MEMO

To: **Reporters and Editors**

From: **Ways and Means Committee Chairman Sander M. Levin**

Date: **September 22, 2010**

Re: **Background on China's undervalued currency and its economic impact**

Issue Overview

Economists generally agree that the Chinese currency (the renminbi – "RMB" or "yuan") is "substantially undervalued" (in the words of IMF staff) as a result of market intervention by the Government of the People's Republic of China. This policy artificially raises the price of U.S. exports to China and suppresses the price of Chinese imports into the United States. In June (shortly before a G-20 meeting), China announced that it would allow the RMB to appreciate for the first time since the middle of 2008. Since then, however, China has allowed the RMB to appreciation less than one percent against the dollar. This policy is one of many policies in China that appears to distort trade and investment flows, and there are growing concerns that China may be moving further away from market-based economic reform in key areas toward increased use of a system often described as "state capitalism."[1]

Section I of this paper describes China's exchange rate policy. Section II describes the effect that China's policy has on the U.S. trade deficit, and the effect of that deficit on U.S. economic growth and employment.

I. China's Exchange Rate Policy

The Government of China determines the value of the renminbi (RMB) by intervening in the currency markets: Its central bank sells RMB and buys dollars, dollar-denominated assets and other foreign assets, thereby keeping the value of each unit of RMB artificially low. By contrast, the United States, the EU, and most other major economies allow the market to determine the value of their currency relative to other currencies (a "floating" exchange rate).

Degree of Undervaluation. Estimates of RMB undervaluation vary, based on the economic models that are used. But, according to one often cited estimate by the Peterson Institute of International Economics, the RMB is undervalued by about 24 percent against the dollar.[2] While the Government of China announced that it would begin to allow some flexibility

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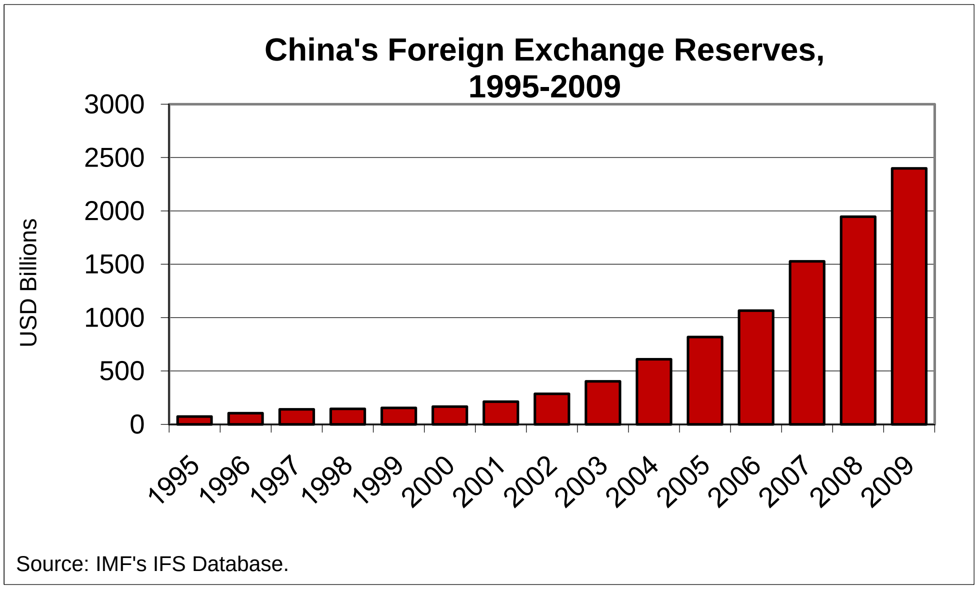
[1] The Committee held a hearing on many of these policies, and on China's general economic direction, on June 16th. See also Keith Bradsher, "On Clean Energy, China Skirts Rules," New York Times, September 8, 2010.

[2] "Estimates of Fundamental Equilibrium Exchange Rates, May 2010," William R. Cline and John Williamson, Peterson Institute for International Economics, Policy Brief Number PB10-15, June 2010. According to reports in the Wall Street Journal and elsewhere, the IMF staff recently estimated that undervaluation is as much as 25 percent. Other estimates of undervaluation include 25% (Rodrik, Harvard University, December 2009), 30-48% (Ferguson &

in the exchange rate on June 19th (shortly before a G-20 Summit), the Government of China continues to intervene in the currency markets and has allowed the RMB to appreciate less than one percent against the dollar in the past three months.

