Congressional Testimony

Correcting the Chinese Exchange Rate

C. Fred Bergsten
Director, Peterson Institute for International Economics

Testimony before the Hearing on China's Exchange Rate Policy, Committee on Ways and Means, US House of Representatives

September 15, 2010

Summary and Recommendations

1. The US and Chinese global trade imbalances are increasing sharply. This makes it considerably harder to reduce unemployment and achieve a sustainable recovery in the United States.
2. China's currency remains substantially undervalued, importantly due to that country's massive intervention in the foreign exchange markets, and is a major cause of its large and growing trade surplus. It has risen by less than 1 percent since the announcement of a "new policy" in June 2010.
3. China let its exchange rate rise by 20 to 25 percent during 2005–08. Our goal should be to persuade it to permit a similar increase over the next two to three years. This would reduce China's global current account surplus by $350 billion to $500 billion and the US global current account deficit by $50 billion to $120 billion.
4. Elimination of the Chinese misalignment would create about half a million US jobs, mainly in manufacturing and with above-average wages, over the next couple of years. The budget cost of this effective stimulus effort would be zero.
5. The United States should seek to mobilize a multilateral coalition to press China to let its currency rise by the needed amount. The European Union and a number of important emerging market economies, including all three of the other BRICs, have expressed deep concern over China's currency policy.
6. This currency realignment is an integral part of the global rebalancing strategy adopted by the G-20 and laid out in detail as part of its new Mutual Assessment Process. This strategy has been agreed by the Chinese (as well as all other) member governments. Further development and implementation of the program is to be discussed, and hopefully adopted, at the next G-20 summit in Korea in November.
7. To date, however, the efforts of the International Monetary Fund (IMF) to persuade China to move sufficiently have largely failed. The Fund has no enforcement tools of its own. Hence the United States and its allies should seek authorization from the World Trade Organization (WTO) to impose restrictions on imports from China unless it allows its currency to adjust adequately.
8. To lead this effort credibly, the Administration must of course designate China as a "currency manipulator," as it has been for at least seven years. We can hardly ask the world, through the IMF and WTO, to indict China if we are unwilling to do so ourselves. The Committee, and the Congress more broadly, should insist that the Administration do so—preferably at these hearings.

9. In addition, the Administration should initiate a new strategy of "countervailing currency intervention" (CCI) against Chinese purchases of dollars by making offsetting purchases of Chinese renminbi.[1] China has been intervening at an average of about $1 billion per day over the past several years, by purchasing dollars with renminbi to keep the price of our currency up and the price of its currency down. This greatly enhances the price competitiveness of Chinese products in world trade. The United States should counter by buying corresponding amounts of renminbi with dollars, which we can of course create without limit. This is technically challenging, since the renminbi is not fully convertible, so our authorities will have to find and buy market proxies such as nondeliverable forward contracts for renminbi and renminbi-denominated bonds in Hong Kong.
10. The United States should also henceforth treat currencies that are substantially and deliberately undervalued as constituting export subsidies for purposes of calculating and applying countervailing duties (but not antidumping duties). They clearly represent a subsidy (and an equivalent import barrier) in economic terms and I believe the Department of Commerce erred in its recent determination that they are not countervailable under current US law. As a result of Commerce's decision, however, I recommend that Congress pass that part of the Ryan-Murphy bill (H.R. 2378) that would clarify that currencies that are substantially and deliberately undervalued are to be treated as export subsidies subject to US countervailing duties.

The Global Imbalances

The US deficit and Chinese surplus have both moved substantially, first down and now back up, over the past several years. Both declined sharply to 2009: Our deficit fell from 6 percent of our GDP in 2006 to 3 percent, and China's surplus declined from an astounding 11 percent of its GDP in 2007 to 5½ percent.

There were two main causes for this improvement. The sharp decline in all world trade, due to the Great Recession, trimmed imbalances as well as overall trade levels because exports and imports both fell by roughly equivalent percentages. This meant that a country that started with an export surplus (China) experienced a drop in that surplus while a country that started with an import surplus (the United States) experienced a fall in its trade deficit.

