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Not Just a Bill Sitting on Capitol Hill: International Repercussions of the Currency Exchange Rate Oversight Reform Act 2011

Abstract: China maintains a growing trade surplus with the U.S. at US\$273 billion in 2010, and the IMF projects that the current account surpluses will increase to US\$874 billion in 2016. In response to increasing surpluses, the U.S. Senate passed the Currency Exchange Rate Oversight Reform Act of 2011 (S.1619) on October 11, 2011. If enacted, this "currency bill", which is tabled in the House of Representatives, would place further pressure on China to appreciate its currency or face economic consequences such as countervailing duties on U.S. imports from China. The issue is politically charged, but analysis from an economic perspective can inform better policy and hopefully better politics. Through reviewing the history of the bill and analyzing the potential effects of the bill, this paper finds that the currency bill would neither reduce the trade deficit nor raise employment in the U.S. Rather, it would have a negative economic impact overall and lead to a decrease in real wealth and real wages. Evidence suggests that international trade law supports China's case and there would also be significant political costs. This paper concludes that the U.S. should not pursue the currency bill, but that China must make continued credible signals of currency reform in order to prevent U.S. domestic politics from interfering in Chinese economic development.

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INTRODUCTION

Deng Xiaoping once described China's development strategy as *crossing the river by feeling the stones* (摸着石头过河 *mozhe shitou guo he*). The world has watched as China's reform process has gradually unfolded, from land and agricultural reform, to SOE, financial, and social security reform. Bucking outside pressures, China has managed this process with great care and tremendous acumen, its broad success understated in numbers: second largest economy, double-digit growth for three decades, 200 million lifted out of poverty. Yet, despite its proven success, China continues to confront outside pressure to adjust its policies, particularly as they relate to trade. Most recently, the U.S. Senate passed the Currency Exchange Rate Oversight Reform Act of 2011 (S.1619) on October 11, 2011. This "currency bill", though not yet voted on in the House of Representatives, would in short place further pressure on China to appreciate its currency or face economic consequences such as countervailing duties on U.S. imports from China.

Section I of this paper highlights the terms of the currency bill and defines currency manipulation. Section II provides background on China's exchange rate practices that spawned the bill. Section III lays out U.S. lawmakers' case for the bill by identifying growing current account surpluses, growing trade surpluses, and currency misalignment which hurt U.S. exports and lead to U.S. unemployment. Section IV postulates what the outcomes of a passed bill would be. I argue that the currency bill would neither reduce the trade deficit nor raise employment in the U.S.; rather, it would have a negative economic impact overall and lead to a decrease in real wealth and real wages. I also argue that there would be significant political costs and that international trade law supports China's case. Section V examines China's position on the bill. I suggest that China is opposed to the bill given its intended interference with Chinese core interests, but that there are opposing schools of thought on overall currency reform within Chinese leadership. Finally, the conclusion charts the way forward. I argue that China must make continued credible signals of currency reform in order to prevent U.S. domestic politics from interfering in Chinese economic development.

SECTION I: BILL BASICS

Several versions of the most recently passed currency bill have been debated in Congress over the years. The first iteration of such a currency bill was put forth by Senators Schumer (D-NY) and Graham (R-SC) in 2005. In response to much of the same issues that the U.S. faces today – ballooning trade deficits and manufacturing non-competitiveness – the Schumer-Graham bill of 2005 would assess a 27.5 percent tariff on all Chinese goods arriving in the U.S. within two years, unless Beijing allowed more flexibility in the *renminbi* (RMB).¹

¹ Senator Charles E. Schumer, "Schumer, Graham Urge Action Against China's Unfair Currency Manipulation." Accessed November 5, 2012, http://schumer.senate.gov/new_website/record.cfm?id=260664.

