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Spotlight on China

Is China illegally manipulating its currency's exchange rate?

by **Daniel Arthur Laprès**

The question of whether China is illegally manipulating its currency's exchange rate has given rise to considerable controversy, especially in the United States, where imports from China (excluding Hong Kong and Macao) are alleged by some observers to have cost more than 2.5 million manufacturing jobs over the last decade[1].

A sense of outrage among US legislators led to the adoption in both the Senate and the House of Representatives of bills that would treat China's allegedly abusive manipulation of its currency as an export subsidy.

Despite the pressure from Congress, the US Treasury has refused, most recently in its April 2013 report on International Economic and Exchange Rate Policies, to designate China as a currency manipulator.

In fact, since 2005, when China departed from the peg to the US dollar initiated in 1996 and moved to determination of the exchange rate with respect to a basket of currencies, the Renminbi (RMB – also called the currency's unit of account, the Yuan – CNY) has appreciated by 26% in nominal terms against the dollar and by 22% against the euro.

But a more significant reference by which to evaluate the implications of the RMB's value for foreign trade is the real effective exchange.

Between June 2010 and February 2013, the RMB had appreciated in real terms against the dollar by 16.2%, which, according to the Bank for International Settlements (BIS), is the most of any currency with the exception of the Venezuelan peso. According to the BIS, the RMB appreciated in real terms by 5% between January and May 2013.

These trends in the evolution of the RMB's value have coincided with a decline of China's current account surplus from a peak of 10.1% of GDP in 2007 to 1.9% in 2011 and 2.3 percent in 2012.

Still, an appreciating currency such as the RMB could remain undervalued, i.e., if it should have appreciated even more than it did. The International Monetary Fund (IMF) concluded that, as of July 2012, the RMB was undervalued by 5 to 10% on a real effective basis against a broad basket of currencies.

Violations?

Now we turn our attention to the question of whether China's management of its currency has violated *international* legal norms such that any of its trading partners might legitimately impose sanctions against the country.

First, while China admittedly manages the rate of exchange of the RMB, there is nothing illegal *per se* about a country's

imposition of any specific exchange rate. While the euro and the dollar are classified by the IMF as "freely floating" currencies, i.e., the authorities do not seek to influence the evolution of their currencies' exchange rates. The vast majority of its member countries practice some form of officially managed exchange rate.

Second, the decisive international norms that might be invoked against China to justify sanctions against it for illegally manipulating its exchange rate are in the IMF's Articles of Agreement.

Under article IV (iii) of those provisions, China is obligated "to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members".

China's massive accumulation of international currency reserves surely reflects an imperfect adjustment of its balance of payments. At the end of 2012, the PBOC held over $3.3 trillion in total reserves, equivalent to 40% of China's GDP, or about $2,446 for every Chinese citizen – almost three times more than the next largest holder (Japan with $1.2 trillion) – and amounting to almost 50% of the world's total.

But, the IMF has adopted an interpretive statement according to which it would also have to be proved that currency manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." Furthermore, the latter test would only be satisfied if the Fund determined *both* that the member engaged in these policies for the purpose of securing "fundamental" exchange rate misalignment in the form of an "undervalued" exchange rate and that the purpose of securing such misalignment was to increase net exports.

Chinese exports

It is indeed the case that China's share of world exports has risen dramatically since 1978 when the policies of internal economic reform and opening up to international trade and investment were first launched. After a hundredfold increase in the annual value of its exports between 1978 and 2007, China became the world's leading exporter of merchandise in 2010, capturing a share of 10%.

In 2011, China generated the world's largest current account surplus ($201.7 billion) ahead of Germany ($188.6 billion) and Saudi Arabia ($144.2 billion). On the other hand, as a share of its Gross Domestic Product (GDP), China's current account surplus in 2011 ranked only 13th at 2.2%.

Based on these results, international financial theory would suggest that the RMB should have appreciated against foreign currencies until it pushed the cost of Chinese goods and services up such that its surpluses on current account would have been reduced and ultimately even reversed. But since China continues to run large current account surpluses, that result has not materialized.

> "China's share of world exports has risen dramatically since 1978"

Consequently, while it might appear at first glance that China has manipulated the exchange rate of the RMB contrary to the IMF's Article IV (iii), other explanations are also plausible.

First, by soaking up the RMB, mostly through sales of financial instruments, the People's Bank of China (PBOC), China's central bank, for many years intervened to sterilize the increases in the local money supply generated when the excesses of inflows of foreign currencies were converted into local currency. Chinese authorities intervened to limit domestic inflation lest it reach degrees not considered politically tolerable in China (it is worth recalling the demonstrations at Tian an men Square in 1989 followed a bout of inflation.)

Between 2005 and the third quarter of 2011, the PBOC purchased dollars in order to stabilize the RMB exchange rate, adding about $400 billion per year to its balance sheet. While in an open economy, these actions would have pushed up domestic interest rates, China implements controls on international flows of capital that allow the PBOC to cap the domestic interest rate.

Arguably, it is that sterilization process that generated the accumulation of international reserves.

But, in 2012, China's accumulation of official foreign exchange reserves slowed to $130 billion, which was the smallest annual increase since 2003.

Other factors

Other factors to consider as contributing to the unusually high levels of reserves include Chinese wealth holders' willingness to buy the financial instruments offered to them by the PBOC. Figures released by the IMF at the end 2012 showed that China's personal savings rate (50%) has become the world's highest and that it is far above the global average of (20%).[2]

That trend in China is explained by the need for the Chinese population to adjust to the disappearance of the "Iron Rice Bowl" system prevailing between 1949 and 1978 under the Maoist régime. The reform movement undertaken since then has led to declines in the public sector's provision of education, health and housing services. While the government has ambitious goals to extend social insurance (retirement plans, unemployment insurance, health insurance and maternity insurance), much of the population remains inadequately covered.

As a result, households have to self-finance much of such social expenditures; hence, there is a propensity to save in anticipation of having to cover them, especially since the offerings of private insurance companies are insufficient.

According to some estimates, the motive of saving for health expenditures accounts for an increase of more than 5% and saving for house purchases increased average saving rates by 3% relative to the 1990s[3].

> "There is little prospect that China could be found guilty..."

At such levels of savings, China's current account surpluses are inevitable, unless the Chinese government were to incur offsetting budget deficits. But the Government has shunned running up its deficits (they averaged 1.92% of GDP from 1988 until 2012[4]) and has instead oriented its policies, such as they are articulated for instance in the current Five-year Plan, toward reducing savings in favour of consumption, with the expected effect that imports would rise causing the current account surpluses to decrease.

According to some economists, causing the RMB to appreciate, without adjusting domestic saving and

consumption levels, would have little effect on the current account because the income elasticity of Chinese exports is much more significant than their price elasticity, meaning that the levels of income in the importing countries matters more than the exchange rate at which the imports are purchased[5].

In conclusion, there is little prospect that China could be found guilty under any applicable international norms of illegally manipulating the exchange rate of its currency, because the authorities' administration of the exchange rate is arguably not targeted to dope exports, but instead it targets domestic macroeconomic objectives. Furthermore, were any country to impose sanctions against China for manipulating its exchange rate, it might well find itself to be the legitimate target of Chinese reprisals. ■

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