The sizable currency adjustments of previous years also had major positive effects. The dollar fell, in a gradual and orderly manner, by a trade-weighted average of about 25 percent from 2002 until early 2007. The renminbi, as already noted, was permitted by the Chinese authorities to rise by 20 to 25 percent from the middle of 2005 to the middle of 2008 (before they re-pegged it to the dollar). With the usual lags of two to three years, these currency corrections made important contributions to the subsequent adjustments in trade imbalances.

Over the past six months or so, however, both countries' external imbalances have again been climbing sharply. The US deficit in goods and services, which fell to $25 billion in May 2009, climbed back to $50 billion this June and remained above $40 billion in July, the latest months for which data are available. China's surplus, after almost disappearing earlier this year (for peculiar statistical reasons), has now soared to monthly averages of about $25 billion during the last four months (to August) for which data are available. These reversals are due partly to the recovery of international trade, in response to renewed economic expansion around the world. They are also due partly to the renewed rise in the dollar during the crisis period,

[1] I initially proposed this idea in testimony before the Senate Committee on Banking, Housing and Urban Affairs on January 31, 2007. Senators Schumer and Graham have included a version of it in S.1254 and S.3134.

as safe-haven investments into the United States, and to the Chinese authorities' termination of appreciation of the renminbi.

The outlook unfortunately is for more of the same. The IMF projects that China's surplus will rise back to 8 percent of its GDP by 2015 (after foreseeing even higher levels in some of the earlier drafts of its latest forecast). In light of China's continued rapid economic growth, this number would reach almost $800 billion and far surpass its previous record high in absolute terms. It could also mean that China's global surplus would exceed the US global deficit in dollar terms.[2]

Exchange Rate Developments

This renewed growth of the current account imbalances, under normal market conditions, would produce a renewed rise of the renminbi and decline of the dollar. The dollar has indeed weakened a bit lately against most currencies, after strengthening earlier this year due to the flight from risk surrounding the European public debt crisis (as it did for similar reasons during 2008–early 2009 at the depth of the Great Recession), but not by enough to make much difference. The Chinese authorities apparently set the stage for an upward move of the renminbi when they announced on June 19, 2010 a return to a more flexible and more market-based exchange rate regime like that they had pursued during 2005–08.

The results to date have been very meager, however. As of September 10, 2010 the renminbi had risen by less than 1 percent. If maintained over the coming year, this would amount to an annual rate of only 4 percent. Such appreciation would barely be enough to reflect the annual rise in productivity growth in China, compared with that of its trading partners, let alone reduce the large undervaluation accumulated over the last half decade.[3]

Our Peterson Institute's latest calculations suggest that China would have to let the renminbi appreciate by about 15 percent on a trade-weighted basis and about 25 percent against the dollar to achieve equilibrium, defined as cutting the Chinese surplus to 3 percent of GDP.[4] These numbers are less than the "25 to 40 percent" undervaluation that I and others have cited until recently[5] because the IMF and most other projections of China's future current account surpluses, though still very high as noted above, have been reduced considerably from their earlier levels so less currency appreciation would be required to reach the current account target. If one believes that China should totally eliminate its surpluses, however, the required adjustment would still be on the order of those earlier numbers. **A reasonable goal would be a rise of 20 percent in the trade-weighted average of the renminbi over the next couple of years, about the same amount the currency rose during its earlier period of appreciation in 2005–08.**

It is obvious that China continues to intervene heavily in the currency markets to keep the renminbi from rising much more rapidly. It does not publish intervention numbers and the latest data on its foreign exchange reserves cover only the second quarter, including only the first ten days of the "new policy."

---

[2] I refer throughout this statement solely to the global trade and current account positions of the two countries. The bilateral imbalance between them is analytically irrelevant in a multilateral world economy. As China's global surplus approaches the US global deficit in absolute terms and as its share of the US global deficit continues to rise, however, the bilateral number will be an increasingly accurate proxy for the global totals.

[3] William R. Cline. 2010. *Renminbi Undervaluation, China's Surplus, and the US Trade Deficit*. Peterson Institute for International Economics Policy Brief 10-20, estimates that the RMB needs to rise by about 2 ½ percent annually to prevent China's rapid productivity growth from generating steady increases in its external surpluses.

