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IN FOCUS

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China's Currency Policy

China's policy of intervening in currency markets to control the value of its currency, the renminbi (RMB), against the U.S. dollar and other currencies has been of concern for many in Congress over the past decade or so. Some Members charge that China "manipulates" its currency in order to make its exports significantly less expensive, and its imports more expensive, than would occur if the RMB were a freely traded currency. Some argue that China's "undervalued currency" has been a major contributor to the large annual U.S. merchandise trade deficits with China (that deficit was $365.7 billion in 2015) and the decline in U.S. manufacturing jobs. Legislation to address foreign currencies deemed to be undervalued has been introduced in every Congress since 2003. China has often been the main target of such legislation, although in recent years, the currency policies of other countries have also come under scrutiny.

Economic Effects of the RMB's Value

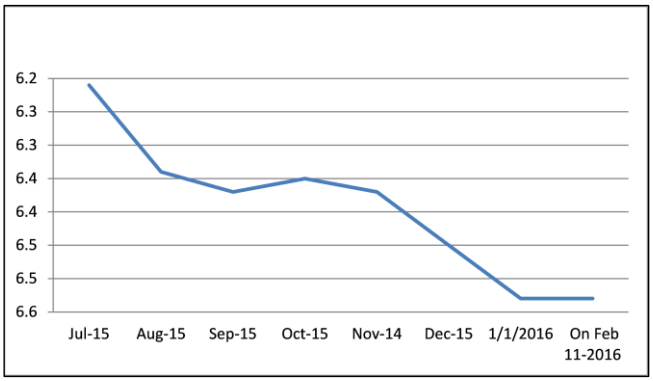
The effects of China's currency policy on the U.S. economy are complex. If the RMB is undervalued (as some contend), then it might be viewed as an indirect export subsidy which artificially lowers the prices of Chinese products imported into the United States. Under this view, this benefits U.S. consumers and U.S. firms that use Chinese-made parts and components, but could negatively affect certain U.S. import-competing firms and their workers. An undervalued RMB might also have a more limiting effect on the level of U.S. exports to China than might occur under a floating exchange rate system. However, China's large purchases of U.S. Treasury securities (which have been a consequence of its currency policy) have helped the U.S. government fund its budget deficits, which help keep U.S. interest rates low.

RMB-Dollar-Exchange Rate Trends

China has largely pegged the RMB to the dollar for several years. Each day China's central bank announces a central parity rate of exchange between the RMB and the dollar (and other currencies) and buys and sells as much currency as needed to reach a target rate within a specific band. In 1998, the Chinese government's central target exchange rate with the dollar on average was 8.28 yuan (the base unit of the RMB) per dollar, and this rate was generally maintained consistently through June 2005. Due in part to pressure from its trading partners, including the United States, China announced in July 2005 that it would appreciate the RMB by 2.1%, peg its currency to a basket of currencies (not just the dollar), and allow the RMB currency to gradually appreciate (described by some as a managed peg), which it did over the next three years. In July 2008, China halted RMB appreciation because of the effects of the global economic crisis on China's exporters, and then resumed RMB appreciation in June 2010. From June 2005 through June 2015, the RMB appreciated by 35.3% on a nominal basis against the dollar.

On August 11, 2015, the Chinese central bank announced that daily RMB central parity rate would become more "market-oriented." Over the next three days, the RMB depreciated by 4.4% against the dollar (it went from 6.12 yuan per dollar to 6.40 yuan). The RMB/dollar exchange rate changed very over the next few months, but in December 2015, RMB depreciation resumed. From August 10, 2015 to February 11, 2016, the RMB depreciated by 6.9% against the dollar (it went from 6.11 yuan per dollar to 6.53 yuan).

Figure 1. Recent Changes in RMB-Dollar Exchange Rates (Yuan per Dollar)*



Source: Global Insight and Bank of China.

Note: Chart inverted for illustrative purposes. *hly rates.

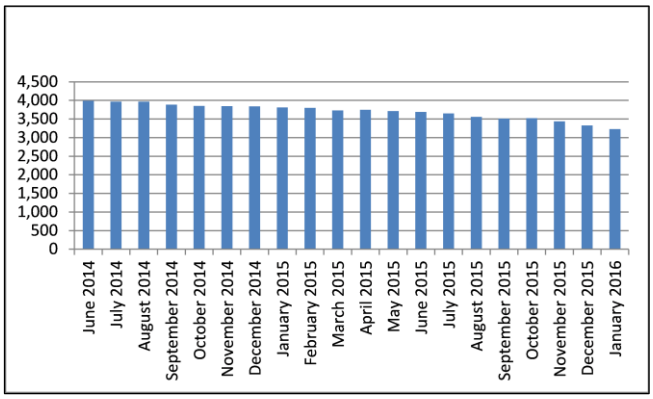
Factors Used by Some Analysts to Assess the RMB's "Valuation"

China's large trade surpluses and accumulation of foreign exchange reserves (FERs) have been cited by some analysts as indicators of China's currency intervention. China's current account (CA) surplus (which includes the balance of trade in goods and services, plus net income and net transfers) as a percent of gross domestic product (GDP) rose from 1.7% in 2000 to a historic peak of 10.1% in 2007. It subsequently has fallen sharply since that peak, reaching 2.1% in 2014. This decline was caused in part by the effects of the global economic slowdown that began in 2008, which decreased foreign demand for Chinese exports.

