Chinas exchange rate regime and currency manipulation economics essay

Economics

The United States objective to promote its trade with China continued further in the early 90’s when Clinton’s Administration required from China to make changes in the record of human rights if it was willing to be granted with the status of " Most Favoured Nation- MFN"[2]. Finally in 1997, Clinton Administration granted China the MFN status and shortly after China joined the WTO in 2003. In this case, US did not used trade as a weapon but it used trade as a carrot to push China enter into the world market system[3]. With the so called " US Commercial Diplomacy", american businesses could benefit from trade and at the same time could help China change its political institution. US-China trade relations lead to win-win progress and mutual benefits; the two countries improved the well being of their people, as well as created more jobs and gave consumers more choices. Within thirty years period (1981-2011) the trade between two countries increase from $5 billion to $503 billion. China’s accession to WTO made United State’s exports to China three times higher than exports to other countries. The growth of China’s import increased pararerlly with China’s export to the US as well. According to the Institute for International Economics " the rapid growth of the Chinese market increased US exports; China's exports to the US and its investments in American financial assets ". As a result, China’s purchases of US Treasury bonds were $247. 6 billion and its foreign exchange reserve reached $2. 4 trillion at the end of 2009 (The US-China Business Council 2010). China very soon becameUS’s sponsor by holding a $585 billion American government debt (The US-China Business Council 2009; 8; BBC World News America 2008). It is true that US and China are constructive and cooperative in nature. Yet there are problems, differences and even disputes arising from these relationships. The US trade imbalances with China are mostly related with job losses in the manufactoring sector in the US as well as lower US exports to China. For these reasons the US pressure to reevaluate the Chinese has been intensified over the last five years. In the recent trends of globalization both countries need to make necessary economic adjustments, adapt proper trade policies in order to further promote economic development and make a better life for their citizens.

China's exchange rate regime and Currency Manipulation

For more than fifty years Chinese currency known as the Yuan (also called Renminbi) has been non-convertible. Between 1995 and 2005 China pegged its currency at a fixed rate of 8. 28 to 1 dollar. This exchange rate was used by the People's Bank of China (that is equivalent of the US's Federal Reserve) to buy US dollars that entered the Chinese market as investment spending and revenues from exports. Finally these dollars were placed in China's foreign exchange reserve that increased enormously by the time.

Only under a considerable pressure of the US, could China decide to move to a managed float exchange rate regime with a " central parity" based on a currency basket[4]by allowing the Yuan to fluctuate within narrow band of ±2. 1%. The basket was dominated by the dollar, and depending on the trade flows, daily dollar fluctuations were limited to 0. 3%.

So the effective was the rate of the Yuan to dollar 8. 20 that gradually reevaluated to around 8. 10 by the end of 2005. During 2006, China changed its " central parity" by appreciating its currency to 8. 0 to the dollar and at the same time Chinese government announced that individuals could invest as much as $20. 000 in foreign assets and Chinese companies could make overseas investments[5]. This new method gave market a minor role to determine Yuan's rate. However the old Yuan rate of 8. 28 and the new Yuan rate of 8. 0 were still considered

depreciating because Yuan has raised its value only by 3 % which de facto means that China continued depreciating its currency towards dollar. On the one hand, China increased its

current account surplus and had a greater number of FDI than in any other developing countries (UNCTAD's World Investment Report 2005). On the other hand, in the year of 2004, 2005 and the first half of 2006 China has recorded a booming in Chinese economy with the annual growth rate of 9%[6]. Further reevaluation of Yuan was useful in order to dampen exports and encourage imports as US was seeking.

Let's consider an example from Annex Table 1, with prices of T-shirts and computers and see how Chinese exports and imports are affected by either undervalued or revalued Yuan. Within the case of T-shirts prices, the revalued yuan from 8. 28 to 4 makes export prices of Chinese T-shirts more expensive in US markets; and vice-verse the undervalued Yuan means a cheaper Chinese goods in US markets. But the effect of undervalued Yuan on computer prices from the example shows that US goods are more expensive in China due to the higher import prices. Economic theories say that an undervalued Yuan puts Chinese producers at an advantage by making Chinese goods cheaper in the US markets and US goods more expensive in China[7]. These reasons of trade imbalances considered by the US in particular, led to a continued pressure of the US on China, to " adujst the exchange rate", in other words to reevaluate its currency. The US observers and economists have even defined " Currency Manipulation" by which China is manipulating its exchange rate to reduce the cost of Chinese goods and services and increase the cost of American goods and services[8].