[4] William R. Cline and John Williamson. 2010. *Estimates of Fundamental Equilibrium Exchange Rates, May 2010*. Peterson Institute for International Economics Policy Brief 10-15.

[5] See my testimony on that topic to this Committee on March 24, 2010.

Through that period, however, the data on reserves suggest that intervention has averaged at least $1 billion daily since 2005.[6] This official buying of dollars keeps the price of the dollar artificially high and the price of the renminbi artificially low, generating the currency undervaluation that adds substantially to China's international competitive strength. **It is hugely ironic that China complains about the international role of the dollar but does far more than anyone else on the planet to further increase that role by adding such massive amounts to its, and thus global, dollar reserves.**

Hence it **remains obvious that China is "manipulating" the value of its currency**. This clearly violates both the international monetary rules of the IMF Articles of Agreement and the global trading rules of the WTO Charter. The latest report of the Treasury, while stating clearly that "the renminbi is undervalued," nevertheless again fails to label China a "manipulator." One can understand Treasury's tactical desire to avoid further antagonizing China on the issue, even if disagreeing that doing so would reduce the prospect of its adopting more constructive policies, but it is violating both the letter and spirit of existing legislation as well as common sense by refusing to designate.[7]

Some critics still argue that currency adjustments would be ineffective in correcting the imbalances. To be sure, such adjustments must be considered in the context of complementary economic policies. This notably includes decisive US action to correct our budget deficit over the next several years and expansion of domestic demand in China, as already undertaken via their huge fiscal and monetary stimulus programs, to offset the negative impact on growth of a declining external surplus. But this proviso is well understood and is imbedded in the G-20's rebalancing strategy. Moreover, the process demonstrably works: The earlier rise of the renminbi during 2005–08 contributed importantly to the subsequent sharp fall in China's surplus, as noted above, without denting China's rapid overall growth during the period.

On the current accounts themselves, our latest studies show that every rise of 1 percent in the trade-weighted average of the renminbi will cut China's global surplus by $17 billion to $25 billion over the succeeding 2 to 3 years and will cut the US global deficit by $2½ billion to $6 billion over a like period. Hence the **proposed renminbi appreciation of 20 percent could be expected to reduce China's global surplus by $350 billion to $500 billion and the US global deficit by $50 billion to $120 billion.**[8]

A Proposed Action Plan

Under current conditions of high unemployment, an improvement of $50 billion to $120 billion in the US trade balance would generate 300,000 to 700,000 new US jobs. About half of these would occur in manufacturing and pay wages well above the national average. The initiatives proposed here to achieve this outcome would have virtually zero budget cost. Hence renminbi correction (and exchange rate adjustment more broadly) must be one of the most cost-effective stimulus measures now available to the US Government.

The cardinal issue remains what initiatives should be undertaken to promote the needed Chinese actions. Some of these steps range well beyond the currency issue itself. Most importantly, the US case would

---

[6] China's total foreign exchange reserves have now reached about $2.5 trillion. The next largest holder is Japan, at about $1 trillion. No one else exceeds $500 billion. The headline number for China's reserve increase in the second quarter was only $10 billion but this included a markdown of $70 billion in the dollar value of their euro holdings so intervention must have approximated $80 billion—more than $1 billion per working day.

[7] See C. Randall Henning. 2008. *Accountability and Oversight of US Exchange Rate Policy*. Washington: Peterson Institute for International Economics, especially pp. 44-52 on the report's treatment of manipulation in the case of China.

[8] See William R. Cline. 2010. *Renminbi Undervaluation, China's Surplus, and the US Trade Deficit*. Washington, Peterson Institute for International Economics Policy Brief 10-20.

be much more credible, and much more effective in achieving its goals, if it would take tangible steps to address the imbalances from its own deficit side of the equation. The key step would of course be an effective program to reduce, and preferably eliminate, the budget deficit over the next three to five years. President Obama's National Export Initiative, to double exports over the next five years, is a laudable goal in this context but has yet to encompass any meaningful content—and will be impossible to achieve without substantial appreciation of the renminbi and some other important currencies against the dollar. But it "takes two to tango" so China (and the other large surplus countries, notably Germany and Japan) must also adopt corrective policies to enable the needed adjustment to take place even if the United States were to do everything right.

