Washington-Beijing *Currency Friction*

BY GREG MASTEL

The latest flash points in the U.S. Congress.

While China's trade surplus with the United States has ballooned in the last two decades, the United States and China have had a growing list of bilateral trade disputes ranging from restrictions on exports of rare earth metals to Chinese subsidies of new energy technologies. Now one issue, China's controls on the exchange rate of its currency—known as the renminbi, or yuan—with the dollar has come to eclipse all others. At least on this side of the Pacific, the consensus that China's currency policy is unfair and should change is broad enough to encompass both "big business"—the National Association of Manufacturers—and leading labor unions. Even both President Obama and his 2008 opponent Senator John McCain have criticized Beijing's currency policy and it seems most members of Congress agree.

Those opinions are well-founded as there is strong evidence China has pursued a policy of keeping the renminbi artificially weak versus the dollar. China's primary motive boils down to modern mercantilism: a cheap renminbi makes China's exports relatively cheap and imports into China relatively expensive, which stimulates manufacturing employment in China. China is certainly not the first or only country to pursue such a weak currency policy. Many other coun-

Greg Mastel is a Managing Director of Dutko Worldwide. Formerly, he served as Chief Economist and Chief International Trade Adviser on the Senate Finance Committee.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W.
Suite 740
Washington, D.C. 20006
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

tries—most notably Japan—have been accused of doing the same thing over the years.

But China appears to be acting on a scale without precedent. In order to defend the renminbi at below-market rates, China has steadily acquired dollars and dollar-denominated assets in order to make dollars scarcer and thus more expensive relative to the renminbi. Beijing added nearly $200 billion to its foreign exchange reserves—mostly dollars—in just the last quarter of 2010. As a result, China has acquired a staggering total of nearly $3 trillion in dollars and dollar-denominated assets, far more than any other country. In the last five years, China's trade surplus with the United States has remained firmly stuck at over $200 billion per year. Unquestionably, a number of factors contribute to that imbalance, but it would be difficult to argue that China's currency policy is not one important driver of the continuing imbalance.

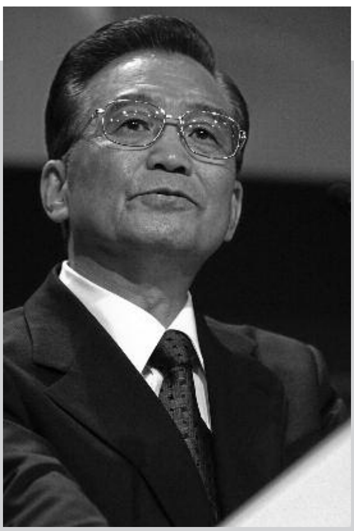
As the U.S. Department of the Treasury—hardly a nest of currency hawks—summarized in July of 2010: "China's continued rapid pace of foreign reserve accumulation; the limited appreciation of China's real effective exchange rate relative to rapid productivity growth in the traded goods sector; and the persistence of current account surpluses even during a period when China's trading partners are in deep recession—together suggest that the renminbi remains undervalued."

It is difficult to know precisely how undervalued the renminbi is. Ultimately, only allowing the renminbi to float in world currency markets would determine the appropriate exchange rate. Credible estimates, however, from sources such as the Peterson Institute for International Economics have put the figure at between 20 percent and 40 percent undervaluation. China has

It would be difficult to argue that China's currency policy is not one important driver of the continuing imbalance.

grudgingly agreed to some strengthening of the renminbi including an announcement with some fanfare in June of 2010 that appreciation would be allowed. In reality, appreciation has only amounted to a bit over 3 percent since that announcement. China's rapidly growing economy and rapidly increasing productivity continue to suggest that the real value of the renminbi may still be increasing faster than the adjustments allowed. As critics point out, China's policy also encourages other smaller export powers to follow suit or at least resist any strengthening of their currencies that might undermine their competitiveness, increasing the global distortion.

As noted, the concept of employing artificially low exchange rates to boost exports is certainly not new. It has been a part of the U.S. debate on international trade since at least the Omnibus Trade and Competitiveness Act of 1988, which created a process under which the Treasury Secretary could identify countries that "manipulate" the value of their currency for the purpose of "gaining unfair competitive advantage in international



WORLD ECONOMIC FORUM/SWISS-IMAGE.CH

Strange Admission

Strangely, though it has made it clear that Beijing is controlling the value of the renminbi for trade advantage, the Treasury has always avoided directly labeling China a "currency manipulator." In 2010, the evidence became close to definitive with China's burgeoning dollar reserves and Chinese **Premier Wen Jiabao's** admission that China would not allow the renminbi to appreciate substantially because, "We cannot imagine how many Chinese factories will go bankrupt, how many Chinese workers will lose their jobs." Still, Treasury refused to brand China with the scarlet "M" of currency manipulator.

—G. Mastel

> *There might be enough votes to overcome a presidential veto.*

trade." At the time, China was not the primary focus of the statute, but given its rapidly soaring trade surplus and dollar holdings, China has come to define the statute and has been the public focus of this twice-annual report by the Secretary of the Treasury for more than a decade.

