB is "substantially undervalued." Hence the required advice should be readily forthcoming.

A three-pronged initiative of this type would focus global attention on the China misalignment and its unwillingness to initiate corrective action to date. The effort would have maximum impact if it could be undertaken by the United States in concert with countries that constituted a substantial share of the world economy, including emerging market and developing economies as well as the Europeans and other high-income nations. Asian countries, such as Japan and India, will be skittish in confronting China in this way but are hit hard by the Chinese undervaluation and should be increasingly willing to join the coalition as its size grows.

The objective of the exercise is of course to persuade, or "name and shame," China into corrective action. Unfortunately, the IMF has no sanctions that it can use against recalcitrant surplus countries.[12] Hence the WTO, which can authorize trade sanctions against violations of its charter, needs to be brought into the picture from the outset.[13] Unfortunately, there are technical and legal problems with the WTO rules too (like the IMF rules) so they may also need to be amended for future purposes.[14]

The United States could of course intensify its initiative by taking unilateral trade actions against China. For example, the Administration could decide that the undervaluation of the RMB constitutes an export subsidy in determining whether to apply countervailing duties against imports from China. Congress could amend the current countervailing duty legislation to make clear that such a determination is legal. In either case, China could appeal to the WTO and the United States would have to defend its actions under the Subsidy Code.[15]

Countervailing duties and other product-specific or sector-specific steps, such as the Section 421 case on tires last year or traditional Section 201 safeguard cases, are basically undesirable, however, because they distort and disguise the across-the-board nature of the Chinese currency misalignment.[16] These measures are intended to address problems that are unique to a particular product or sector rather than affecting trade and the economy as a whole. As noted above, China's competitive undervaluation represents a subsidy to all exports and a tariff on all imports. Hence it requires a comprehensive response via the exchange rate itself since there is no good alternative. A US effort that encompasses unilateral, IMF and WTO dimensions to that end is likely to be the most effective strategy we can undertake at this time.

[12] It can of course withhold funding from recalcitrant deficit countries, like Greece at present, that need both to borrow from it directly and to receive its blessing for adjustment policies that will permit them to resume borrowing in private capital markets.

[13] The entire range of WTO options are described and analyzed in Gary Clyde Hufbauer, Yee Wong and Kekti Sheth, August 2006. *US-China Trade Disputes: Rising Tide, Rising Stakes*: Policy Analyses in International Economics 78, Washington DC, Peterson Institute for International Economics.

[14] As proposed by Aaditya Mattoo and Arvind Subramanian, "Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization," Peterson Institute for International Economics, 2008, Working Paper 08-02.

[15] Any new legislation on this issue should require that the Treasury Department make the exchange rate calculations and that the United States withdraw its cases if they are rejected by the WTO Dispute Settlement Mechanism.

[16] There are likewise a number of China's trade and industrial policies of current concern, most notably of late under the heading of its National Indigenous Innovation Policy and particularly including protection of intellectual property rights, that are product-specific or sector-specific and need to be addressed via policy actions of that type rather than the across-the-board measures discussed here in the currency context.