It is also essential to embed the exchange rate issue in the broader context of rebalancing the world economy, with the United States consuming less and exporting more while China consumes more and exports less. The G-20 has adopted such a strategy, the IMF has laid out the implementation details in its Mutual Assessment Process, and the US and Chinese leaders have committed their countries to pursue it.

Most fundamentally, China will of course allow its currency to rise only if its authorities believe that doing so makes sense in terms of the country's own economic and international objectives. There is much debate around that issue but most analysts agree that it does. A stronger currency and smaller trade surplus, offset in growth terms by expansion of domestic demand, will rebalance the Chinese economy from capital-intensive investment and exports toward consumption and services. This in turn will promote a more rational allocation of capital, create more jobs, help check inflation, sharply reduce the country's need for energy and other raw materials, and cut pollution.[9] Such adjustment will of course also reduce the risk of international conflict, caused by China's surpluses, and thus promote its broad foreign policy interests along with its economic goal of maintaining open markets for its exports.

But the top Chinese authorities have clearly not accepted that diagnosis to date. Hence direct action on the exchange rate will be needed. One clear lesson of the recent past is that China is likely to respond more constructively to multilateral pressure than to bilateral pressure from the United States alone. The timing of its announced policy change in June 2010, albeit of limited practical effort so far, was apparently motivated by the upcoming G-20 summit in Toronto and the need to comply at least nominally with the MAP being presented there by the IMF. The sharp criticism it had recently received from fellow emerging economies, notably Brazil and India, may have had some impact as well. Hence the United States should seek to mobilize as broad a coalition as possible, in terms of both the number and development level of countries, to support its efforts to achieve effective adjustment by China.

There are two multilateral instruments for pursuing adjustment by China (or any surplus country), the IMF, and the WTO, neither of which has been very effective historically.[10] The IMF has been seized of the currency issue at least since 2005, with very modest results. When the Executive Board finally discussed the Fund staff's latest report on the country's economy (including the exchange rate), after China had delayed that conversation for three years, it could not even muster a majority to agree that the currency was "substantially undervalued"—as the IMF's Managing Director and staff have been saying repeatedly on the basis of their own in-depth analyses for some time. Close observers believe that only five or six of the Fund's 24 Directors, presumably a few (but not even all) of the Europeans as well as the United States and no

---

[9] Nicholas R. Lardy. 2008. Sustaining Economic Growth in China [pdf] in *China's Rise: Challenges and Opportunities*, C. Fred Bergsten et al. Washington: Peterson Institute for International Economics, and Nicholas R. Lardy. 2007. China: Rebalancing Economic Growth [pdf] in *The China Balance Sheet 2007 and Beyond*, C. Fred Bergsten et al. Washington: Center for Strategic and International Studies and the Peterson Institute for International Economics.

[10] John Williamson. Forthcoming 2010. *Encouraging Adjustment by Surplus Countries*. Peterson Institute for International Economics Policy Brief. Washington: Peterson Institute for International Economics.

developing countries, were willing to criticize China even to this very modest (and obvious) extent. Even if the IMF Board were willing to indict China, it has no power of enforcement and could only "name and shame"—which would be helpful, particularly in promulgating a WTO case (see below), but would certainly not guarantee a constructive response.

Hence attention has turned toward the WTO, which can authorize member countries to erect barriers against imports from other members that violate its rules. The issue is whether current WTO rules do in fact effectively prohibit currency manipulation à la China at present. There are two routes to such action[11]:

- a general indictment of China under Article XV, which proscribes countries from "frustrating the intent of the provisions of this Agreement by exchange action," prosecution under which would authorize members to retaliate against China; and
- approval of case-by-case action by individual countries that chose to regard China's currency undervaluation as an export subsidy under the Code on Subsidies and Countervailing Duties, which China would have to challenge to overturn.

I recommend that the United States pursue both courses of action if China continues to resist adequate appreciation of the renminbi. In both cases, it should seek to move in concert with as many other WTO members as possible. In both cases, it should be noted that the WTO will be guided on the exchange rate issue itself (as opposed to the trade policy responses) by the IMF.

