"The Continuing Problem of China's Currency Management Policy"

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For the hearing on "Assessing the U.S. Rebalance to Asia"

Before the U.S.-China Economic and Security Review Commission

March 31, 2016

I appreciate the opportunity to address the commission and to discuss what I see as the key issues in rebalancing trade between the United States and China. I will make two main points in my testimony.

First, I will argue that the Chinese yuan and the U.S. dollar remain misaligned. The dollar continues to be substantially over-valued against the yuan, which is the cause of our persistent trade deficit with China. This over-valuation is the result of China's central bank policy; specifically, its holding of large amounts of foreign exchange reserves. The effect of this large stock of reserves has more impact in keeping down the value of the yuan than its recent sales of reserves did in raising or maintaining its value.

The second point is that we must recognize that the United States does not have a single national interest when it comes to dealing with China. Different groups in the United States have distinct interests that are to some extent competing and, in many cases, in direct conflict. The commission must recognize these differences, since government policy will inevitably be forced to prioritize the concerns of some groups over others.

The Value of the Dollar and the Yuan

In recent years, many economists have proclaimed that the imbalance between the yuan and the dollar has been corrected. They have pointed to the sharp increase in wages in China, the rise in the nominal value of the yuan, and more recently the sale of foreign exchange reserves by China's central bank as evidence that the yuan is now properly valued against the dollar and that China is no longer deliberately managing its currency to gain a trade advantage.

There are some basic facts that suggest the opposite. First, as a general proposition we would expect that a relatively fast growing developing country like China would be far more likely to run a trade deficit than a relatively slow growing rich country like the United States. While everyone recognizes that China's economy is slowing, even in the most pessimistic scenarios it is expected to see growth of more than 5.0 percent in the near-term future. This compares to projected growth of just over 2.0 percent for the United States.

The difference in growth rates should translate into differences in returns to investment. In other words, we expect that the average return on capital invested in a country with a 5.0 percent growth rate will be greater than the return on an investment in a country with a 2.0 percent growth rate. For this reason, we would expect that capital would be flowing from the United States and other wealthy countries to China, not in the opposite direction as is now the case.

Of course China does not allow for the free flow of capital, with restrictions in both directions, so we can't know for sure what the flows would look like in the absence of government intervention, but the fact that they are strongly in the opposite direction of what is predicted in economic theory should provide grounds for suspicion.

But the more immediate issue is whether the government is still acting to depress the value of the yuan against the dollar. Here, the focus exclusively on flows is misleading. China had accumulated a massive amount of foreign reserves over the last two decades. While it has sold off some of these reserves in the last year, it still holds more than $3.2 trillion in foreign exchange reserves.[1] This is far more than the amount that would conventionally be held in reserve to cover any unexpected drops in imports or surges in exports.

The standard rule of thumb is that reserve holdings should be equal to six months of imports. In China's case, this rule would imply that it should hold reserves of roughly $1 trillion — $2.2 trillion less than its current holdings of foreign exchange reserves. In fact, this rule of thumb likely exaggerates the amount of reserves that China realistically needs to hold for precautionary purposes. As a large country with a diverse range of exports to a large group of buyers, there is little risk of a precipitous fall in its exports due to a crisis in a major trading partner or a glut of a particular product. Furthermore, a large portion of China's imports are intermediate goods that are used in the

1 Trading Economics. 2016. "China Foreign Exchange Reserves 1980-2016." http://www.tradingeconomics.com/china/foreign-exchange-reserves (accessed March 21, 2016).

production of exports. If exports of manufactured goods fell for some reason, the imports of these intermediate goods would fall as well, reducing the country's need for foreign exchange.

For these reasons, the rule of thumb that reserves should be equal to six months of imports likely overstates China's true need for foreign exchange, but even if this figure is accepted at face value it still implies that the country holds $2.2 trillion in reserves in excess of what is needed for normal purposes. This is a massive stock of foreign reserves that is pulled off world markets, with the supply of yuan considerably greater than it would be if China's central bank had not acquired these reserves.

The excessive stockpile of reserves that China's central bank holds would be expected to drive up the value of the currencies it holds relative to the counterfactual where private parties had to hold these reserves and implicitly there were fewer yuan in circulation. This conclusion would follow directly from an application of James Tobin's portfolio balance theory.[2] With fewer dollars in circulation in the world and more yuan, investors are willing to pay more for the stock of dollars available to hold and less for the stock of yuan than if the central bank had not intervened.