In addition many US manufacturers and unions argued that such a manipulation makes US goods less competitive globally, increases the US trade deficit, and moves US jobs to China. Only during 2005 they have to confront with a massive $202 billion trade deficit with China[9](See Table 3 in the Annex) and demanded that China take steps to increase the Yuan's value. In reponse to this, China has not denied its control over the exchange rate but argued that thereal cause for US trade imbalance is because goods that US imports from China used to be imported from Japan, Taiwan, and other Asian economies[10]. According to this US trade deficits with China has increased while US trade deficits with the rest of East Asia has fallen. (See table 3 in the Annex). China cointinued to reevaluate its currency by very slightly rate but the US trade deficits countinued to increase except in the year of 2009.

Foreign exchange and Trade Balance

Now let’s see how the trade balance is related to the foreign exchange market where the exchange rates are determined. " The adjustment of exchange rate " referes to either reevaluation or devaluation of currency while " foreign exchange" referes to currencies (US dollar or Chinese yuan) we use in transactions in the market for goods and services[11]. For example exports and imports increase the demand for (buying) and supply of (selling) foreign ecxhange; Americans buy Yuan to pay for Chinese goods and Chinese buy the dollar to pay for US goods[12]. This is the economic language of supply and demand whereas the demand for Yuan is the supply of dollar and vice-versa the demand for dollar is the supply of Yuan. Each transaction on the foreign exchange market, related to buying or selling of goods, corresponds to the record in the balance of payments. Therefore transactions recorded in the balance of payment result in the demand and supply of foreign exchange. Economic theories has tought us that a deficit in the trade balance implies an exccesive demand for foreign exhange and a surplus in the trade implies an excessive supply for foreign exchange. The demand for foreign exchange equals the coutries import expenditures (trade deficit) while the supply of foreign exchange equals countries export revenues (trade surplus). Assumption to adjust or change rates, or to reevaluate or devaluate domestic currencies affect directly the domestic price of imports (consiquently demand for import and imports costs), as well as the foreign currency price of exports (export revenues). As we have mentioned before , the devaluation of domestic currency (in our case dollar) increases the domestic price of import, whereby the demand for import fall and at the same time it reduces the foreign price of exports (China's exports) which implies a growth in american exports. Theoritically this improves the US trade balance, and possibly eliminates US trade deficit with China but only if a number of other variables are satisfied such as interest rates in the United States relative to interest rates in China relative price levels in the US to price levels in China, and relative business expectations in both countries[13]. For instance, the inflation rate in China is much higher than in US and that during 2008-2010 when the exchange rate was steady the trade deficit has raised. In today's world economic occurences if these conditions are satisfied then the arguments for Yuan reevalution will be likely to happen.

The Reevaluation of Yuan debate - Reasons and Consequences

As noted earlier in this paper, State leaders and officials tend to regard the balance of payment as being the most important in the short term because it causes decline in exports and job loses. Ideally, state officials would like to see an equilibrum in the balance of payment. Theoretically, countries should spend only as much as they earn. But in practical terms this might not neccesarly be a good thing. Why is that so? Because international economy to grow needs liquiduty from both debtor and creditor nation. A nation with current account deficit, or a debtor nation, as the US, must either increase foreign ownership of domestic assets or borrow funds from abroad in order to balance its payment. Economically the current account deficit requires the capital account surplus[14]. It follows from this that United States will need to increase output and generate more exports and decrease consumption especially on imports. In pursuit of these aims the Chinese Yuan has to be reevaluated and the US dollar will be devaluated. Currency devaluation is very attractive to states that intend to raise output and balance the trade, although economically and socially it involves higher consumer taxes, reduction in government subsidies, higher interest rates to lower consumption and encourage FDI.

By contrast with US, China is a nation with current account surplus, acting as a creditor nation that receives more revenue from exports and income from investment payment. Thus its international transaction generates net income that it uses to buy foreign assets.

Needless to say, both countries need to reach equilibrium in the balance of payments. Practically, if United States cuts its deficit by consuming less, then it will push other countries to produce less. International economy needs a source of money for new investments and production that comes from countries with balance of payments deficit such as the US which is the driving force within the systems and it helps other member of the system to generate growth and benefits.

Trade imbalances between US and China have raised concerns of many Americans, public and private sector officials. China's " currency manipulation" lies in the fact that US products cannot compete with Chinese products because they are either cheap in US markets or US products are too expensive in Chinese markets.

