In the short space of three decades China has transitioned from a largely self-sufficient economy to the world’s third largest trading nation. As its role in the global trading system has expanded, the rest of the world has taken a keen interest in the evolution of its trade regime. This interest was apparent in China’s negotiation to enter the World Trade Organization (WTO). Members of the WTO leading the negotiations sought to impose conditions that maximized the prospects that China’s entry would occur on “commercially viable terms.” In response, during the 14-year negotiation process China unilaterally cut its tariffs substantially, in large measure to demonstrate its commitment to a liberal trade regime. Since China’s entry into the WTO in December 2001, the members have periodically reviewed China’s compliance with the terms of its commitments.

More recently, China’s foreign exchange regime also has received growing attention from the international community. A rapidly growing external surplus and substantial official intervention in the foreign exchange market, combined with large-scale sterilization of the resulting increases in China’s international reserves, have naturally raised a number of important questions about the nature of China’s foreign exchange regime. For example, to what extent have the actions of the authorities resulted in an undervalued exchange rate for the renminbi? To what extent are China’s international obligations on exchange rate policy in conflict with its domestic economic priorities? Did China’s large external surpluses contribute to the emergence of the global financial crisis in 2008? Do China’s massive holdings of US treasury obligations and other US dollar-denominated financial assets provide China with substantial leverage vis-à-vis the United States that China might use to advance its own economic
and political interests? What role has the International Monetary Fund (IMF) played and what role should it play in overseeing developments in China’s exchange rate regime?

Almost four years have passed since China announced a number of changes to its foreign exchange regime on July 21, 2005. During this period, the debate on the pros and cons of China’s exchange rate policy, which had begun several years earlier, intensified. In our analysis we identify the key issues in that debate and offer policy prescriptions for the period ahead. In framing these policy suggestions, we have taken account of the fact that, like most of the rest of the world struggling with the global financial crisis and economic slowdown, economic growth in China has slowed markedly—from 14 percent (at an annual rate) in the second quarter of 2007 to only 6.1 percent in the first quarter of 2009.

In chapter 1 we review the evolution of China’s foreign exchange regime since the beginning of the reform period three decades ago, including developments since the regime change in July 2005. In chapter 2 we analyze key economic challenges facing the Chinese authorities in light of the increasingly undervalued exchange rate through 2007, the accelerating buildup of foreign exchange reserves, and more recently the sharp decline in economic growth. These challenges include maintaining progress on currency reform while trying to use monetary policy as an effective instrument of macroeconomic management; reducing excessive reliance on investment and external demand to sustain economic growth; preventing defense of the currency regime from unduly handicapping efforts to strengthen and transform banks into truly commercial entities; and containing the risk of protectionism abroad in response to the emergence of China’s very large global current account surplus. We conclude in chapter 3 with a scorecard on the leading options for China’s exchange rate policy going forward, contrasting a “stay-the-course” policy with a bolder three-stage approach to expedite correction of the renminbi’s undervaluation.