Foreign Asset Accumulation. The Government of China accumulates roughly $1 billion each day in foreign assets as a result of these interventions. It now holds more than $2.4 trillion in foreign assets – far greater than the reserves of any other country today and generally believed to be greater than the reserves held by any other country in history.[3]



II. Impact on U.S. Economy (GDP Growth and Job Creation)

China's policy may have at least four harmful effects outside of China: (1) it may contribute to large trade deficits in the United States (and other economies), putting a drag on economic growth and job creation; (2) it may have a negative impact on trade policies, as some countries are reluctant to open their economies further to imports (including in WTO negotiations); (3) it may depress interest rates, and may have contributed to the financial crisis[4]; and (4) it may distort investment patterns, as China looks to invest overseas the dollars it accumulates to keep the RMB undervalued. This memorandum and the hearing focus on the first effect.

Schularick, Harvard and Freie Universistat Berlin, October 2009), 12% (Reisen, OECD, December 2009), 49% (Economist's "Big Mac" Index, January 2010), and 50-60% (Aliber, University of Chicago, December 2009).

[3] International Monetary Fund, *International Financial Statistics*, 1940 to 2009, foreign exchange reserves, data series 1D.SZF and 1D.DZF. In fact, China currently has more foreign exchange reserves than the entire world did in 2000.

[4] See, e.g., Sebastian Mallaby, "What OPEC Teaches China," *Washington Post*, January 25, 2009 ("[China's currency] manipulation is arguably the most important cause of the financial crisis".); see also White House Press Release, December 21, 2008 ("[T]he most significant factor leading to the housing crisis was cheap money flowing into the U.S. from the rest of the world so that there was no natural restraint on flush lenders to push loans on Americans in risky ways.").

Recent economic data has highlighted the role the U.S. trade deficit plays in economic growth and job creation.[5] Government data released in August indicated that an increase in the U.S. trade deficit in the second quarter of 2010 deducted 3.4 percentage points from GDP growth – the largest subtraction since the fourth quarter of 1947.[6] (Second quarter GDP growth was 1.6 percent.) Over the past 10 years, the United States has experienced its largest trade deficits in recorded history, and our trade deficit with China is by far the largest contributor to the overall U.S. trade deficit. Peter Morici, the former chief economist of the International Trade Commission recently estimated that the U.S. trade deficit with China will reduce U.S. GDP in 2010 by more than $400 billion, or nearly 3 percent.[7]

The undervalued RMB contributes significantly to the U.S. trade deficit.[8] It makes China's exports cheaper than they would be if China allowed its currency to appreciate, leading many economists to describe China's policy as effectively operating as an export subsidy.[9] It also makes U.S. and other countries' exports to China more expensive.[10] Suppose, for example, that a U.S. manufacturer wishes to export widgets to China. In the U.S. market, he sells the widget for $100. His Chinese competitor sells widgets in China for 600 RMB. At an exchange rate of 6.80 RMB per dollar, the $100 U.S. widget would sell in China for 680 RMB, substantially higher than the Chinese widget price. But if the RMB appreciated 20 percent relative to the dollar, the price of the $100 U.S. widget would be 544 RMB – well below the price of the Chinese widget.

The National Association of Manufacturers recently reported that "NAM members, especially smaller manufacturers, have made it clear that the number-one factor affecting their exports is the value of the dollar."[11] Based on an historical analysis going back to 1972, NAM concluded that, if the dollar is overvalued relative to other currencies, "there is virtually no chance of doubling U.S. exports in five years [an objective of President Obama's] – or even

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[5] A country's gross domestic product (GDP) is equivalent to the sum of: household consumption, government spending, investment, and net exports (exports minus imports). Thus, a trade deficit (value of imports exceeds the value of exports) reduces a country's GDP, all other things being equal.

[6] *See, e.g.,* Bureau of Economic Analysis, National Economic Accounts, Table 1.1.2 (Contributions to Percent Change in Real Gross Domestic Product), last revised Aug. 27, 2010 (http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=2&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Qtr&FirstYear=1947&LastYear=2010&3Place=N&Update=Update&JavaBox=no); and Lucia Mutikani, "Imports Stifle 2nd-Quarter Growth," Reuters, August 27, 2010.

[7] Ariana Eunjung Cha and Sonja Ryst, "Stocks Plunge as U.S. Trade Deficit Is Wider Than Expect," Washington Post, August 12, 2010.

[8] President George W. Bush recognized this more than six years ago, in 2004, and again in 2007: "We still have got a huge trade deficit with China which then causes us to want to work with them to adjust – to let their currency float. We think that would be helpful in terms of adjusting trade balances."

[9] *See, e.g.,* Federal Reserve Chairman Ben Benanke, December 2006 (and reiterated in July 2010): Describing China's exchange rate policy as an "effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market." And Martin Wolf, Chief Economics Commentator for the Financial Times, December 2009: "[T]he policy of keeping the exchange rate down is equivalent to an export subsidy … in other words, to protectionism."