This is the same logic that applies to the Federal Reserve Board's quantitative easing program, now that it is no longer actively purchasing new assets. While the decision to buy assets during the period of accumulation almost certainly helped to drive down long-term interest rates, the fact that the Fed now holds in excess of $3 trillion in assets continues to put downward pressure on long-term interest rates compared to a scenario in which private investors had to hold these assets. By putting more money into circulation and reducing the stock of longer-term assets available to the public, the Fed has raised the price of long-term assets, thereby reducing interest rates.[3]

The Fed's actions can still on net be holding interest rates down, even as it makes a decision to raise the federal funds rate, as it did in December. This is analogous to the decision of China's central bank to sell some of its reserves last year in an effort to support the value of the yuan. While that decision raised the value of the yuan compared to what it would have otherwise been, this does not

2 Tobin, James. 1969. "A General Equilibrium Approach To Monetary Theory." *Journal of Money, Credit and Banking*, Vol. 1, No. 1, pp. 15–29. http://www.deu.edu.tr/userweb/yesim.kustepeli/dosyalar/tobin1969.pdf.

3 Just to be clear, the argument is that by holding this large stock of assets the Fed is putting downward pressure on long-term interest rates. This is an implicit comparison of two different stock positions. One in which it had the same federal funds rate, but did not have a stock of more than $3 trillion of assets, compared with the situation where is does hold this stock of $3 trillion in assets. Of course if it were to start selling assets, the Fed would be putting downward pressure on interest rates compared to its current position.

mean that China's central bank is on net acting to hold up the value of the yuan. The impact of its huge reserve holdings means that the net effect of the central bank's intervention is holding down the value of the yuan.

It is difficult to quantify the impact of the central bank's holdings since there are extensive restrictions on the flow of capital in both directions. In recent months there have been numerous reports of individuals in China who are desperately trying to reduce their holdings of yuan in order to get a currency they view as safer, or at least to diversify their asset holdings. While legal barriers reduce the size of this outflow, legal barriers also hold down the size of the potential inflow of capital from other countries. Undoubtedly, many more foreign investors would opt to invest a portion of their wealth in China if this could be done more easily, especially if they knew they could change their yuan back into other currencies without restrictions. However, a system where China has a freely floating currency implies a qualitatively different economic environment than what exists today. So it is not clear that it would be an appropriate counterfactual for determining a market exchange rate.

Even if there is no simple way to quantify the size of the effect of the central bank's holdings of excessive amounts of foreign reserves, since there is not a well-defined counterfactual, it is relatively straightforward that the value of the dollar is higher and the yuan is lower as a result. Under fairly general conditions, fewer dollars on world markets and more yuan in circulation, will translate into a higher valued dollar and lower valued yuan.

If it is the case that China is still propping up the dollar against the yuan through its policy of holding excessive amounts of reserves, it is certainly reasonable policy for the United States to demand that China allow the dollar to fall by reducing its stock of reserve holdings. The resulting decline in the dollar will make U.S. made goods and services more competitive in the world economy, thereby reducing the size of the trade deficit.

This doesn't mean that the United States should expect an immediate correction in currency values. China is clearly experiencing a difficult transition process which is the main priority of the country's leadership. They are not likely to accept demands for an appreciation of the yuan which will make this transition even more difficult. However, it would make sense to press for a timetable under which the central bank gradually reduces its holdings of foreign reserves, allowing the yuan to rise to a level more consistent market forces.

Conflicting U.S. Interests in China

The discussion in the prior section implicitly assumed that there is a general interest in the United States in seeing a higher valued yuan and more nearly balanced trade with China. This is not true. Much of the workforce would benefit from a smaller trade deficit and the increased employment that would result, especially workers without college degrees who have been the big losers as result of the trade deficit.[4] This would mean not only more jobs, but higher pay for less-educated workers more generally, as the increased demand for their labor would put upward pressure on their wages. However, there are important interest groups who would be harmed by a rise in the yuan either directly or indirectly.