The Article XV action is preferable in principle because it would apply to Chinese exports of all products to all countries. However, the language and legislative history of the provision make it difficult to apply to the current Chinese case (or any other foreseeable currency case). Some observers therefore oppose invoking the article because they fear that a negative ruling would make it harder to challenge currency undervaluations in the future and might also undermine very valuable dispute settlement mechanism of the WTO. I would nevertheless urge its pursuit, including via a push from the Congress if necessary to convince the Administration, because doing so (1) would represent an impressive multilateral effort that (2) would publicize the need for Chinese action much more widely than at present and (3) highlight the desirability of reform of the WTO itself to handle such cases if the present language does in fact prove to be impotent. All this would play out over at least a couple of years, because WTO cases take that long to run their course, and would thus desirably keep the spotlight on the issue as long as it remained unresolved.

In the meanwhile, the United States and as many allies as possible should act on their own to treat the renminbi undervaluation as an export subsidy—as Fed Chairman Ben Bernanke has noted publicly that it is—that must be included in calculating countervailing duties against Chinese products. The Department of Commerce has recently concluded that currency undervaluation is not actionable as a subsidy under current US law so Congress should pass legislation, along the lines of H.R. 2378 (Currency Reform for Fair Trade Act of 2009), to reverse that ruling.[12] It is not clear whether this approach will pass WTO muster either but in this case, unlike the Article XV option under which the United States would take China to the WTO and seek authorization for action, the action would already be taken by the United States (and hopefully others) and China would have to take the United States to the WTO in an effort to remove the countervailing duties. This too would take a considerable period of time, during which the countervailing duties would be in place,

---

[11] Gary C. Hufbauer, Yee Wong, and Ketki Sheth. 2006. *US-China Trade Disputes: Rising Tide, Rising Stakes*. Peterson Institute for International Economics Policy Analysis in International Economics 78. Washington: Peterson Institute for International Economics.

[12] There are a number of technical problems with H.R. 2378 as currently drafted, however. For example, its threshold level of 5 percent for an "actionable undervaluation" is far too low in light of the imprecision of all misalignment calculations; the number should be at least 10 percent. It muddies the waters by calling for parallel treatment of currency *over*valuations, which do not require similar policy action. And it erroneously treats undervalued currencies, which reflect *government* export subsidies, as a source of discriminatory pricing of exports by *private* parties for antidumping purposes.

and—again depending importantly on how many countries joined the US initiative—would provide a powerful "shot across the bow" to help induce China to let the exchange rate move substantially.

Mobilization of an international coalition should be particularly feasible under the countervailing duty option. Other major importers would fear diversion of subsidized Chinese goods to their markets if the United States acted alone against its products. Hence they would almost certainly emulate the US action very quickly and should be willing to act simultaneously with it. Chinese awareness of potential action by a large number of its key markets, especially the United States and the European Union as by far the two largest, would presumably provide maximum inducement for China to prevent the planned action by letting its exchange rate move substantially. Other countries might also be willing to join the Article XV, however, because only the plaintiffs in the case would be authorized under WTO rules to retaliate against the offensive Chinese practice.

A New Option

There is one, directly monetary, measure that the United States should contemplate taking against China: direct purchases of renminbi to counter China's direct purchases of dollars. It is absurd, especially from a US national perspective but also from the standpoint of global financial stability, that other countries set the exchange rate of the dollar. This is a consequence of the international role of the dollar, one of several of which lead me to question whether that role remains in the national interest of the United States.[13]

In principle there could be little objection to such "countervailing currency intervention" against manipulation by another country that was keeping its exchange rate substantially undervalued as a result. In practice, the United States could easily adopt such a policy against any currency that is generally convertible, such as the euro if it too became substantially undervalued (as appeared to be occurring several months ago).

The United States has of course bought foreign currencies on many past occasions, most recently the euro in 2000 and the Japanese yen in 1998. Those interventions were taken in close coordination, and via joint market operations, with the issuer of the other currency at its request because they believed (and the United States agreed) that it had become too weak. It would be very different for the United States to intervene **against** the desires of another country, especially to **counter** its intervention, but the market techniques would be identical. Moreover, the objective would be to push a specific exchange rate toward equilibrium levels and thus to reverse a misalignment that was distorting global trade and the world economy.