There have been many arguments and a lot of pressure by the US to prevent these policies. US senators Schumer and Graham, in 2005 proposed a 27. 5 percent tariff on all Chinese products as its ultimate extent to increase the Yuan value[15]. Under this bill, the president can assert if China has a " good will" toward reevaluating its currency and postpone the imposing of tariff for 180 days. A few months later in 2006, senators: Charles Grassley and Max Baucus proposed another prominent bill to put pressure on Chinese government to reevaluate its currency. This time they required the denial of market economy status (equal to antidumping) to countries they identified as having " currency misalignments"[16]. However, from both policies only American households will be affected by paying the tax. Regardless the demands proposed by the US officials, the legislation that imposed a tariff on imports from China to balance currency, undervaluation was not approved because it was inconsistent with World Trade Organization (WTO) rules[17]. GATT's article confine to cases whereby

countries experience trade balance difficulties but not because they have a surplus in balance of payments. Moreover, under the provision of Article XV on GATT, countries with difficulties in balance of payments could impose the tariff on all imports and not only on imports with China[18].

With all due respect to the US requirements, by April 2006, China could slightly change its exchange regime but not substantially appreciate its currency.

US government asked for direct negotiations with China and referred a case to WTO when found out that China breached International Trade Rules such on the case of export subsidies[19]whereby the undervalued Yuan acted as a prohibited export subsidy. Under the WTO " prohibited export subsidy" China has violated Article 1, 2 and 3 of the WTO Agreement on Subsidies and Countervailing measures (SCM). Following the GATT Article I and repeated article to the Marrakesh Agreement establishing the WTO, the balanced multilateral trade shall promote high standards of living, full employments and the full use of resource and help expand the production and exchange of goods.

There is another issue concerning the undervalued exchange rate that involves China's " financial contribution". Within this debate US argues that importers are paying too much Yuan for their purchases which means that undervalued rate takes money from importers and gives it to exporters and acts as a tax on import and subsidies on export[20]. This implies that the policy of " financial contribution" exists because Chinese central bank performs the service of exchanging dollars to Yuan. Additionally, China's policies provide grants, lend loans with low rates under the market rates, and provide tax breaks and cheap transport for exported good. According to the Nobel Prize winner, Paul Krugman, China is keeping its currency artificially weak, running an artificial trade surplus by taxing imports and subsiding exports[21]. He calls for US officials to put pressure on China to streghten its currency beacuse as he cites

" it will be in China’s own interest". Krugman believes an undervalued Yuan promotes inflation, worsen the real wages of Chinese workers and waste Chinese resources[22].

Chinese authorities argue that the revaluation of Yuan will not shrink US-China trade deficit. So does the Nobel Prize laureate Joseph Stiglizt who argues that the Reevaluation of Yuan will eliminate China’s trade surplus but as he maintains " it will have little effect on the US trade deficit" because imports will be likely unchanged as the US is going to buy from other developing economies. According to Stiglizt, United States investments must decline and national savings rise otherwise the current intensity of the trade deficit will continue.

Similar to Stiglizt argues another Nobel Prize winner , Robert Mundell who points out that " Yuan appreciation would more rapidly " increase deflation" and import price will fall. He believes that the pressure on Yuan Chinese creates economic and financial instability, impacts the problem of nonperforming loans and increase unemployment by raising the dollar cost of wages[23](see Table 5 in the Annex for PRO and AGAINS revaluation arguments).

The persistent pressure of the US did influenced The Peoples Bank of China to change its parity rate by reevaluating its currency gradually. The starting of 2013 exchange rate reached 6. 28 Yuan against the US dollar[24]. Within this rate Yuan is allowed to rise or fall by 1% daily. Economists expect that Yuan appreciation will lower prices of imported goods and inflation concerns and most definitely China will attract more investors to market, strengthen asset prices and improve its relation with the United States. Upon reevaluation of Yuan Chinese officials announced that consumer prices in the country rose by 2. 5% since December. China's trade surplus is shrinking as well.

Reevaluation of Yuan is as attractive to the US as it is willing to generate more exports but with this, it can bring " defensives" policies by other states and this will lead to more tensions between states. Decisions of currency reevaluation or devaluation are neither easy for the states nor for the societies to be taken. In the late years they proved to be politically influenced.

Far better than challenging China, is the fact that US and Chinese economy are greatly interdependent. China remains dependent on US markets as it relies on US to buy its goods. While the United States relies on China to finance its spending.

The US economy is well over the China's economy despite the huge Chinese growth and it added more than a full China to its economy (see Table 4 in the Annex). Chinese GDP per capita is $5. 400, compared to $48. 100 for the average American.[25]

It is in the United States interest the development of China's economy because as China's economy develops and more Chinese move into the middle class, the US exports of manufacturing and services will grow. The growth of China's consumer class which is estimated to reach 600 billion people by 2020 and domestic market would be an opportunity for US companies to strengthen by selling goods and services in China[26].

In the years and decades to come, economic success of the US will seek engagement and cooperation with China. Resolving disputes case by case is a challenge that faces both Washington and Beijing. Benefits of open trade and investments are gains for both US and China, the same as there are risks for losing hundreds of billions of dollars.