Notably, after a trip to Beijing that year, Schumer said that he better understood the challenges China faced in its trade and monetary policies. He observed that the Chinese were taking positive steps toward exchange rate reform, saying, “I’m convinced they do want to get there [market-based currency adjustments], which I wasn’t a week ago.” Graham remained a staunch supporter of the bill, but Schumer seemed to begin to see things differently. As Charles Freeman, then managing director of the China Alliance and the former top trade official dealing with China, said, “Even Schumer would like to have something to vote on other than the Schumer bill.”²

That said, it seems Schumer’s doubts about the bill were short-lived. Schumer with Graham has continued to lead the charge on pressuring currency reform in China. The two senators have submitted several bills over the years, including their most recent version: the Currency Exchange Rate Oversight Reform Act of 2011. This act requires the Secretary of the Treasury to issue a report that evaluates the monetary policies of U.S. trading partners and their effects on currency exchange rates in order to identify countries with “fundamentally misaligned currencies”.³ Symptoms of such currency misalignment include “excessive and prolonged official or quasi-official accumulation of foreign assets for balance of payments purposes.”⁴

If such currency misalignment is discovered, the bill calls for priority action to eliminate it. It amends the Tariff Act of 1930 in order to allow for adjusted export prices to be reduced by the same percentage of currency undervaluation in relation to the U.S. dollar.⁵ For example, an undervalued RMB of 40 percent would trigger a 40 percent countervailing duty on Chinese imports. It should also be noted that the bill does not name any specific countries that it targets, but as *The Economist* has quipped, no prizes will be awarded for guessing which large Asian nation the senators have in mind.⁶

Under current terms, the Secretary of the Treasury is required to submit this biannual report to Congress; however, the criteria used by the Government Accountability Office (GAO) to determine if a country is a “currency manipulator” are vague. These are: (1) a material global current account surplus; (2) a significant bilateral trade surplus with the United States; and (3) the intent of gaining a trade advantage through currency adjustments.⁷ Most notably, it is difficult to define and objectively judge “intent.” With these vague qualifications, it is difficult for the US to take concrete action in response to what it deems currency manipulation, apart from its official definition.

² Stakelbeck Jr., Frederick W. “Schumer-Graham ‘nuke’ holstered,” *Asian Times*, March 31, 2006.

Accessed November 28, 2011, http://www.atimes.com/atimes/China_Business/HC31Cb05.html.

³ S. 1619: Currency Exchange Rate Oversight Reform Act of 2011, 112th Congress, 1st Session. Accessed November 27, 2011, <http://www.govtrack.us/congress/billtext.xpd?bill=s112-1619>

⁴ *Ibid.*

⁵ Currency Exchange Rate Oversight Reform Act of 2011 Summary. Accessed November 27, 2012, http://www.thepoliticalguide.com/bill_info.php?chamber=senate&session=112&bill=S%201619

⁶ “And now, protectionism.” *The Economist*, October 15, 2011.

⁷ “International Trade: Treasury Assessments Have Not Found Currency Manipulation, but Concerns about Exchange Rates Continue,” *GAO Report*, May 19, 2005. Accessed December 3, 2011, <http://www.gao.gov/htext/d05351.html>.

The bill removes this vague wording and replaces it with the more objective term “misaligned currency”; thus, regardless of intent, any currency that is deemed misaligned (or over/undervalued) is vulnerable to having countervailing duties placed on that country’s goods.

SECTION II: BACKGROUND ON CHINA’S EXCHANGE RATE POLICY

To understand the economic ramifications of this bill and China’s overall position, one must understand the history of China’s exchange rate policy. Before exchange rate reform in 1994, China used a dual exchange rate system: (1) an official fixed rate used by the government and (2) a market-oriented rate used in larger volumes by importers and exporters in swap markets. The rates between the two differed considerably, with official rates at 5.77 in 1993 compared with 8.70 in the swap markets.⁸ This, of course, also led to arbitrage opportunities and the development of black markets.

In 1994, the government did away with the dual system and used solely the rate of 8.70 RMB to the US dollar. This was revalued at 8.28 in 1997, but otherwise China maintained a pegged RMB to the US dollar in order to provide a stable trade environment.⁹ As a result, Beijing gave up an independent monetary policy in order to buy or sell as many dollar-denominated assets as necessary to maintain a stable exchange rate.