China's FERs rose from $166 billion in December 2000 to a peak of $3.99 trillion in July 2014. Critics argue that China's FERs are very large relative to the size of the economy (in 2014, they were equal to 37.1% of GDP) and that these levels are well beyond the amount of FERs that might be needed as insurance against an economic crisis, leaving little economic rationale for the large holdings. A large amount of Chinese of FERs have been used to buy U.S. Treasury securities. China's holdings rose from $118 billion in 2002 to $1.25 trillion as of October 2015, making it the largest foreign holder of Treasury securities.

From December 2004 to December 2013, China's FERs grew at an average annual rate of $342 billion. However, from June 2014 to January 2016, China's FERs fell by $762 billion (but remain large at $3.23 trillion). Some analysts argue that the fall in China's CA surplus relative to GDP, and the drop in FERs, indicate that the RMB is not as undervalued as it once was.

Figure 2. China's FERs ($billions)



Source: China State Administration of Foreign Exchange.

China's slowing economy, including stagnate export growth, are major factors in the Chinese government's currency policy. A slowing Chinese economy has meant less inflows of "hot money" from abroad into China and more outflows of capital out of China to other countries by those seeking safety or higher investment returns. China's merchandise export growth fell from 20.3% in 2011 to 6.0% in 2014. During the first 11 months of 2015, exports declined by 3.0% over the same period in 2014.

A broader measurement of the RMB's movement involves looking at exchange rates with China's major trading partners by using a trade-weighted index (i.e., a basket of currencies) that is adjusted for inflation, often referred to as the "real effective exchange rate" (REER). Such an index is useful because it reflects overall changes in a country's exchange rate with its major trading partners as a whole—not just the United States. According to the Bank of International Settlements, from November 2013 to November 2015, the RMB's REER rose by 11.9% against a basket of 61 currencies, even though on a nominal basis the RMB depreciated by 4.6% against the dollar. The RMB's relative peg to the dollar has meant that as the U.S. dollar has appreciated in global markets, so has the RMB (even when the RMB has depreciated against the dollar).

Assessments of the RMB's Value

There is little consensus among economists on how close the RMB's exchange rate may (or may not) be to its "market value," or the extent the Chinese government may be intervening in currency markets to affect the RMB's exchange rate (since China does not publicize this information). To illustrate: in February 2014, Lombard Street Research (an economic forecasting firm) estimated that the RMB has been "overvalued since 2012. In May 2015, William Cline with the Peterson Institute for International Economics (PIIE) stated that for the first time, China's currency was found not to be undervalued.

Similarly, in July 2015, the International Monetary Fund (IMF) assessed that the RMB is "no longer undervalued." In its April 2015 report on exchange rates, the U.S. Department of the Treasury said that the RMB remained "significantly undervalued." Treasury's October 2015 report noted that China had intervened heavily in exchange rate markets from July to September 2015 to prevent the RMB from further depreciating and that market forces were currently pushing the RMB downward. However, Treasury concluded that RMB "remains under its appropriate mid-term valuation."

The RMB and the Chinese Economy

China's August 2015 surprise announcement of currency reforms, and the RMB devaluation that followed, may have contributed to volatility to global stock markets. Some analysts raised concerns that China's currency actions, coupled with sharp declines in China's stock exchanges (see CRS Insight IN10325, *China's Recent Stock Market Volatility: What Are the Implications?*, by Wayne M. Morrison and Gabriel M. Nelson), could be an indicator that the Chinese economy was slowing at a much quicker rate than reflected in official Chinese economic data. Some analysts speculated that the Chinese government was attempting to jumpstart the economy by devaluating the RMB in order to boost exports, a risky move, it was argued, because it threatened to spark a "currency war" among its major trading partners and antagonize commercial relations with the United States.

Other analysts contend that China's August 2015 currency moves represented a genuine effort to reform China's financial sector and were done largely to promote the RMB's inclusion in IMF's Special Drawing Rights (SDR) currency basket, which the IMF's Executive Board approved on November 30, 2015 (see CRS In Focus IF10327, *The IMF's Special Drawing Right and China's Renminbi*, by Martin A. Weiss). The IMF noted that the inclusion of the RMB in the SDR basket was "an important milestone in the integration of the Chinese economy into the global financial system" and was in "recognition of the progress that the Chinese authorities have made in the past years in reforming China's monetary and financial systems." Although the RMB's inclusion on the SDR basket appears to be largely a symbolic victory for China, it may be an indicator that the Chinese government is serious about making the RMB a global reserve currency.

The RMB's devaluation against the dollar in December 2015 and early 2016 has renewed concerns about the health of China's economy. China's FERs declined by $108 billion in December 2015 and $99 billion in January 2016, indicating that the government is facing increasing pressure to halt capital flight. It is unclear how recent volatility in China's financial sector will affect the pace of China's currency reforms and the liberalization of its capital account.

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