First among the groups who would be hurt directly are the businesses that profit from importing goods at low cost from China. At the top of this list would be retailers like Walmart who have built up a low-cost supply chain in China and other developing countries by contracting with developing country manufacturers for many of the items they sell in their stores. These retailers would not be anxious to see the price of the items they import from China rise by 15–20 percent in dollar terms as a result of the drop in the value of the dollar against the yuan.

The same story would apply to large manufacturing companies that have set up operations in China in order to produce for export back to the United States. A substantial rise in the value of the yuan would directly lead to a rise in production costs for the items they produce in China. For these groups, an increase in the value of yuan would mean surrendering an important advantage they had developed compared to their domestically based competitors. Both U.S. retailers with substantial sourcing in China and U.S. manufacturers with Chinese subsidiaries producing for export would be directly hurt by an increase in the value of the yuan relative to the dollar.

In addition, there are other important interests who could stand to lose if the U.S. government were to press a demand for a higher valued yuan due to the fact they have a competing set of demands they would like to be pressed on the Chinese government. The logic here is straightforward: pressing the Chinese government to raise the value of its currency is asking it to do something it would not otherwise choose to do. Although the Chinese government has indicated an intention to allow its currency to rise and to move towards a system of freely flowing exchange rates, it clearly is not in a

4 Autor, Dorn, and Hanson. 2013. "The China Syndrome: Local Labor Market Effects of Import Competition in the United States." *American Economic Review*, Vol. 103, No. 6, pp. 2121–2168. http://economics.mit.edu/files/6613.

rush to change its currency policy. The goal of the U.S. government in this area is to press China to move more quickly.

However, the United States is not in a position to simply dictate a set of policies that it wants the Chinese government to follow. As the second most powerful country in the world, China can very well refuse to act on demands it considers too onerous. It can also make its own demands and expect to get some of them met in exchange for its own concessions.

This matters in the context of negotiations over currency values because the United States also presses a variety of other economic and non-economic issues in its negotiations with China. While I am not in a position to comment on the non-economic issues, I will note several areas in which the United States has made competing economic demands of the Chinese government.

First, the United States regularly presses for more market access in a range of areas. This list includes various areas of finance, including underwriting and insurance, telecommunications, and retailing. Arguably China has inappropriately restricted the access of U.S. corporations in these and other areas.

The second area in which the U.S. has made demands on China is in the enforcement of intellectual property rights. China has vast amounts of unauthorized copies of U.S.-designed software, as well as recorded music and video material. It also allows for the sale of unauthorized copies of trademarked merchandise, such as designer clothes and watches. And it allows for the manufacture of generic versions of drugs that would be subject to patent protection in the United States.

In these and other cases, U.S. corporations arguably have legitimate grievances under W.T.O rules and other agreements to which China's government has committed itself. However, as a practical matter, China is not going to simply acquiesce to a laundry list of demands from the United States. Any administration seeking to make progress in trade relations with China will have to prioritize these concerns, highlighting some to the detriment of others.

This means that those with competing complaints against China are in a very real way competitors rather than allies. The commission may not wish itself to seek to prioritize the various concerns raised by different interest groups in the United States, but it should nonetheless recognize this reality. Any path forward does not mean that the groups who feel they have been harmed will collectively beat up China. Rather some of these groups will be working to marginalize the interests of others, in order to get their own concerns moved to the top of the agenda.

Conclusion

To sum up, I would argue that the United States continues to have a large trade deficit with China because of a deliberate decision by the Chinese government to keep the value of its currency at a level that is lower than would be the case without intervention. While it is not currently buying reserves for this purpose as had been the case in years past, its decision to continue to hold a massive amount of reserves has the effect of raising the value of the dollar and lowering the value of the yuan compared with a scenario in which it had a more normal stock of reserves.

The other point that is insufficiently appreciated is that the various interest groups in the United States with complaints against the actions of the Chinese government are in direct competition with each other. There is no plausible scenario in which the United States is going to be able to impose its will on China in a wide variety of areas. This means, for example, those who hope to see China make major concessions on the value of its currency are in competition with those who would like to see China open its markets to U.S. firms in various sectors or increase its protection of U.S. copyrights, patents, and trademarks. More progress in one area will come at the expense of progress in other areas. The commission may not choose to set priorities, but the administration and Congress cannot avoid this need.