This policy was further reformed on July 21, 2005. Beijing announced that the exchange rate would thereafter be “adjustable, based on market supply and demand with reference to exchange rate movements of currencies in a basket,” those being the dollar, yen, euro, and a few others. This market-based rate began as 8.11 RMB to the US dollar, an appreciation of 2.1 percent, and would be allowed to fluctuate by up to 0.3 percent (later changed to 0.5 percent) on a daily basis.¹⁰ Over the next three years, the exchange rate appreciated 18.7 percent to 6.83 under this managed float system.

Due to the global financial crisis and declining global demand for Chinese exports, Beijing decided to re-peg its currency in mid-2008 to around 6.83. However, this hiatus was short-lived as China’s central bank, the People’s Bank of China (PBC), decided to move forward with further currency reform in mid-2010. Consistent with China’s gradualist approach, it sought to allow the RMB to fluctuate over time, rather than a one-time revaluation, which could cause instability in the system. Since then the RMB has appreciated by 5.7 percent with a nominal yuan/dollar exchange rate of 6.46 in July 2011.¹¹

⁸ Morrison, Wayne, and Marc Labonte. “China’s Currency: An Analysis of the Economic Issues,” *Congressional Research Service*, August 3, 2011.

⁹ Morrison, Wayne, and Marc Labonte. “China’s Currency: An Analysis of the Economic Issues,” *Congressional Research Service*, August 3, 2011.

¹⁰ Morrison and Labonte assert that this is heavily weighted toward the dollar as evidenced by its stability against the dollar between mid-2008 and mid-2010.

¹¹ *Ibid.*

It is also important to note the changes in real exchange rates over time. Inflation is higher in China than in the US, which is, in effect, also an appreciation of the RMB relative the U.S. dollar. Given the same time period above but accounting for inflation, the RMB actually appreciated 7.0 percent in real terms, instead of only 5.7 percent. Figure 1 captures well this increased gap between nominal and real exchange rates. The high inflation can be attributed to the excess liquidity in China due to its stimulus package.

Figure 1: China's yuan-dollar exchange rates



SECTION III: THE CASE FOR THE BILL

The RMB, then, is not a fixed exchange rate and has demonstrated appreciation since it was allowed to float. However, there is a strong case for it being misaligned and the U.S. makes much of the detriment this alleged misalignment causes to its economy. Again, the GAO definition of manipulation is three-fold: (1) global current account surplus, (2) bilateral trade surplus, and (3) intent of gaining trade advantage.

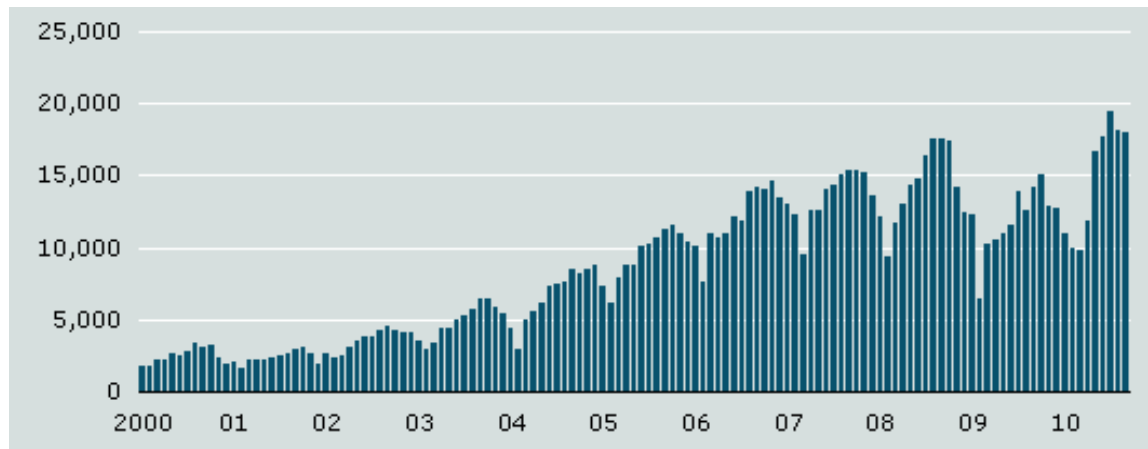
U.S. lawmakers can then make a strong case against China. First, China's current account surpluses grew from US\$46 billion in 2003 to US\$297 billion in 2010.¹² Moreover, the IMF projects that the surpluses will continue to increase to US\$874 billion in 2016.¹³ Second, China maintains a growing trade surplus with the U.S. at US\$273 billion in 2010.¹⁴ Figure 2 highlights this growing trade surplus. Finally, China has focused on an export-growth model that has benefitted from a weaker RMB vis-à-vis the U.S. dollar. However, again, the *intent* of gaining trade advantage is hard to prove.