Conclusion

The US-China trade disputes initially started with indentifying undervaluation of Yuan and arguing that goods in China are cheap, China has large trade surplus and huge foreign exchange reserves and China's is manipulating its currency in foreign market exchange. It is obvious that a country such as US aims to give market forces a greater role in determining the Chinese exchange rate. The US trade deficit and the American problem of spending more than it earns and finance its spending by borrowing, is a problem that US deals for many years. At the end of the day the United States economy is anywyas bigger than China's ; well over three times the size of China's; on a per capita basis, the US economy is nearly nine times bigger[27]. China is competitive not because of cheap exports but because of cheap factor of production. China holds so much of US currency in the form of US Treasury bonds as they are highly liquid (can easily convert to the cash), in other words because they are flexible and safest investments. China's motivation is to facilitate US consumption in order to increase its own exports.[28]All of these reasons make China powerful but its economy size is yet smaller than the United States. The Revaluation of Yuan will even overcome the fear that the US dollar will drop if People's Bank of China decides to sell a large of US dollars and Treasury securities because of the their Co-dependency. To conclude I would say that Revaluation of the Yuan was neither a serious problem nor threatening because of the certain co-dependency of both countries and especially China's higher interdependency resulting in the resolving of controversies and maintaining of long-term economic health and political relationship with the US.

ANNEX

TABLE 1: Reevaluation of Yuan and its affect in Chinese export and import:

Exchange Rate:

Yuan/Dollar

Price of T-Shirts in:

Yuan/Dollar

Price of Computers in:

Yuan/Dollar

8. 28/1(undervalued Yuan)

100 Yuan/ $12. 08

8280 Yuan/ $ 1000

4/1(revalued Yuan)

100 Yuan/ $25

4000 Yauan/ $1000

Source: " Introduction to International Political Economy" David N. Balaam, Michael Veseth- 4th ed. Box- The Tangled Web of China's Currency Manipulation page 144; 2008 Pearson Education, New Jersey

TABLE 2: CNY-USD Exchange rate and the relation to Trade Deficits

Source: US- China Business Council" Published January 2013; https://www. uschina. org/info/trade-agenda/2013/china-exchange-rate. html

As showed in the table, during the period of 2005-2008 the Chinese Yuan strengthens gradually and trade deficit grows. Within the period of 2008-2010 trade deficit drops then arises again. And finally during 2010-2011 as the Yuan strengthens, trade deficit increases.

TABLE 3: US Trade deficit with China (in USD billions)

Source: US- China Business Council" Published January 2013; https://www. uschina. org/info/trade-agenda/2013/china-exchange-rate. html

TABLE 4: The US economy is three times China's economy

Source: US- China Business Council" Published January 2013; https://www. uschina. org/info/trade-agenda/2013/china-economy-size. htmlAs shown in the table United States economu grew by the equivalent percentage as the entire Chinese economy in the past two decades.

TABLE: 5 Reevaluation Debate PRO and AGAINST arguments

Prominent economist/

US Official

Date

Percentage of Reevaluation/

Against Reevaluation

Reasons

Paul KrugmanNobel Prize winnerPrinceton University(2010)Reevaluation no specified percentage. China is keeping its currency artificially weak. Undervalued Yuan promotes inflation and loss in Chinese worker wages. Jamie Marquez and John SchlinderUS Federal Reserve economist(2006)10% reevaluation10% appreciation of the Yuan will decrease China' s export share of world trade by 1. 5% and lower import share of world trade by 0. 1% because half of China's imports are used as inputs for assembled exports . With this China's bilateral trade with US will drop by $14 billion. Joseph StigliztNobel Prize laureateColumbia University(2005)Against reevaluation. Reevaluation of Yuan will eliminate China trade surplus but will have little effect on US trade deficit. US must decline its investment and rise national savings. Robert MundallNobel Prize laureateColumbia University(2005)Against reevaluation. Reevaluation would raise Chinese unemployment by increasing the dollar cost of wages. Alan GreenspanFormer Chairman ofFederal Reserve (2004Reevaluation but no specified percentage. China first needs to solve the problem of nonperforming loans to restore the internal balance. Then reevaluation takes place. Ernest H. PreegManufacturers Alliance(MIPA)20% Reevaluation and liberalized capitol controlsChinese Currency Manipulation violates WTO commitments, increase US trade deficit and harms manufacturing and defense sector.

Source: US China Trade Disputes : Rising Tides, Rising Stakes" Hufbauer, Gary Clyde Wong, Yee Sheth, Ketki, Page 91/92, Washington DC 2006; " China, Japan, America" Paul Krugman; The New York Times 2010/09/13; " US-China Trade Dispute : Facts, Figures and Myths " Moosa, Imad , Cheltenham, Glos, GBR 2012;