[10] While the export price of the Chinese exports would rise as a result of the appreciation, the costs of imported inputs in China would decline. Thus, a decline in input costs could offset some of the increase in export prices necessitated by the appreciation of the RMB.

[11] "Blueprint to Double Exports in Five Years," National Association of Manufacturers, July 26, 2010.

seeing any amount of significant growth." [12] NAM therefore urged that the Administration to "spare no effort to see that other currencies are market-determined and free of government intervention[.]"[13]

Several economists have estimated the effect of China's policy on the U.S. trade deficit, economy, and employment:

- **Paul Krugman**, winner of the 2008 Nobel Prize in Economics, estimates that China's exchange rate policy reduces U.S. GDP by 1.4 to 1.5 percentage points annually and reduces U.S. employment by **1.4 or 1.5 million jobs.**[14]

- **Fred Bergsten**, Director of the Peterson Institute for International Economics, estimates that a 20-40% appreciation of the RMB would result in $100-$150 billion improvement in the U.S. trade deficit and would generate **700,000 to 1 million jobs in the United States.**[15]

- **Steven Dunaway**, a former IMF official and senior fellow at the Council on Foreign Relations, has noted that some analysts expect an appreciation would add **half a percentage point to GDP** in the United States and other developed countries."[16]

Commentators also note that it will be difficult for countries such as the United States to reduce their fiscal deficits without a substantial revaluing of the RMB – and that an appreciation of the RMB is a relatively "costless" way to improve the economy and create U.S. jobs. [17] By the same token, as the New York Times editorial board recently noted, "fiscal stimulus efforts have been weakened by inflows of cheap Chinese imports that have soaked up some of the money added by these government programs."[18]

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12 Id.

13 Id.

14 See Paul Krugman, "Chinese New Year," New York Times, January 1, 2010 (China "follows a mercantilist policy, keeping its trade surplus artificially high. And in today's depressed world, that policy is, to put it bluntly, predatory."); and Comments at Economic Policy Institute Forum, March 12, 2010.

15 C. Fred Bergsten, Comments at Economic Policy Institute Forum, March 12, 2010; C. Fred Bergsten, "How Best to Boost Exports," Washington Post, February 3, 2010; A15 (The exchange rate "is the most important factor in determining U.S. export competitiveness.").

16 Steven Dunaway, "China's Exchange Rate Policy: The Heat Is On," Council on Foreign Relations Expert Brief, February 18, 2010.

17 Martin Wolf, "Why China's Exchange Rate Policy is a Common Concern," Financial Times, December 9, 2009, p.11 ("What would happen if the deficit countries [such as the United States] did slash spending relative to incomes while their trading partners were determined to sustain their own excess of output over incomes and export the difference? Answer: a depression. What would happen if deficit countries sustained domestic demand with massive and open-ended fiscal deficits? Answer: a wave of fiscal crises."); see also Olivier Blanchard and Gian Maria Milesi-Ferretti, "Global Imbalances: In Midstream?" IMF Staff Position Note, SPN/09/29, December 22, 2009, pp. 14-15.

18 "It Isn't Working for Anyone Else," New York Times Editorial, January 12, 2010; but see "Return of the Killer Trade Deficit," New York times Editorial, August 16, 2010 (Arguing that "any move to slap punitive tariffs on Chinese goods could lead to destructive tit-for-tat retaliation").

Some economists note that the U.S. trade deficit with China grew despite the RMB appreciating roughly 20 percent against the U.S. dollar from June 2005 to August 2008.[19] But this analysis does not take into account the “time lag” between a change in an exchange rate and the effect that change has on trade (i.e., it takes time for changes in production decisions and trade flows to materialize, and for the market to interpret changing exchange rates as more than a temporary fluctuation). In a recent study, William Cline of the Peterson Institute corrected for this time lag using recent data, including from the 2005-2008 period.[20] After adjusting for the time lag, he concludes that a 10-percent real effective appreciation of the RMB would directly reduce the U.S. current account deficit with China by between $22 billion and $54 billion annually (or between 6 and 14 percent of the 2009 current account deficit of $375 billion). A real effective appreciation of the RMB of 20 percent would double the effect.

[19] See, e.g., Derek Scissors, “Targeting the Yuan: A Feel-Good but Futile Response,” Heritage Web Memo #3005.

[20] The current account balance equals the trade balance plus net factor income from abroad (e.g., income on foreign investments), plus net unilateral transfers from abroad. The trade balance is by far the largest component of the current account.