¹² "China economy: Foreign reservations," *Economist Intelligence Unit*, October 10, 2010. Accessed November 29, 2011, http://viewswire.eiu.com/index.asp?layout=VWArticleVW3&article_id=1457510330®ion_id=&country_id=1800000180&channel_id=190004019&category_id=&refm=vwCh&page_title=Article&rf=0

¹³ "World Economic Outlook Database," *IMF*, April 2011.

¹⁴ "Trade in Goods with China," US Census Bureau. Accessed December 2, 2012, <http://www.census.gov/foreign-trade/balance/c5700.html>

Figure 2: China's bilateral trade surplus with US (US\$m)



Source: *Economist Intelligence Unit*

Once lawmakers establish the RMB as a misaligned - if not manipulated - currency, they can cite two core grievances against China: gaping trade deficits and loss of jobs. The trade deficits, as enumerated above, are wider than they would be with a market-oriented exchange rate. By managing its currency up to 40 percent below its appropriate value, as some studies claim, China is essentially subsidizing its export sector and forcing additional cost on U.S. exporters to China. Some analysts further assert that China's undervaluing policies then prompt other East Asian countries to undervalue their currencies, further contributing to U.S. global trade deficits. The implication is that this undercuts American businesses, workers, and farmers and reduces their ability to compete with China.

Proponents of the bill also assert that the trade deficit contributes to the U.S. unemployment rate, taking jobs from the manufacturing sector in particular.¹⁵ The Economic Policy Institute, for example, claims that the deficit with China directly contributed to the loss or displacement of 2.4 million manufacturing jobs between 2001 and 2008.¹⁶ Particularly in light of persistent unemployment rates above 9 percent in the U.S. and pressure on the administration to create jobs, these numbers are substantial and easily spark the ire of U.S. policymakers and citizens alike.

SECTION IV: EFFECTS OF THE CURRENCY BILL

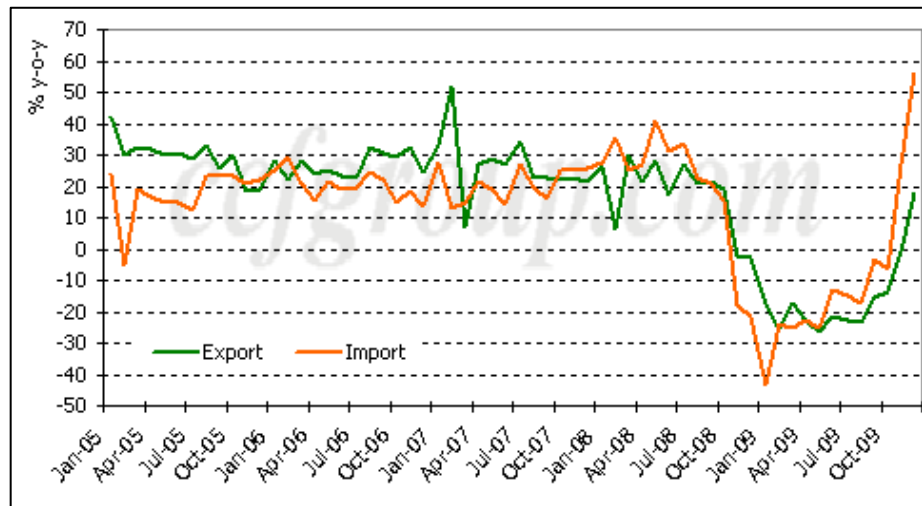
¹⁵ Gladstone, Rick. "U.S. Senate's Bill on Tariffs Angers China," *New York Times*, October 4, 2011. Accessed November 30, 2011, http://www.nytimes.com/2011/10/05/world/asia/china-criticizes-senates-currency-manipulation-bill.html?_r=1&pagewanted=print