Strangely, though it has made it clear that Beijing is controlling the value of the renminbi for trade advantage, the Treasury has always avoided directly labeling China a "currency manipulator." In 2010, the evidence became close to definitive with China's burgeoning dollar reserves and Chinese Premier Wen Jiabao's admission that China would not allow the renminbi to appreciate substantially because, "We cannot imagine how many Chinese factories will go bankrupt, how many Chinese workers will lose their jobs." Still, Treasury refused to brand China with the scarlet "M" of currency manipulator.

In Treasury's defense, it is not clear that officially labeling China a currency manipulator would have much positive impact. Certainly, Beijing would bristle at the public shaming, but it is unlikely to react by immediately revaluing the renminbi. Naming China might only result in continued negotiations with Beijing, which are already occurring and—some at Treasury argue—they can more effectively appeal to China's better angels through quiet discussions.

Unfortunately, diplomatic pressure to varying degrees is a fair summary of the stated policy on Chinese currency of the Clinton, Bush, and now Obama administrations. But it has little to show in terms of results. Especially at a time when the United States faces near-double-digit unemployment while China grows at a double-digit rate, it is difficult to endlessly counsel patience.

The new Republican leadership of the House seems somewhat less enthusiastic than their Democratic counterparts about pursuing legislation on the Chinese currency issue, but at different times strong majorities have demonstrated their concerns. The House voted 348 to 78 for one China currency bill in late 2010 (with majorities from both parties); for its part, 67 senators voted in favor of another China currency bill in 2005. If it came to it, those majorities suggest there might be enough votes to overcome a presidential veto, though in the end the president would likely try to strike a bargain with Congress rather than use his veto pen.

Assuming that China does not take clear action on the issue, chances are increasing that Congress will grow tired of both Beijing's excuses and Treasury's counsel for quiet diplomacy, and pass new legislation to challenge Chinese renminbi manipulation, but what would that legislation look like? Unfortunately, there is no simple, perfect legislative approach to address the currency problem. There are four core concepts that have been combined in various forms in the various bills introduced in Congress:

■ **Name China a Currency Manipulator.** This is the most obvious step given that this has been the core of U.S. legislation on the topic since 1988. Public naming would demonstrate the resolve of Congress on the issue, but as noted that would not necessarily guarantee action. The threat of naming China a currency manipulator may continue to move Beijing to take positive steps, but it is unlikely to be a "game-changer."

■ **Challenge China's Practices at the World Trade Organization or the International Monetary Fund.** The International Monetary Fund has already criticized China in general terms, but is not truly a dispute resolution body. The World Trade Organization does have clear dispute settlement procedures with the potential threat of sanctions. There are also provisions of the WTO that speak to currency manipulation, but there is little history of the WTO ruling on currency issues. It is at least possible that a WTO might defer to the IMF or, worse yet, not find sufficient grounds to rule with the United States—setting back U.S. efforts.

■ **Treat Currency Manipulation as a Subsidy and Apply Countervailing Duties to Chinese Imports.** There are several legislative versions of this, but the central concept is to treat currency manipulation as a subsidy under trade remedy laws and potentially impose duties on particular imports that benefit. This approach has not been tried, but it likely could be managed under the current system of trade remedies with some tweaking. It could be helpful to counter imports of specific products with an organized U.S. competitor, such as steel. But this approach would not automatically be extended to all imports from China, would require each domestic industry to engage in expensive and lengthy litigation, and would not address the competitive problems of U.S. exports to China or U.S. exports that compete with Chinese products in third markets.

■ **Impose Sanctions on China.** A bill put forward by Senators Charles Schumer (D-NY) and Lindsey Graham (R-SC) would have imposed a 27.5 percent tariff on Chinese imports if China refused to adjust the exchange rate of the renminbi. The hope of the authors is likely that the threat of sanctions would be enough to move Beijing to action, and that may be the case. But actually imposing such a tariff would certainly have adverse impacts on the U.S. economy, fail to address the problem of competition of U.S. exports, likely be condemned by the WTO, and potentially trigger the oft-threatened "trade war."

Even if there is no ideal policy counter to China's currency manipulation, the combination of high U.S. unemployment, the enormous U.S. trade deficit with China, and the strong evidence that China is pursuing a mercantilist exchange rate policy may well bring Congress to act. In the end, some combination of the above measures is likely to be Congress' solution.

The United States and China are economically interdependent and neither can afford to see the other fail. Any action the United States might take to counter China on renminbi policy would certainly have risks. That said, China cannot continue to drive its spectacular economic growth with exports—effectively exporting unemployment to the world. Beijing also should not ultimately expect to be protected by the institutions and rules of international commerce when they serve its interest, but ignore them when they do not. A stronger renminbi would also help control inflation and increase consumer buying power, both of which are clearly in Beijing's own best interest. Hopefully, leaders on both sides of the Pacific can responsibly address this problem as Washington and Tokyo did in the 1980s, but there seems to be a significant and growing chance that a major clash over currency is in the future for Beijing and Washington. ◆