There is a practical problem in the Chinese case. The absence of full convertibility for the renminbi, and the existence of widespread Chinese capital controls, make it impossible for the US authorities to enter well-functioning currency markets (as for the euro or yen) to buy renminbi because no such markets exist. Hence the United States would have to identify proxy assets and buy them instead. Candidates would include nondeliverable forward (NDF) contracts for renminbi and renminbi-denominated securities in Hong Kong. The magnitude of such interventions by the United States would be limited by the size of the relevant markets and thus to far less than the daily purchases of dollars by the Chinese authorities. But such an initiative by the United States would clearly indicate the seriousness of its concern over the misalignment of the renminbi, provide an unmistakable and indeed dramatic signal to the markets themselves, and add further to the pressure on China to cooperate.

There is nothing in US law or the IMF Articles of Agreement that would prohibit the United States from undertaking such "countervailing currency intervention" today. However, the Congress might want to

[13] C. Fred Bergsten. November/December 2009. "The Dollar and the Deficits: How Washington Can Prevent the Next Crisis," *Foreign Affairs*.

consider amending the relevant portion (Section 3004) of the Omnibus Trade and Competitiveness Act of 1988 to authorize Treasury to conduct countervailing currency intervention operations whenever it determines that a country is manipulating its exchange rate to gain an unfair competitive advantage. Such an authority would greatly strengthen the hand of the Treasury in conducting the negotiations to remedy an unfair currency practice as called for under the Act. A version of the idea is included in S.1254 and S.3134, proposed by Senators Schumer and Graham.

The exchange rate is of course an inherently international issue because it involves at least the two countries between whose currencies it provides a price. Hence the use of countervailing currency intervention by the United States, or by any other country, should be subject to review by the IMF. Any country that believed it was being unfairly challenged by such a policy should be able to appeal to the Fund, and the countervailing country should be required to desist if its justification for the action was found to be inconsistent with the objectives and rules of that institution. This would parallel the treatment of countervailing duties by the WTO, described above, under which target countries can win disapproval of the countervailing action if they can demonstrate that their alleged subsidies are in fact not actionable under the rules of the institution.

The United States would be in a strong position to defend itself against any such protest from China, however. The IMF Guidelines for Exchange Rate Policies call on member countries to "take into account in their intervention policies the interests of other members*, including those of the countries in whose currencies they intervene*" (italics added). There is no evidence that China has done so vis-à-vis the United States despite its massive intervention in dollars. Japan has interestingly just posed a similar question concerning China, complaining that the Chinese are driving up the exchange rate of the yen by buying Japanese bonds while blocking Japanese purchases of Chinese bonds that might have a counteracting effect.

Countervailing currency intervention would be decidedly superior to countervailing duties to deal with the problem of manipulated exchange rates. Undervalued currencies subsidize all of the exports of the country in question and pose a barrier of equivalent magnitude to all of its imports. Countervailing duties, however, address only exports of individual products from such a country on a case-by-case basis and do not apply to its imports at all. The currency approach is monetary and comprehensive whereas the trade tool, useful as it is for its intended purpose, involves cross-retaliation and is very selective in its application.

Conclusion

The time has clearly come, indeed has long since passed, to devise effective strategies to achieve adjustment of the world's largest international imbalances: the US deficit and the Chinese surplus. Continued failure to do so will generate increasing risks of renewed financial crisis, encourage new outbreaks of restrictive trade measures as countries respond to China's blatantly protectionist currency policy, trigger renewed transpacific tensions, and make it more difficult to reduce the US unemployment rate as China exploits demand in other countries to create jobs at home.

The proposed action program entails risks as well. The designation of China as a "currency manipulator" could increase its intransigence rather than promote constructive action. Appealing to the WTO on "exchange action" enters new territory and could jeopardize that valuable institution. Expanding the scope for countervailing duty actions could lead to protectionist abuse of that safeguard device. "Countervailing currency intervention" could trigger temporary instability in financial markets.

But the risks of inaction, including to the open system of international trade and finance, are much greater than these and other possible costs of the measures proposed. I strongly recommend that the Congress work closely with the Administration to advance them and, if necessary, insist that the Administration do so.