¹⁶ "Unfair China Trade Costs Local Jobs 2.4 Million Jobs Lost, Thousands displaced in Every US Congressional District," *Economic Policy Institute*. Accessed December 2, 2011, <http://epi.3cdn.net>.

The question then is this: were this bill to pass, would these primary concerns be assuaged? Some analysts contend that even a considerable appreciation of the RMB – such as 25 percent as some economists suggest – would not reduce the trade deficit.¹⁷

One cause of this is that analysis of previous instances of the RMB's appreciation revealed a sustained growth in the trade deficit. According to the Congressional Research Service, while the RMB appreciated 21 percent between 2005 and 2008, the U.S. trade deficit vis-à-vis China still rose by 30.1 percent. This is contrary to what one would intuit. Given RMB appreciation, one would expect exports to increase and imports to decrease.

Figure 3: China's export and import growth, 2005-2009



Source: <http://www.ccfgroup.com/newscenter>

Another underlying reason that RMB appreciation would have little effect on the U.S.-China trade balance is that China is the world's assembly line. China's exports are composed primarily of imported goods, so an appreciated RMB would have insignificant impact on the overall price of goods. Apple's iPod is a good example of this trend. One study found that components for the iPod were imported from other multinational corporations outside of China while a Taiwanese company owned the very factory where they were assembled. Thus, the value-added of Chinese workers was only about 3 percent relative to total production cost of the unit; this is even more dramatic when compared to the retail price of the unit in the United States.¹⁸

Furthermore, if the RMB appreciates and exports from China become too expensive for U.S. consumers, manufacturing will not shift back to the United States. As Peking University professor Yang Yao said, "The U.S. does not produce what China exports to it – shoes, clothes, toys, electronics, etc. If the U.S. does not import those products from

¹⁷ Bottelier, Pieter, and Uri Dadush. "The RMB: Myths and Tougher-to-Deal-with Realities," *International Economic Bulletin*, March 2010. Accessed November 5 2012, <http://carnegie.ru/publications/?fa=40364>.

¹⁸ "Who Captures Value in a Global Innovation Network? The Case of Apple's iPod, March 2009. Accessed November 28, 2011, pcic.merage.uci.edu/papers/2008/WhoCapturesValue.pdf.

China, it will import them from other countries.”¹⁹ Chairman of Morgan Stanley Asia, Stephen Roach, likened it to rearranging the chairs on the deck of the Titanic; it would shift the Chinese piece of the U.S. trade deficit to someone else – most likely to a higher cost producer. He states, “That would be the functional equivalent of imposing a tax hike on already hard-pressed middle class workers...It is bad politics driving bad economics.”²⁰ Thus, an appreciated RMB would have little impact on the trade deficit.

Nor would it have notable impact on job creation. An appreciated RMB might provide some amount of relief to U.S. companies that are Chinese-import sensitive; however, in the long-run, an appreciation would result in a shift of resources allocation, away from U.S. exporters and import-competing firms, and toward the firms that benefit from Chinese capital flows. Thus, according to the Congressional Research Service and trade theory, appreciation is expected to have no medium- or long-run effect on aggregate U.S. employment or unemployment.²¹

Short of not having the suggested economic benefits, many analysts contend that the currency bill would have a negative economic impact overall. Economic theory usually measures economic welfare by levels of consumption. Therefore, an undervalued RMB means that Chinese exports are cheaper for U.S. consumers and inputs are cheaper for U.S. businesses. This raises economic welfare of the U.S. as a whole through improved terms of trade. An appreciated RMB, on the other hand, would hurt poor U.S. citizens the most, as they are the ones most dependent on cheap Chinese consumer goods. An increase in import prices will be much more substantial relative to a poor citizen’s salary compared to the upper class, leading to a decrease in real wealth and real wages in the United States.²²

One Yale study by Ray Fair even portends a negative effect on demand, output, and jobs.²³ Given an assumed 25 percent RMB appreciation, Fair’s multi-country econometrics model analysis reveals that any export benefits to the U.S. economy would be offset by falling exports in China and therefore lower economic growth. Lower growth would also stifle demand for U.S. exports, leading to reduced welfare for both the U.S. and China.

Effects of the bill also extend beyond economic theory; political factors must be considered too. One of the biggest threats that the currency bill poses is that of a U.S.-

¹⁹ Yang Y. “Should China Allow the Yuan to Rise?” *The Economist*, June 10, 2010. Accessed December 4, 2011, http://www.economist.com/economics/by-invitation/guest-contributions/yes_its_own_reasons.

²⁰ Roach, S. “Should China Allow the Yuan to Rise?” *The Economist*, June 10, 2010. Accessed December 4, 2011, http://www.economist.com/economics/by-invitation/guest-contributions/it_wont_solve_americas_problems.

²¹ Morrison, W. and Marc Labonte. “China’s Currency: An Analysis of the Economic Issues,” *Congressional Research Service*, August 3, 2011.

²² Stakelbeck Jr., Frederick W. “Schumer-Graham ‘nuke’ holstered,” *Asian Times*, March 31, 2006. Accessed November 28, 2011, http://www.atimes.com/atimes/China_Business/HC31Cb05.html.

²³ Fair, Ray C. “Estimated Macroeconomic Effects of a Chinese Yuan Appreciation,” *Cowles Foundation Discussion Paper No. 1755*, Yale University, March 2010. Accessed November 30, 2011, <http://cowles.econ.yale.edu/P/cd/d17b/d1755.pdf>

China trade war. In fact, a statement released last month from the Chinese Ministry of Commerce stated that it “will retaliate in kind against the United States if a measure targeting the yuan becomes law.”²⁴

But, with the global economy still slumped in a recession, a trade war is the furthest thing from a good idea. The U.S. should be the first to recognize this economic truth. The ills of trade protectionism during economic slowdown was a lesson learned back in 1930 with the passage of the Smoot-Hawley Tariff Act. This raised U.S. tariffs on more than 20,000 imported goods and triggered a global trade war that drew out the Great Depression.²⁵ This course of action is not the key to creating U.S. jobs or reducing the trade deficit.

The U.S. also does not find itself on the right side of international trade law with this issue. Though the bill mandates filing a complaint through the WTO, Reuters suggests that the U.S. is more likely to be found in violation of WTO agreements by taking currency valuations into account than China is to be found violating them for keeping its currency too low.²⁶ Moreover, no WTO provisions regarding countervailing duties or exchange rate issues (GATT, Articles VI and XV, respectively) would allow for direct U.S. action against China. In fact, it specifically states, “Nothing in the GATT should preclude countries from using exchange controls or exchange restrictions that are permitted by the IMF under its own Articles of Agreement.”²⁷ To date, the IMF has not deemed China’s exchange rate practices inconsistent with its obligations under Article IV.

SECTION V: THE CHINESE PERSPECTIVE(S)

Beijing’s position on the currency bill is clear: it will not succumb to U.S. bilateral pressures that interfere with Chinese core interests. Many Chinese economists agree that appreciation may be an appropriate tool to improve domestic economic conditions. Indeed, the RMB has already appreciated 28 percent since 2005. However, China also has myriad other factors to consider in the balance. These factors are captured in two opposing schools of thought within China: the People’s Bank of China (PBOC), champion of currency reform; and the Ministry of Commerce (MOFCOM), antagonist to currency reform.

Two official, yet diametrically opposed, statements released by the two official agencies in November 2009 illustrate this cleavage within Chinese central leadership. Cheng Deming, the Minister of Commerce, called for “maintaining the stability of the RMB exchange rate” so that “export companies could have a stable expectation of the future.”²⁸ Concurrently, a report published by the PBOC that very month pledged to “continue the market-based reform of interest rates and improve the RMB exchange rate mechanism.”²⁹

²⁴ Ding Q.F., “US currency bill would see 'retaliation,’” *China Daily*, November 1, 2011.

²⁵ “Pushing yuan bill risks trade war, won’t help U.S. recovery,” *Xinhua*, October 3, 2011.

²⁶ “US Currency Bill Likely Misses Target” *Reuters*, March 16, 2010. Accessed December 3, 2012, <http://blogs.reuters.com/great-debate/2010/03/16/u-s-currency-bill-likely-misses-target/>

²⁷ *Ibid.*

²⁸ Freeman III, Charles W. and Jinyuan Wen. “China Exchange Rate Politics.” *CSIS*, June 2010.

²⁹ *Ibid.*

These opposing viewpoints are because these two agencies have different incentives. The duty of the PBOC is to control inflation. An increasingly flexible exchange rate would be a welcome tool to influence monetary policy. Currently, the PBOC actually has to buy all of the U.S. dollars on its current account surplus with RMB, which increases the money supply. This, in turn, would drive up inflation – contrary to its duty - so the PBOC must take sterilization measures. It does so by issuing RMB-denominated central bank bills. This entire process exposes the PBOC to risk because, between its exchange rate management and sterilization, the PBOC balance sheet racks up assets of foreign reserves and liabilities of RMB and central bank bills. The foreign reserves are used to buy U.S. Treasury bills, which produce an annual return of less than 3 percent; meanwhile, the annual interest rate that the PBOC must pay on its liabilities is more than 3 percent. Independent monetary policy would be a more direct tool to control for inflation and reduce balance sheet risk as well.

Conversely, MOFCOM exists to maintain competitiveness in the export sector. A currency appreciation is thus contrary to its *raison d'être*. Fears of a lost decade worry the MOFCOM as it recalls Japan's stagnant economy after signing the Plaza Accord in 1985. Moreover, studies contend that a 3 percent appreciation of the RMB would lead to a drop of 30-50 percent in the net profits of labor-intensive exports.³⁰ However, it should be noted that these studies were reported by local Chambers of Commerce, which are also the groups representing the interests of China's export companies.

CONCLUSION

Chinese economists overwhelmingly support continued appreciation of the RMB. Ba Shusong, a researcher with the Development Research Center of the State Council, Zhang Bin, a research fellow at the Institute of World Economics and Politics at the Chinese Academy of Social Sciences, and Chen Zhiwu, a finance professor at the Yale University, all assert that an appreciation of 5 percent to 10 percent over 2011 would be ideal for curbing inflation and the housing bubble, while maintaining export competitiveness and jobs for migrant workers. However, although China's likely policy prescription aligns with the end goal of the U.S. currency bill – that is, RMB appreciation - the bill is an unwelcome intrusion into Chinese policy-making. Beijing is balancing myriad factors in its decision-making process and Washington's misguided and self-interested threats do not foster the cooperative trade environment necessary to pull out of the global recession.

In conclusion, as it is so doing, Beijing must continue sending credible signals of commitment to currency reform. Official statements achieve this, as does a long-term trajectory of currency appreciation. Credible signals are what continue to prevent the Department of Treasury from naming China a "currency manipulator" in its biannual report and it also can change public opinion in the U.S.. Continued currency reform measures have the power to stave off U.S. domestic politicking. Obama does not want a trade war on his hands while trying to revive the U.S. economy, and Speaker of the House, John Boehner (R-OH), has signaled repeatedly his staunch opposition to even

³⁰ Freeman III, Charles W. and Jinyuan Wen. "China Exchange Rate Politics." *CSIS*, June 2010.

bringing up the currency bill for a vote in the House. Only continued credible currency reform will prevent U.S. domestic politics from interfering in Chinese economic development and prepare China to continue with its next item on its To-Do list: financial reform.